Submissions on the Competition Amendment Bill, 2018

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6 August 2018

Mrs EM Coleman, MP

The Chairperson of the Portfolio Committee on Economic Development

South African Parliament
Cape Town

Dear Madam,

Genesis Analytics welcomes this opportunity to submit written comments on the Competition Amendment Bill 2018 and would also welcome the opportunity to make oral submissions before the Portfolio Committee on Economic Development. We believe oral submissions would also be beneficial to the Portfolio Committee due to the technical nature of this submission and the debates raised around such provisions in the economics literature.

Genesis Analytics is an economics-based advisory firm that was founded in South Africa 20 years ago, and has gone on since then to work in over 20 different countries in sub-Saharan Africa, as well as countries in south Asia, the Middle East, and Europe. The Competition and Regulatory Economic practice within Genesis is a leading provider of competition and regulatory economics services in South Africa. It is also the oldest, having been established shortly after the introduction of the Competition Act and the opening of the Competition Commission's doors.

Over this period, Genesis has worked on many of the high-profile, precedent-setting cases including those that have dealt with abuse of dominance and public interest in mergers. We have also been involved in all of the major market inquiries to date. Importantly, our reputation for independent, rigorous economic analysis has afforded us the unusual position of having worked for both private firms, the Competition Commission and even the Minister on such matters. For example, we assisted SACCAWU and the Economic Development Department on the Massmart/Walmart merger and the Competition Commission on the various abuse of dominance cases, including foreclosure/margin squeeze against Telkom, health provider consolidation and excessive pricing investigations.

Genesis Analytics made extensive submissions on the initial draft Bill published on 1 December 2017. We welcome the fact that a number of the suggestions for improvements contained in that submission have found their way into the current Competition Amendment Bill. As with our previous submission, our focus is primarily on the substantive economic provisions in the Act and proposed amendments. In making this submission we have sought to draw not only on best practice economic thinking (locally and globally) but also on our extensive experience in a wide variety of competition matters, including those with a public interest dimension.

Although we do not comment extensively on process and procedural points, as these are best dealt with by the legal fraternity, we believe it is important to emphasise that procedural fairness, analytical rigour and independence are all critical elements of competition policy that have underpinned the success of the relevant institutions to date. Hence, we would not support any legal or procedural aspects of the amendments that undermined these principles.

Sincerely,

James Hodge,

Managing Partner,

Competition and Regulatory Economics Practice

Genesis Analytics

INTRODUCTION

1. Competition law is ultimately underpinned and guided by economic theory. It is that theory which informs what behaviour is likely to be detrimental to the functioning of markets, consumers and overall economic welfare, and how one might test to distinguish such behaviour from behaviour which improves welfare. The relative risks that certain behaviour might be positive or negative to competition and consumers also informs how the legal tests should be constructed in order to limit the extent of type 1 (incorrectly condemning conduct that is not anti-competitive) and type 2 (failure to condemn anti-competitive behaviour) errors. As a number of proposed amendments to the Competition Act ("**the Act**") contained in the Competition Amendment Bill 2018 ("**the Bill**") focus on strengthening provisions against the abuse of market power, it is therefore important to have regard to the economic underpinnings of these sections of the Act in order to ensure the appropriate adaptation of any legal tests.

2. In addition to protecting competition, our Act also seeks to achieve certain public interest objectives which may be broadly summarized as improved and more equitable access to the economy. Whilst competition policy is not the only instrument for achieving such outcomes, indeed preventing the abuse of market power itself assists in opening up access to markets, the thinking is that at the very least competition policy should not undermine the achievement of this objective. Currently public interest finds its way into the Act primarily through the merger control regime where the impact on public interest factors are independently assessed, including the impact on employment, participation by small and medium businesses ("**SMEs**") and firms controlled/owned by historically disadvantaged persons ("**HDP firms**") and industrial development.[1] A material element to the proposed amendments in the Bill involve extending public interest considerations into other parts of the Act, namely the abuse of dominance and market inquiries. Once again, economic theory is informative of how this may best be done to ensure the achievement of such objectives without the risk of substantially undermining competition and consumer welfare.

3. The purpose of this submission is to provide an economics perspective on the substantive economic provisions that are materially affected by proposed amendments to the Act given this is our area of expertise. In this respect, the primary focus is on certain abuse of dominance provisions (namely buyer power, price discrimination and excessive pricing) where we believe that the current formulation of the test is not only still out of line with economic thinking, but also risks undesirable consequences including to the very public interest objectives that the Bill seeks to promote. In so doing we propose adjustments to the drafting structure and language which we believe still achieves the objectives but reduces the possibility of adverse outcomes.

4. We also discuss the direction taken in guidelines and exemptions, but in that instance we focus primarily on how disciplines on the actual implementation is necessary if real gains from these amendments are to be made, to the benefit of the economy and the focal points of public interest. Finally we make targeted comments on other economic provisions in the amendments. Some of these changes may appear small but each is material in improving the functioning of the Act and its enforcement.

[1] Public interest also features in the exemption regime but is rarely utilised and therefore has not had a material impact.

5. Before proceeding to provide our perspective on specific proposed amendments, it is worth highlighting that extending public interest provisions to abuse of dominance and market inquiries raises a number of interesting questions and debates. At this stage we simply flag these issues as requiring proper consideration by the Portfolio Committee on Economic Development.

    5.1. First, it would seem to be that certain amendments are motivated almost exclusively on the basis of the difficulties facing small firms specifically and yet extend to all classes of firms covered by public interest. This raises the question as to whether such provisions should be limited to small firms only or be extended (as is currently the case) to medium or HDP firms.[2] It may depend on the provision and/or the intent. For instance, if the amendment is designed to fix a problem specifically faced by one class of firm under public interest then limitation may be appropriate (e.g. lower thresholds due to small firms facing difficulty in proving substantiality under price discrimination). Alternatively, if the amendment is specifically designed to bring a closer focus and assistance to firms covered by public interest then a broader application is appropriate.

    5.2. Second, in seeking to focus on the effect of certain market features or behaviour by dominant firms on small or HDP firms, is the relevant unit of analysis the individual firms that may fall into these categories, or the class of firms falling into each category (or both). Again, this may differ depending on the amendment. In a market inquiry where one is looking broadly at competitive structure, it would seem the concern is related to whether any feature impedes SMEs or HDP firms as a class from participation, rather than specific individual firms. In the case of a complaint of abuse of dominance the unit of analysis may switch to an individual firm as complainant, but then does the test still have reference to the class of firms in undertaking the assessment (e.g. does the price differential impede small firms more generally from participation or just the complainant)? The reference to the class of firms may be relevant in some cases if, for instance, one is trying to determine whether the inability to participate is causally related to the behaviour of the respondent or the potential inefficiencies of the complainant.

    5.3. Third, the amendments to administrative penalties propose to do away with the so-called "yellow cards", whereby first time offences for certain provisions of the Act do not attract a penalty. As explained in the initial draft Bill, greater certainty and awareness now exist around the offences in the Act making the "yellow cards" no longer appropriate. Whilst this may be the case for existing provisions, the extension of public interest provisions to abuse of dominance is novel even in the context of international practice and therefore there will be less certainty and precedent as to the interpretation of such provisions, including the lower threshold tests. Whilst maintaining the "yellow card" for such offences would be inappropriate if they are to be effective, the level of administrative penalties imposed might need to have regard to their potential novelty until such time as case precedent is more firmly established. The new section 59(3)(h) may or may not accommodate such requirement for flexibility (although that amendment would make more sense if an "OR" is inserted between "contravention of this Act" and "is substantially the same").

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[2] On a related point, the Bill does not itself define the boundaries of medium firms but rather leaves this to the discretion of the Minister. This is not ideal in the context of determining at this point whether provisions are suitably extended to medium firms or not.

BUYER POWER PROVISIONS

6. Buyer power is currently addressed via the insertion of new provisions 8(1)(d)(vii) and 9(4) under sections 8 and 9 respectively. The introduction of the provisions that deal with buyer power is directly related to the main objective of the amendments – that is, to address the problems of **economic concentration** and **ownership** in South Africa. In particular, the motivation for section 8(1)(d)(vii) is described as follows:

   "Subsection (1)(d)(vii) is introduced to protect suppliers to dominant firms, especially small and medium businesses or a firm owned or controlled by historically disadvantaged persons, from being required, through the abuse of dominance, to sell their goods or services at prices that impede their ability to participate effectively."[3]

7. In the section that follows we seek to provide some context to the buyer power concerns that the amendments are trying to address. In particular, we draw on economic thinking and international experience to outline when buyer power can result in competition and/or public interest concerns and how one might best address such concerns. This context, informs our comments on the buyer power amendments and recommendations on how best to address these in the section thereafter.

RELEVANT CONTEXT TO BUYER POWER AS A CONCERN

8. Buyer power arises when the downstream market is more concentrated than the upstream market resulting in an imbalance in bargaining power in favour of the buyer. Downstream buyers may be able to use their relative bargaining power to extract low prices, special discounts, favourable credit terms or other favourable supply terms from suppliers who depend on that buyer.

9. When economists consider the exercise of buyer power based on a consumer welfare standard (the standard applied when assessing anti-competitive conduct), it is widely accepted that such conduct is more often than not pro-competitive – the ability of a buyer to exert its countervailing bargaining power over upstream firms so as to lower input prices is typically beneficial to end-consumers. As explained in more detail below, it is only in exceptional circumstances that a buyer's attempts to lower input prices would be considered detrimental to consumers.

10. However, a public interest approach brings an added dimension to the considerations as it seeks to elevate the welfare of particular economic actors (other than consumers) such as SMEs and HDP firms. This means that there may be instances where buyer power does not negatively impact on consumers but is still considered problematic in terms of public interest due to its impact on such groups.

11. In particular, there is concern that in certain circumstances the exercise of buyer power can be used to exploit suppliers through unreasonable trading terms or prices that are too low, transferring undue risk to suppliers or putting their profits and margins under pressure. This can ultimately have a negative impact on supplier's planning and investment, and potentially even result in the supplier exiting the market. Although,

[3] Paragraph 3.3.6. of the Memorandum on the Objects of the Competition Amendment Bill, 2018.

ultimately it is the relative bargaining power of firms that matters, such concerns are more often than not, isolated to the case of suppliers that are small firms.

12. It is this concern that the inclusion of buyer power provisions in the sections of the Act dealing with abuse of dominance are trying to address. It is important to note that such concerns are what competition economists would consider exploitative rather than exclusionary conduct. This is because the exercise of buyer power results in a transfer of wealth from sellers of inputs to buyers – whilst such conduct could result in the exclusion of the supplier, it need not be the case. In fact, it is recognised that large buyers have little incentive to engage in conduct that would ultimately exclude their suppliers from the upstream market. Rather, they have a strong incentive to maintain competitive supply in the input market.

13. South Africa is not alone in its concern that buyer power could be used to exploit smaller suppliers. The existence of exploitative buyer power concerns have been recognised in other jurisdictions. Indeed, Article 102(a) of the Treaty of the Functioning of the European Union ("**TFEU**"), the provision dealing with exploitative abuses by dominant firms in the EU, allows for the prosecution of unfairly low purchase prices or other unfair trading conditions. However, more often than not, EU member states address concerns of the imposition of unfair trading practices by larger buyers through means other than competition law.

Approach to exploitative buyer power with respect to prices

Lower prices are likely to benefit consumers

14. From the perspective of identifying anti-competitive conduct based on a consumer welfare standard, input prices that are too low are rarely a concern. This is because the likelihood that such conduct will negatively impact on consumer welfare or competition is extremely low. In most instances, the use of bargaining power tends to be efficiency enhancing as it can be used as a means to counterbalance seller market power via a transfer of profits from suppliers (who have been keeping supra-competitive profits) to buyers. Further, as the economic literature indicates, some or all of the gains extracted from the supplier through buyer power are usually passed on to downstream customers and therefore are consumer welfare enhancing (not detrimental).

    14.1. For instance, in cases where the downstream markets are competitive (as is the case in many forms of retail), virtually all the gains are passed on to consumers. The OECD's paper on monopsony and buyer power states that *"[i]f a lower price can be achieved without restricting supply, then in a competitive market place, any lower prices obtained by a powerful purchaser are likely to be passed on to consumers as part of a strategy to increase market share downstream."*[4] [5]

    14.2. However, even where the downstream markets are not competitive, a reduction in the prices of variable inputs (i.e. that vary in proportion to the number of products manufactured) also result in lower downstream prices for customers.

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[4] OECD. 2008. Policy Roundtables: Monopsony and Buyer Power, p. 258.

[5] See also the EC guidelines on horizontal mergers, which express similar sentiments: *"if increased buyer power lowers input costs without restricting downstream competition or total output, then a proportion of these cost reductions are likely to be passed onto consumers in the form of lower prices."* See: EC. 2004. Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings. 2004/C 31/03, para. 62.

15. Hence, the concern with buyer power as an abuse of dominance under a consumer welfare standard only arises in the rare situations where market power on the part of the dominant firm in *both* the buyer and downstream seller markets leads to a reduction in output resulting in a fall in the overall welfare to end-consumers and input producers. Indeed, the Irish Competition Authority outlines this principle in its rejection of a complaint that the commission paid by Aer Lingus to travel agents was abusively low:

    "While the reduction in commissions may affect the welfare of travel agents, it is not clear that there is a corresponding damage to the consumer or the competitive process. For the exercise of any monopsony power that Aer Lingus might have to be harmful, this requires that it must be correlated with market power on the seller side. Specifically, a firm with market power on both sides can reduce the price it pays for inputs – the services of travel agents – in order to reduce overall supply of airline tickets sold so that prices to the consumer can be raised. However, as noted below, the strategy that Aer Lingus has adopted is to lower prices to the consumer."[6] [emphasis added]

16. The benefits associated with the exercise of buyer power from a consumer welfare perspective is likely the reason for the significant lack of exploitatively low pricing cases in the European Union. Although the EU law acknowledges that the use of buyer power by a dominant firm could notionally result in prices to suppliers that could be considered abusively low, such cases have been an extreme rarity and, to the best of our knowledge – with the exception of a case in Serbia[7] – none of the few cases that have been investigated by the EU or national competition authorities have resulted in a finding of an abuse.

Difficulties in assessing when prices are too low

17. However, even in circumstances where authorities may suspect that the exercise of buyer power by a dominant firm results in valid abuse concerns on the basis of consumer welfare or even public interest, it is in fact very difficult to establish that purchase prices are indeed too low.

18. This is particularly difficult to determine in the context of a consumer welfare standard where harm needs to be demonstrated to consumers downstream, which means that an assessment should incorporate a determination of how output has changed and whether downstream prices are potentially excessive (i.e. low input prices are not passed through to consumers.

    18.1. These difficulties are perhaps best summed up by European competition law experts Padilla and O'Donoghue (2013). In so doing, they also point out that if there is a requirement to demonstrate excessive prices downstream due to a lack of pass through, it is unclear that the buyer power offence adds anything to the abuse of dominance provisions.

    "Although the definition of what constitutes an excessive price is far from clear, a rule of law which said that it would be an abuse for a dominant buyer to reduce payments to sellers in an effort to limit output and reduce prices would be even

[6] Commission Decision of 10 June 2003, Reduction In Travel Agent Commissions by Aer Lingus plc, Case COM/15/02.

[7] The case related to two dairy food companies, Melkara a.d. Imlek a.d., that were found to have abused their dominant position in the purchase of raw milk. As referred to in Anchustegui, I.H. (2018) Buyer power in agreements and abuse of market power cases: An overview of EU and national case law", Concurrences (19 April 2018).

more precarious. <u>It would need to be specified at what point output reductions/price increases that do not give rise to excessive pricing [by the dominant firm in the downstream market] nevertheless constitute an abusive exercise of monopsony purchasing power.</u> This would be even more uncertain, and open to divergent interpretations, than determining whether final selling prices are in themselves excessive. In other words, <u>if monopsony purchasing could be an abuse even in circumstances where prices on the selling market do not rise to the level of excessive prices, the law would be even more complicated and unclear.</u> At the same time, if monopsony purchasing is only contrary to Article 102 TFEU if it results in excessive pricing on the selling market, this adds nothing of substance to the existing law." [8] *[emphasis added]*

19. However, even if the assessment of the price level is restricted to an assessment of the welfare of the supplier under a public interest type approach, it is still unclear from an economics perspective how one would determine a workable test that also did not risk substantial unintended consequences such as higher input prices. <u>Indeed, it is worth noting that neither the EU nor its national competition authorities have attempted to traverse issues of how to determine an abusively low price.</u> This is the case for a couple of reasons:

    19.1. First, the costs of production will differ amongst firms, with some more efficient than others. This implies that a price that is "too low" for one firm may not be the case for another more efficient firm. In this context, a purchase price test would need to distinguish between the situations where the supplier is simply inefficient and where the purchase price is genuinely too low. In other words, if a price was set at a level that was unprofitable for a supplier currently (i.e. below variable costs which is the predation standard), that alone cannot be the basis for concluding that a purchase price was too low.

        19.1.1. If other firms could supply profitably at that price (even if because they are large and have scale economies), then it would be unreasonable to conclude that the price is too low even if it was unprofitable for a small supplier. This is because it would be unreasonable to expect a buyer to source from inefficient suppliers at higher prices simply because they are less efficient than other suppliers. This would have the undesirable consequences of either rewarding inefficiency in the supply chain, or resulting in buyers not purchasing from smaller firms. The former would raise costs in the supply chain to the ultimate detriment of consumers, but also provide no incentives to suppliers to improve efficiencies which are the primary source of economic development. The latter would undermine the very public interest objectives that may be sought to be achieved by denying SMEs an opportunity to enter supply chains in the first place.

        19.1.2. A comparator type approach confronts other difficulties aside from just the relative levels of efficiency. Additional reasons may exist for lower relative prices being reasonable, such as differences in product quality and characteristics, including associated brand and/or risk (e.g. reliability or experience of performance). These may constitute a sound basis for a buyer demanding a lower price relative to its other suppliers (based on

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[8] O'Donoghue, R. and Padilla, J. 2013. *The Law and Economics of Article 102 TFEU*. 2nd ed. Hart Publishing: Oxford and Portland, p. 846.

lower economic value). Again, in most cases, the court is unlikely to have the ability to quantify such factors legitimately and without dispute.

19.1.3. However, even outside of a comparator firm context, buyer pressure on suppliers is precisely the market mechanism for driving efficiency improvements in upstream supplier markets. Many supplier contracts include incentives for cost reductions and passing on a portion of such gains to the downstream buyer. As a result, even outside of the comparator supplier price the authority would not be able to avoid an inquiry into the efficiency of the supplier in order to determine if the price is too low. This will be subject to considerable dispute and alternative views which are unlikely to be resolved in a legal setting.

19.2. Second, if the supplier is already active with a buyer then the courts are likely to be faced with the context where any price would be above at least variable costs because otherwise the supplier would not continue to supply. From an economic perspective, any price that is at least recovering variable costs is not considered too low as this is the benchmark for predation. As such, the courts would need to engage in some form of assessment of the fairness of the division of margin between the supplier and the buyer. This too has no easy solution and would be subject to considerable disputes, especially in the context of what is reasonable from the buyer's perspective and a consideration of the dynamic effects.

19.2.1. For instance, a lower price may provide the incentive for a buyer to take on a new supplier that poses a degree of risk not associated with incumbent suppliers. Extracting more margin may be the only means of compensating for such risk. This may be reasonable and to conclude otherwise may result in the unintended consequence of small suppliers being excluded from the market altogether.

19.2.2. In a retail environment where the adverse effects of buyer power are mostly claimed, the lower wholesale price may reflect in lower retail prices to the consumer. In this context, an assessment of reasonableness would need to account for both the pass through to consumers but also the response of consumers themselves to changes in prices. As a retailer cannot force consumers to purchase the product, the consumer response will be a reflection of relative pricing as well as other product features including brand value. In that context, a higher price may in fact be counter-productive for the supplier (and public interest) if that higher price led to consumers selecting alternative products on the shelf. Similarly a lower price on the shelf may enhance the ability of the supplier to participate in the market through greater sales and not be prejudicial at all, even if it is at a low margin initially until the firm built a stronger position in the market. However, it may also be that even at a lower price the consumer does not respond but this cannot be laid at the door of even a dominant retailer that passed through a lower price.

19.2.3. Similarly outside of a retail context, a lower price may incentivise a buyer to purchase larger volumes from the supplier. This would in fact encourage the participation of the supplier who may be able to expand its position in the market and gain economies of scale on the back of higher volumes even if the current price does not. Hovenkamp recognizes

volume assessments as an important distinction in a buyer power assessment:

"Now the complaint is about low prices, which can result from either monopsonistic output suppression or cost reductions that result from efficiency gains. While antitrust policy wants to condemn the former it has no reason to condemn the latter. The most important theoretical difference between monopsony and efficiency in procurement is the impact on output. A firm or cartel monopsonizes in the purchasing market by suppressing output. By contrast, cost savings that result from efficiency should result in increased purchases, as well as increased output in the market in which the firm sells."[9]

20. For these practical economic reasons there has simply been no real traction for "unfairly low pricing" type complaints or enforcement even in countries where such laws exist. However, as we discuss next, there is considerable traction for action on trading terms which are the main source of concern for small business, are more easily detectable and enforceable, and are also likely to benefit consumers as well.

Approach to exploitative buyer power with respect to trading terms

21. The other mechanism via which buyer power can be used to exploit suppliers is the use of unfair trading terms or unfair trading practices ("**UTPs**"). These concerns have been explained by the European Commission in the context of the food supply chain as follows:

"When occurring, UTPs can put operators' profits and margins under pressure, which can result in a misallocation of resources and even drive otherwise viable and competitive players out of business. For example, retroactive unilateral reductions of the contracted quantity for perishable goods equates to income foregone for an operator who may not easily find an alternative outlet for these goods. Late payments for perishable products after they are delivered and sold by the buyer constitute extra financial cost for the supplier. Possible obligations for suppliers to take back products not sold by the buyer after the suppliers and buyer may constitute an undue transfer of risk to suppliers that has repercussions on their security of planning and investment. Being forced to contribute to generic in-store promotional activities of distributors without drawing a commensurate benefit may unduly reduce a supplier's margin."[10][emphasis added]

Trading terms are a more appropriate focus for intervention than prices

22. In contrast to the difficulties faced when determining whether an input price is likely to be too low, a focus on ensuring that buyer power is not used to impose unfair trading terms is likely to yield significant benefits. This is because whilst the exercise of buyer power with respect to prices is more often than not beneficial for consumers (and hence intervention could result in unintended negative consequences for this group), there is a real concern that trading terms can be a means of transferring unforeseen/undue costs and risks to suppliers which is likely to negatively impact on consumer welfare in the long-run. In this respect such interventions can benefit both suppliers and consumers.

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[9] Hovenkamp, H.J. (2018) Is Antitrust's Consumer Welfare Principle Imperiled? University of Pennsylvania Law School, Institute for Law and Economics Research Paper No. 18-15, p. 15.

[10] EU Proposal for a Directive of the European Parliament and of the Council on unfair trading practices in business-to-business relationships in the food supply chain (COM(2018) 173 final), p. 1.

22.1. For example in its 2008 market investigation in the supply of groceries, the UK Competition authority (now the Competition and Markets Authority) explained how buyer power can negatively impact on supplier investment and innovation via certain supply chain practices:

"Grocery suppliers must make investments in an uncertain commercial environment where, for example, demand may fall or costs may rise unexpectedly. Suppliers will decide whether to undertake investment by estimating the likely returns and balancing this against the risks involved. The supply chain practices of grocery retailers may have an important bearing on this calculation in terms of the degree of risk that a supplier faces in undertaking the investment, and the uncertainty arising from these practices has the potential to diminish significantly suppliers' incentives to invest in new products, capacity or production processes.

Competition at the retail level leads grocery retailers to seek the best terms and conditions from their suppliers. The possession of buyer power by a grocery retailer allows grocery retailers to extract lower prices from suppliers than would otherwise be the case, and consumers benefit as a result of these lower wholesale prices being reflected in lower retail prices. However, when, in the hope of gaining a competitive advantage, grocery retailers transfer excessive risks or unexpected costs to their suppliers through practices involving retrospective adjustments to supply agreements or giving rise to moral hazard on the part of the grocery retailer, this is likely to lessen suppliers' incentives to invest in new capacity, products and production processes. If unchecked, these practices, which are essentially a side-effect of competition between grocery retailers with buyer power, will be detrimental to the interests of consumers."[11] [emphasis added]

23. Furthermore, even if the welfare of small firms is elevated above that of consumers, not only does a focus on trading terms provide a practicable, low-risk intervention strategy without the complexities associated with price regulation, but contractual provisions are, in fact, likely to be the primary mechanism used by buyers to transfer costs and risks to suppliers.[12] Hence, most of the benefits related to interventions to curb buyer power are derived through addressing unfair trading terms.

24. Again, drawing on the UK Competition Commission's experience in its groceries supply market investigation, it found that "*of the 380 concerns raised with us by suppliers and supplier associations, nearly half related to the transfer of excessive risks or unexpected costs from grocery retailers to suppliers, and one-third related to requirements for retrospective payments or other adjustments to previously agreed supply arrangements."*[13] These concerns coupled with other evidence, led the UK Commission to summarise its conclusions related to the exercise of buyer power by grocery retailers' as follows:

"Grocery retailers' buyer power is of benefit to consumers since part of the lower supplier prices arising from this buyer power will be passed on to consumers in the form of lower retail prices. We did not find that the financial viability of food and drink manufacturers was under threat as a result of the exercise of buyer power by

[11] UK Competition Commission, 30 April 2008, The supply of groceries in the UK market investigation, para 9.41.
[12] EU Commission Impact Assessment: Initiative to improve the food supply chain (unfair trading practices), Accompanying the document Proposal for a Directive of the European Parliament and of the Council on unfair trading practices in business-to-business relationships in the food supply chain, (SWD(2018) 92 final),pp. 146-147.

[13] UK Competition Commission, 30 April 2008, The supply of groceries in the UK market investigation, para 9.59.

grocery retailers. However, the transfer of excessive risks or unexpected costs by grocery retailers to their suppliers is likely to lessen suppliers' incentives to invest in new capacity, products and production processes. We concluded that, if unchecked, these practices would ultimately have a detrimental effect on consumers.

We concluded that the principal manner in which excessive risks or unexpected costs could be transferred from grocery retailers to suppliers was through retailers making retrospective adjustments to the terms of supply. We also concluded that there were circumstances where allocations of risk may be agreed up-front between a retailer and supplier, but that the extent of risk transferred to the supplier was excessive. We also have concerns regarding the transfer of risk from grocery retailers to suppliers where, as a result, the retailer has less incentive to minimize that risk."[14] [emphasis added]

25. That unreasonable trading terms are more likely to be the core concern under abuse of dominance provisions, is also supported by the fact that cases related to unfair contract terms imposed by dominant undertakings on suppliers have seen a greater success under EU abuse of dominance provisions than input prices that are too low. Although the EU has not defined a precise test for unfair contract terms, the main elements that can be drawn from case law are summarised by O'Donoghue and Padilla (2013) as follows:

"[I]t would need to be shown that the clause bears no reasonable relationship to the object of the contract, that it requires the licensee to forego a right that it would otherwise have under competitive conditions, and that the clause is neither reasonable nor proportionate bearing in mind the respective interests of the licensee and licensor. In essence, objectionable clauses are onerous, one-sided and unfair." [15] [emphasis added]

26. However, as explained below unfair trading terms cases addressed through the abuse of dominance provisions in the EU are still relatively rare.

Buyer power concerns often occur in the absence of dominance and are generally addressed outside of such provisions

27. It is generally recognised by economists that buyer power concerns can arise even when a buyer is not dominant in the relevant market. That is, the existence of buyer power is determined by the relative bargaining position of the buyer and supplier and as a result, a non-dominant buyer may exert bargaining power over a particular supplier even if it does not hold market power in the purchasing market as a whole.

28. In addition, it is in fact typically less common that even a dominant seller may be found to be a dominant buyer in an upstream purchasing market, effectively limiting an abuse of dominance provision to highly selective instances.

    28.1. As any buyer power provision typically fits within the abuse of dominance domain, it is a precondition that dominance is demonstrated in the relevant purchasing market. Dominance for the downstream selling market is not directly relevant as a dominant seller may not be a dominant buyer.

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[14] UK Competition Commission, 30 April 2008, The supply of groceries in the UK market investigation, para 36-37.

[15] O'Donoghue, R. and Padilla, J. 2013. *The Law and Economics of Article 102 TFEU.* 2nd ed. Hart Publishing: Oxford and Portland, p. 859-860.

28.2. As a first observation, it is frequently the case that a purchasing market is far broader than a selling market for a dominant firm making a finding of dominance less likely. The reason is that an input might find application in a range of downstream industries and therefore the seller may have a range of feasible alternative outlets for its product other than a firm that is dominant in one particular downstream product application.

28.2.1. This is well illustrated in the food retail market where many of these concerns arise. Even if the formal retail sector is concentrated, food products are also sold into informal or wholesale supply chains as well as food services (restaurants and catering services). Even if a single retailer were dominant in a narrow formal retail market, they are unlikely to be dominant in any purchasing market for the food product.

28.3. A second important observation is that buyer power in the context of abuse of dominance (i.e. market power) is distinct from bargaining power, making a finding of dominance in the context of low market shares in a purchasing market unlikely. Bargaining power is a reflection of a number of factors, such as the relative size of the seller and buyer or the alternatives available in the market for both the supplier and the buyer. Market power in contrast, is more narrowly related to the lack of alternatives for the trading party and hence the ability of the dominant firm to set a price. In a purchasing market context, market power considerations would be narrowed to the lack of alternatives for the supplier and hence the ability of the buyer to dictate the price. As a result, the observation of bargaining power cannot be the basis for concluding market power, which requires a different inquiry into alternatives for the supplier and would then encounter the problem of broader purchasing markets.

28.3.1. Again the food retail sector is a useful illustration of this point. Whilst concerns may be expressed that the food retail sector is concentrated and that large retailers have considerable bargaining power, the reality is that in most countries including our own, no single retailer is likely to pass the threshold for a dominant position in even its own selling market, let alone a broader purchasing market.

29. It is because buyers that are able to exert bargaining power to the detriment of smaller firms are typically not dominant that jurisdictions elsewhere have generally regarded exploitative buyer power as a concern that is best dealt with outside the ambit of competition law (and the abuse of dominance provisions in particular) even where the jurisdiction has such provisions in its competition law (such as the EU):

"Buyer power exploitation is also linked to the imposition of unfair purchasing practices that transfer wealth from suppliers to buyers, without sufficient compensation. More often than not, these behaviours are outside the scope of EU (and national) competition law, mostly because the buyers are not dominant." [16] [emphasis added]

"Competition law has a scope that is different from rules on UTPs. UTPs are unilateral practices that do not in most cases imply an infringement of competition rules because

[16]"Anchustegui, I.H. (2018) Buyer power in agreements and abuse of market power cases: An overview of EU and national case law", Concurrences (19 April 2018)

such an infringement requires the existence of a dominant position in a given market, as well as the identification of an abuse of that position that affects the market overall."[17]

30. As such, other jurisdictions have chosen to address competition and public interest buyer power concerns in a variety of ways that fall outside of the scope of abuse dominance provisions.[18] It is worth reiterating at this point that these interventions focus on supply terms rather than the level of purchase prices.

    30.1. The concern around the exploitation of small food product suppliers and the public interest objectives of ensuring a fair standard of living for the agricultural community was the underlying motivation for the EU's recent 2018 proposal for a directive on UTPs in business-to-business relationships in the food supply chain.[19] UTPs are defined as practices that "*deviate from good commercial conduct, are contrary to good faith and fair dealing and are unilaterally imposed by one trading partner on another."*[20] This aim of this proposal is summarised as follows:

    "Accordingly, the present proposal for a Directive aims at reducing the occurrence of UTPs in the food supply chain by introducing a minimum common standard of protection across the EU that consists of a short list of specific prohibited UTPs. The protection covers small and medium-sized suppliers in the food supply chain insofar as they sell food products to buyers who are not small and medium-sized. This scope aims at contributing to a fair standard of living for the agricultural community, an objective of the common agricultural policy under Article 39 TFEU." [21] [emphasis added]

    30.2. A similar concern around supplier exploitation was also the motivation for the implementation of the UK Groceries Supply Code of Practice.[22] This code of practice was developed after a 2008 market investigation in the supply of groceries by the UK Competition authority revealed that the exercise of buyer power by grocery retailers was a pervasive feature of such markets and resulted in the *"transfer of excessive risks and unexpected costs to their suppliers"*.[23] An excerpt from the UK Groceries Supply Code of Practice is provided in the Box at the end of this section.

Interventions focus on protecting small and medium-sized enterprises

31. Although, it is ultimately the imbalance in the relative bargaining power of parties that determines whether exploitative buyer power is of concern, interventions largely limit their focus to the potential exploitation of small and medium-sized enterprises. This is because it is such firms that are most likely to bear the brunt of exploitative buyer power, and

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[17]EU Proposal for a Directive of the European Parliament and of the Council on unfair trading practices in business-to-business relationships in the food supply chain (COM(2018) 173 final), p.3.
[18] These include contract law, small and medium-size enterprise policy, agricultural policy, unfair commercial practices law or industry codes of practice.
[19] EU Proposal for a Directive of the European Parliament and of the Council on unfair trading practices in business-to-business relationships in the food supply chain (COM(2018) 173 final).
[20] EU Proposal for a Directive of the European Parliament and of the Council on unfair trading practices in business-to-business relationships in the food supply chain (COM(2018) 173 final), p.15.
[21] EU Proposal for a Directive of the European Parliament and of the Council on unfair trading practices in business-to-business relationships in the food supply chain (COM(2018) 173 final), p.3.
[22] UK Competition Commission, The Groceries (Supply Chain Practices) Market Investigation Order, 2009.
[23] UK Competition Commission, 30 April 2008, The supply of groceries in the UK market investigation, para 36.

further, doing so is likely to minimise the potential for the unintended distortion of efficient, pro-competitive negotiations. As is explained by the EU Commission's proposed directive:

"Smaller operators in the food supply chain are more prone to face unfair trading practices (UTPs) due to their, in general, weak bargaining power in comparison to the large operators in the chain. Agricultural producers are particularly vulnerable to UTPs as they often lack bargaining power that would match that of their downstream partners that buy their products. This is because alternatives for getting their products to consumers are limited."[24] [emphasis added]

"A targeted protection of small and medium suppliers in the food supply chain is justified because they are often the ones who cannot defend themselves against UTPs due to their lack of bargaining power. There is also a risk of negative unintended consequences concerning measures affecting the contractual relationships between larger operators. Therefore, even though in the impact assessment UTPs are defined in terms of absolute fairness considerations, a targeted protection is more proportionate at this stage."[25] [emphasis added]

Interventions focus on markets that are prone to buyer power concerns and then focus on industry conduct as a whole (across most buyers)

32. Certain industries such as food or grocery retailing, are more prone to buyer power concerns than others. Such concerns typically arise in markets characterised by high levels of concentration at the stages downstream of primary production. It is also recognised that in these circumstances the exercise of buyer power at lower levels of the supply chain can have impacts that filter back along the chain. As outlined by the EU Commission:

    "The food supply chain is a continuum of vertically inter-related markets. It is characterised by significant differences in relative bargaining power between smaller and medium-sized enterprises and the larger ones. The concentration levels at the stages downstream of primary production are high in all Member States. In some cases UTPs affect weaker producers such as agricultural producers, even if they are not directly exposed to them, if UTP-induced costs are passed back along the food supply chain to the weakest link which is often the farmer."[26] [emphasis added]

33. Within such industries, buyer power concerns tend to be in respect of a pervasive industry practice and are typically not limited to the conduct of one large buyer. Instead, they can arise from a variety of different actions being undertaken by numerous buyers possessing significant bargaining power.

34. Furthermore, suppliers are often loathe to complain about any particular customer due to the negative impact it could have on their business as was evidenced by the fact that suppliers would not allow the UK Competition Commission to discuss specific trading term complaints with retailers: *"Concerns expressed by suppliers regarding potential damage to their business prevented us from discussing details of individual complaints with the*

[24] EU Proposal for a Directive of the European Parliament and of the Council on unfair trading practices in business-to-business relationships in the food supply chain (COM(2018) 173 final), p.1.
[25] EU Proposal for a Directive of the European Parliament and of the Council on unfair trading practices in business-to-business relationships in the food supply chain (COM(2018) 173 final), p.10.
[26] EU Proposal for a Directive of the European Parliament and of the Council on unfair trading practices in business-to-business relationships in the food supply chain (COM(2018) 173 final), p.2.

grocery retailers. This means that we are unable to form a definitive view on each individual matter that has been brought to our attention. We are, however, able to form a general impression regarding the overall prevalence and relative extent of these practices."[27]

35. The above have resulted in a more holistic approach to address potentially exploitative trading terms.

    35.1. For example at the time of inception the UK Groceries Supply Code of Practice identified 10 large firms as 'designated retailers' to whom the codes should apply. Further the code governs a comprehensive range of grocery retail-related supply terms to ensure the fair allocation of the risks and costs of trading between buyers. The terms covered include: payment periods, unilateral and retroactive changes to contracts (concerning volumes, quality standards and prices), contributions to promotional or marketing costs, payments for better positioning of goods, claims for wasted or unsold products, last minute order cancellations of perishable products, unfair contract termination, compensation for forecasting errors, tying of third party goods and services, and requests for upfront payments to secure or retain supplier contracts.[28]

    35.2. The EU's proposed directive on UTPs in the food supply chain covers largely similar supply terms, drawing on the UK experiences as well as similar rules in 20 Member States. The EU's proposed directive on UTP's also applies to large buyers throughout the food supply value chain.[29]

36. We illustrate the types of Codes of Practice in the Box below, focusing on prices and payment, but note that price levels are not subject to the code for the reasons outlined above.

BOX 1: EXTRACT FROM UK GROCERIES SUPPLY CODE OF PRACTICE[30]

PART 4—PRICES AND PAYMENTS

5. No delay in Payments

A Retailer must pay a Supplier for Groceries delivered to that Retailer's specification in accordance with the relevant Supply Agreement, and, in any case, within a reasonable time after the date of the Supplier's invoice.

6. No obligation to contribute to marketing costs

Unless provided for in the relevant Supply Agreement between the Retailer and the Supplier, a Retailer must not, directly or indirectly, Require a Supplier to make any Payment towards that Retailer's costs of:

(a) buyer visits to new or prospective Suppliers
(b) artwork or packaging design
(c) consumer or market research
(d) the opening or refurbishing of a store or
(e) hospitality for that Retailer's staff

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[27] UK Competition Commission, 30 April 2008, The supply of groceries in the UK market investigation, para 9.59.
[28] UK Competition Commission, The Groceries (Supply Chain Practices) Market Investigation Order, 2009.
[29] EU Proposal for a Directive of the European Parliament and of the Council on unfair trading practices in business-to-business relationships in the food supply chain (COM(2018) 173 final), pp.2, 9.
[30] UK Competition Commission, The Groceries (Supply Chain Practices) Market Investigation Order, 2009.

7. No Payments for shrinkage
A Supply Agreement must not include provisions under which a Supplier makes Payments to a Retailer as compensation for Shrinkage.

8. Payments for Wastage
A Retailer must not directly or indirectly Require a Supplier to make any Payment to cover any Wastage of that Supplier's Groceries incurred at that Retailer's stores unless:
(a) such Wastage is due to the negligence or default of that Supplier, and the relevant Supply Agreement sets out expressly and unambiguously what will constitute negligence or default on the part of the Supplier; or
(b) the basis of such Payment is set out in the Supply Agreement.

9. Limited circumstances for Payments as a condition of being a Supplier
A Retailer must not directly or indirectly Require a Supplier to make any Payment as a condition of stocking or listing that Supplier's Grocery products unless such Payment:
(a) is made in relation to a Promotion; or
(b) is made in respect of Grocery products which have not been stocked, displayed or listed by that Retailer during the preceding 365 days in 25 per cent or more of its stores, and reflects a reasonable estimate by that Retailer of the risk run by that Retailer in stocking, displaying or listing such new Grocery products.

10. Compensation for forecasting errors
(1) A Retailer must fully compensate a Supplier for any cost incurred by that Supplier as a result of any forecasting error in relation to Grocery products and attributable to that Retailer unless:
(a) that Retailer has prepared those forecasts in good faith and with due care, and following consultation with the Supplier; or
(b) the Supply Agreement includes an express and unambiguous provision that full compensation is not appropriate.
(2) A Retailer must ensure that the basis on which it prepares any forecast has been communicated to the Supplier.

11. No tying of third party goods and services for Payment
(1) A Retailer must not directly or indirectly Require a Supplier to obtain any goods, services or property from any third party where that Retailer obtains any Payment for this arrangement from any third party, unless the Supplier's alternative source for those goods, services or property:
(a) fails to meet the reasonable objective quality standards laid down for that Supplier by that Retailer for the supply of such goods, services or property; or
(b) charges more than any other third party recommended by that Retailer for the supply of such goods, services or property of an equivalent quality and quantity.

Key insights

37. The key economic and contextual insights that this section seeks to highlight are summarised below:

37.1. Buyer power concerns are exploitative rather than exclusionary in nature. Buyer power concerns arise when buyers are able to impose unreasonable trading terms or prices on suppliers resulting in the transfer of undue risks and costs putting supplier profits under pressure and undermining investment. Since in these

instances the primary concern arises due to the transfer of wealth from suppliers to buyers, such conduct is considered to be exploitative rather than exclusionary.

37.2. Significant difficulties with establishing exploitatively low purchase prices as an abuse. It is only in exceptional circumstances that purchase prices that are too low will negatively impact on either competition or consumers. This is why despite the fact that EU competition law recognises the existence of such a concern, such cases have been extremely rare. However, even in circumstances where there are potentially legitimate competition or public interest concerns around purchase prices being low it is, in fact, extremely difficult (even more so than excessive pricing) to determine when a purchase price should be considered exploitatively low.

37.3. Interventions target unfair trading terms which are the primary cause of harm rather than price levels. Trading terms are the primary mechanism used by buyers to transfer undue costs and risks to suppliers. Unlike the case of low input prices, interventions with respect to trading terms are also more likely to benefit not only suppliers but also end-consumers. As a result, interventions by authorities have been targeted at regulating such terms. This is also attractive since such interventions are far more practicable than price regulation, and can establish clear codes of conduct which makes identifying and prosecuting violations easier and less costly.

37.4. Buyer power can occur in the absence of dominance and hence concerns are generally addressed outside of abuse of dominance provisions. In most cases, buyer power exploitation falls outside the scope of abuse of dominance provisions. A buyer need not be dominant in the market as a whole to possess significant bargaining power vis-à-vis a particular supplier. This means that authorities typically deem avenues other than competition law intervention as more appropriate to address such concerns.

37.5. Interventions are focused on protecting small and medium-sized enterprises. Although, the terms identified may be regarded as unfair in principle, interventions have focused on protecting only small and medium-sized suppliers. More often than not it is these firms that are the victims of exploitative buyer power. It is also recognised that there is a risk of unintended consequences should such conditions also apply to contractual relationships between larger firms.

37.6. Interventions are focused on markets characterised by high downstream concentration but low upstream concentration. Buyer power concerns arise in markets such as grocery retailing that have high levels of concentration at the stages downstream of primary production and lower concentration upstream. Interventions in such markets seek to address pervasive industry conduct that may not be fully captured in the actions of a single dominant firm (as would be the case in abuse of dominance provisions). For example the UK Groceries Supply Code of Practice governs 15 types of common trading terms and identified 10 large firms as 'designated retailers' to whom the codes should apply. Further, concerns around supplier business interests suggests that suppliers are more willing to identify problematic industry conduct as a whole rather than lodging a complaint around any specific matter.

INCLUSION OF BUYER POWER IN THE AMENDMENTS

38. The amendments seek to address perceived issues related to the exercise of buyer power by dominant firms through explicitly incorporating buyer power as an abuse that negatively impacts on *suppliers*. It has done so through two additions under different sections of the Act, both primarily focused on prices rather than trading conditions. Furthermore, whilst there is a public interest focus, the provisions are not limited to protecting SMEs and HDP firms.

    38.1. First, including a new 'named' exclusionary act under Section 8(1)(d)(vii):

    "*requiring a supplier which is not a dominant firm, particularly a small and medium business or a firm controlled or owned by a historically disadvantaged person, to sell its products to the dominant firm at a price which impedes the ability of the supplier to participate effectively*."

    38.2. Second, including a discriminatory buying clause under section 9, where it is stated in Section 9(4) that the price discrimination provisions apply to "*a dominant firm as a purchaser of goods and services*".

    38.3. Further, with respect to buyer power as an exclusionary abuse, the proposed amendments impose a reverse onus on the dominant firm under Section 8(2):

    "If there is a prima facie case of abuse of dominance because the dominant firm charged an excessive price or required a supplier to sell at a price which impedes the ability of the suppler to participate effectively, the dominant firm must show that the price was reasonable."

39. In our opinion, the inclusion of buyer power as an abuse of a dominant position in the manner that is currently contemplated in the amendments is unworkable for reasons discussed more fully below, and is unlikely to achieve the objectives of such provisions. Whilst it is recognised that there may very well be good reasons for protecting small firms from powerful buyers where the parties are in unequal bargaining positions, this can be better achieved in other ways. Our submission proposes a better approach more likely to achieve the public interest objectives.

Section 8(1)(d)(vii) is unworkable, is unlikely to achieve the objectives and risks serious unintended consequences (even for SME/HDP firms)

40. The inclusion of buyer power in its current formulation under section 8(1)(d) as a named exclusionary abuse raises several serious difficulties. These relate to problems at a conceptual level as well as issues with practical implementation and enforcement. In our view it would be difficult to successfully prosecute a case under this provision, but at the same time, attempts at compliance to reduce risk by firms is likely to result in outcomes that are in fact harmful to smaller suppliers and the economy at large. The inclusion therefore offers unclear benefits which are likely to be outweighed by the immense risks.

41. The various reasons for why this provision is unworkable relate closely to the discussion and lessons drawn out above, and are as follows:

    41.1. **The focus is on price rather than trading terms.** As discussed above, the determination of an unfairly low price has no strong foundation in economic

literature, but also faces insurmountable practical problems in the legal context. It is therefore unworkable, but also likely to find limited actual application in order to achieve the public interest objectives of improving the position of SME or HDP firms. As was outlined above, most of the complaints and negative impacts on SME firm sustainability as suppliers stem from UTPs and not prices which this provision does not address.

41.2. **Few buyers will be deemed to have market power**. This provision would be subject to a finding of dominance under section 7 in respect of a purchasing market where the requirement will be to have a share of 35% in such a market. A share lower than this would shift the onus to the Commission to show dominance. As purchasing markets tend to be broader than selling markets downstream, and one cannot equate bargaining power to market power, it seems unlikely that many firms will be caught in this net.

41.3. **As an exclusionary abuse it is required to show anti-competitive effect.** The current formulation places buyer power within section 8(1)(d) which covers exclusionary abuses. Under that provision, it is still a requirement to show an anti-competitive exclusionary effect under a consumer welfare standard. In other words, must be demonstrated that firms subject to this behaviour a) are excluded from the market, and b) their exclusion is sufficiently substantial that there is a material lessening of competition such that consumers are worse off.

41.3.1. We seriously doubt that any exertion of buyer power will be able to demonstrate a causal link to a) exclusion and b) a material lessening of competition as a whole. There is no reason to presume that the conduct would also be exclusionary as it is recognised that firms have little incentive to exclude their suppliers from the upstream market and instead have every incentive to maintain competitive supply in the input market, even if they may exert their bargaining power to extract better terms. Furthermore, if SMEs are the subject of such bargaining power, even if they were excluded, it is doubtful that a material lessening in competition may be demonstrated.

41.3.2. Whilst the onus may shift to the dominant firm to show if any efficiency or pro-competitive effects outweigh any such harm, this too may be easy to demonstrate in the context where lower prices extracted from suppliers are passed onto consumers to at least some extent. Indeed, as discussed above, on a consumer welfare standard one would effectively have to prove excessive pricing to conclude a lack of pass through.

41.3.3. The primary reason for these difficulties is that the Bill incorrectly construes buyer power concerns as an exclusionary abuse rather than an exploitative abuse. Indeed, even under Article 102 TFEU it is contained in the same provision as excessive pricing, another exploitative abuse. O'Donoghue and Padilla express an exploitative abuse in the context of excessive pricing (not buyer power) as a situation where "*the dominant undertaking takes advantage of its market power to extract "rents" from consumers that could not have been obtained by a non-dominant firm or*

to take advantage of consumers in some other way."[31] They proceed to discuss unfair purchasing pricing and trading terms in the same context. [32] Whilst categories of abuse may not be mutually exclusive, what is clear is that the primary concern is one of exploitation and whether or not the conduct also excludes suppliers is incidental and may not occur.

42. Furthermore, the focus on price risks unintended consequences as outlined above, but which are probably made worse by the risk of fines and a reverse onus provision under section 8(2). In particular:

    42.1. A buyer who would be the subject of such an abuse complaint would not know the costs of its suppliers, making upfront compliance difficult. Given the reverse onus requirements, the buyer may also be in a position where they are unable to mount a proper defence were a complaint to be made.

    42.2. Since there is no obligation for large buyers to deal with SME or HDP firm suppliers, it is conceivable that the risks associated with taking on SME or HDP firms as suppliers may discourage at least some firms from contracting with such firms. This may be particularly pronounced for new entrants where the risks are higher without a track record of performance at the price point negotiated. This outcome would be contrary to the objectives of the drafters of the Bill.

    42.3. The same lack of obligation to purchase from any supplier, let alone at a specified price level, may also mean that suppliers may be loath to make a complaint under this provision, and if they do may also find themselves without a supply contract or considerably lower volumes in future. For all the reasons outlined under the discussion of purchase price above, it would be unreasonable for a court to impose an obligation to supply at a higher price in the context where other suppliers may exist and be willing to deliver at a lower price, even if the firm is found to be the subject of an abuse.

    42.4. Alternatively, it is also conceivable that certain buyers respond by lifting the purchase price of all SME/HDP firm supplier prices in an effort to reduce risks, raising price levels in the economy as a whole. This would be detrimental to final consumers, but also any further downstream firms that are dependent on inputs from the dominant buyer. This has adverse dynamic effects as it promotes inefficiency in the supply chain and may even threaten the competitiveness of certain industries in global markets (including import substitution). This alternative unintended outcome is a treatment far worse than the disease it is trying to cure.

43. **We are of the opinion that an alternative approach as outlined in our recommendations below will achieve the stated objectives without all these unintended consequences.**

Section 9(4) is equally unworkable and risks serious unintended consequences

44. The proposed inclusion of Section 9(4) extends the price discrimination provisions to a dominant firm as a purchaser of goods. At the outset it is important to note that we are not

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[31] O'Donoghue, R. and Padilla, J. 2013. *The Law and Economics of Article 102 TFEU.* 2nd ed. Hart Publishing: Oxford and Portland, pp. 214-215.
[32] Ibid. pp. 838-847.

aware of any other jurisdiction that applies price discrimination provisions to purchase prices, which already sets it apart from the exploitative provisions discussed above. Just as with section 8(1)(d)(vii) above, the inclusion of buyer power under section 9 is not only unworkable, but also raises potentially serious unintended consequences even if this is not always the same reasons.

45. The provision is unworkable for a host of reasons, some unique to a price discrimination context, and others due to the particular design of this provision:

45.1. **The focus is on price rather than trading terms.** As discussed above, this risks the most unintended negative consequences without addressing the primary source of concern for SMEs which are trading terms.

45.2. **As an exclusionary abuse it is required to show anti-competitive effect.** Section 9 much like section 8(1)(d) involves an exclusionary abuse which means there is a requirement to show anti-competitive effect, even if the threshold is lower for demonstrating such an effect.

45.3. **Price difference needs to be the source of exclusion.** The problem of demonstrating exclusion is compounded by fact that under section 9 the complainant will have to demonstrate that the source of the exclusion is the difference in price, not the price level per se.

45.3.1. This makes complete sense in a selling market which this provision is designed to deal with because it is the difference in price that raises the costs of an SME relative to a larger competitor downstream resulting in their product being more expensive and their exclusion from a market to the detriment of competition.

45.3.2. However, this makes little sense in the context of purchasing markets. The usual concern in a buyer power context is the level of the price, not the difference to another supplier. As discussed above, a comparison of the purchase price to that of another supplier is unlikely to even be informative of whether a level is too low or not, but even if it was, that could still not be the basis for a finding of an abuse under section 9. The abuse would have to relate to how a price differential caused harm. In fact, a lower price relative to another supplier may actually confer an advantage as it could result in more sales rather than less – greater participation rather than exclusion!

45.4. **Equivalency is a further hurdle to overcome.** Price discrimination can only occur in the context of equivalent transactions, which means products of like grade and quality as well as transaction terms. This makes sense in the context of a dominant seller as they are invariably selling the same product. However, it is likely to be completely unworkable in the context of purchasing prices and represent a hurdle to any prosecution as there will invariably be differences, however subtle, in the products sold by different suppliers. This may include differences in quality, product differentiation characteristics, etc. All of these would justify differences in prices paid too.

45.5. **Main defence would be excluded by practical considerations.** The main defence in a price discrimination case is that price differences reflect differences in

costs. However, such a defence would not be available in the context of a buyer provision under section 9.

45.5.1. A dominant firm is unlikely to have knowledge of its different suppliers' costs structures, either at the time of the negotiations or when it may be required to defend itself. It will ultimately be unable to assess whether any price differences are based on what would be considered legitimate differences in cost structures between such suppliers.

45.5.2. This problem is compounded by the reverse onus provisions proposed under the new section 9(3) for SME and HDP firms.

46. As with the proposed changes to section 8 to incorporate buyer power provisions, the inclusion of such a provision under section 9 risks a range of serious unintended consequences that may undermine both economic efficiency and consumer welfare but also which may in fact undermine the objective in respect of SME and HDP firms. These are a result of the structure of the provision, but are compounded by the risks of the imposition of a substantial fine and the reverse onus provided for under section 9(3).

46.1. <u>As with the section 8 provision, there is no basis to oblige a dominant firm to purchase from any supplier, let alone an SME or HDP firm.</u> As a consequence, it is conceivable that at least some firms may seek to reduce their risk through ceasing to source from such firms, which would undermine the very objective of including such a provision.

46.2. The alternative risk reduction strategy that might be adopted by a wider set of firms would be to simply bring all prices in line with each other for like products sourced from various suppliers.

46.2.1. <u>Given the risks of falling foul of too low a price under section 8, the logical strategy would be to raise prices to be in line with the highest supplier price.</u> This would have the effects as outlined for buyer power under section 8, namely a <u>raising of price levels in the economy to the detriment of consumers, downstream customers and the competitiveness of the economy</u>.

46.2.2. This effect is compounded in the context of the section 9 provision as whereas section 8 is limited to non-dominant suppliers, no such limitation is specified in section 9(4). <u>This means that section 9(4) prevents the exercise of bargaining power against all types of suppliers, large and small.</u> This is highly problematic as it is widely accepted by economists that countervailing buyer power (i.e. the ability of a buyer to exert its bargaining power over upstream firms so as to lower input prices) is pro-competitive.

46.2.3. Including provisions related to buyer power which would apply to all sellers, even dominant ones, would run the risk of impugning the exercise of such bargaining power despite the fact that such behaviour is typically viewed as pro-competitive and beneficial to end-consumers. Indeed, the ability to play suppliers off against one another in order to get the lowest price possible is a key part of competitive market processes. In South

Africa, where oligopolistic supply is pervasive, this is especially relevant where buyer power serves as a powerful instrument for lowering prices.

46.2.4. The provision could even have the paradoxical effect of hurting SMEs and HDP firms if the offer of uniform terms and prices negatively impacts on company policies which sought to provide favourable terms to small businesses and HDP firms.

47. **As with Section 8 above, we are of the opinion that an alternative approach will achieve the stated objectives without all these unintended consequences. We turn to that recommendation next.**

RECOMMENDATION

Given the objective of protecting SME/HDP firms from exploitative buying practices, we are of the opinion that this is best dealt with through an enforceable Code of Conduct which attracts penalties for violations. This would capture the primary source of harm to SMEs/HDPs without the unintended consequences, and is also more likely to achieve the objectives given that dominance need not be shown but also the ease of demonstrating a violation. This approach would also be consistent with how jurisdictions elsewhere have sought to address these same concerns.

Given that a Code of Conduct is of general application, there might still be room for some exploitative buyer provision under the abuse of dominance provisions to capture unique situations not present in a generic Code. However, such a provision should still focus on trading terms and be incorporated as a separate exploitative abuse under section 8. In particular, we would propose a new section 8(1)(e) that may be drafted in the following manner:

> ***"8(1)(e) It is prohibited for a dominant buyer to directly or indirectly impose unreasonable trading conditions on a supplier that is a small and medium business or firms controlled or owned by historically disadvantaged persons."***

We therefore also propose that sections 8(1)(d)(vii), 8(2) and 9(4) are scrapped.

48. The proposed Code of Conduct directly addresses the concerns around buyer power, which are primarily public interest in nature and relate primarily to trading terms, not price levels, and do so with greater ease and impact.

48.1. Trading terms were found to be the primary concern of small suppliers in other jurisdictions and it is likely to be the case in South Africa too.

48.2. A Code of Conduct will have a far greater impact on the participation of SMEs/HDP firms as it will have far broader application than Competition law. This is because it will not be contingent on demonstrating dominance or any exclusion. It will capture many instances of unequal bargaining power that falls short of market power. This is recognised in the EU's UTP proposal, where the focus is not on dominant buyers, but rather buyers that are not SMEs.

> *"Accordingly, the present proposal for a Directive aims at reducing the occurrence of UTPs in the food supply chain by introducing a minimum common standard of protection across the EU that consists of a short list of specific prohibited UTPs. The protection covers <u>small and medium-sized suppliers</u> in the food supply chain*

insofar as they sell food products to <u>buyers who are not small and medium-sized.</u>" [33] [emphasis added]

48.3. It is unlikely to have any unintended consequences on price levels, consumer welfare, downstream firms and the competitiveness of the economy. Indeed, correcting trading terms for SMEs/HDP firms is likely to be beneficial to consumers in addition to the firms themselves.

48.4. A code of conduct approach that sets out clear guidelines facilitates enforcement and avoids costly litigation with unclear benefits.

48.5. The processes allow for anonymous complaints and avoids the problem of a small supplier having to lodge a complaint against its main customer which comes with substantial risk for the supplier.

48.6. The rules can be designed to deal with the generic concerns (such as payment terms) but also problems specific to certain sectors such as the food sector.

49. Our proposed new section 8(1)(e) enables the retention of some provision under abuse of dominance to capture situations unforeseen by generic Codes of Conduct, but does so in a more appropriate manner by making it an exploitative abuse, targeted at trading terms with a pure public interest angle.

49.1. The focus on trading terms rather than price levels is entirely appropriate given the serious problems with a price provision as informed by the economic literature. These include both the identification of a practical legal test but also the massive unintended consequences that undermine efficiency, consumer welfare and competitiveness.

49.2. The focus on SME/HDP firms is also entirely appropriate as not only will these firms be the most likely to bear the brunt of any exploitative market power, but also it reduces the scope for unintended consequences of weakening negotiations with more powerful suppliers. In addition, if there is to be any loss of consumer welfare as a result of such provisions, this is only justifiable if it is to the benefit of other public interest groups rather than firms in general.

49.3. The move to an exploitative abuse, and one focused on trading terms, makes it easier to prosecute purely exploitative behaviour as there would be no need to demonstrate the broader anti-competitive effect as under section 8(d), which itself, by definition, depends on the consumer welfare standard. It also avoids the need to show that the price differentials themselves are the primary cause of harm as would be the case under section 9.

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[33] EU Proposal for a Directive of the European Parliament and of the Council on unfair trading practices in business-to-business relationships in the food supply chain (COM(2018) 173 final), p.3.

PRICE DISCRIMINATION

50. Currently section 9 of the Act focuses on anti-competitive price discrimination as an abuse of dominance. Price discrimination occurs when two similar products are sold by a firm at different prices, but is only deemed abusive if such discrimination results in substantial harm to competition.

51. Price discrimination is generally seen as beneficial for consumers and the economy since it increases trade and competition between firms by allowing firms to sell at a lower price to more price-sensitive customers than it would under a uniform pricing regime. However, it is often a concern of policymakers that small firms bear the brunt of the potential negative aspects of both price discrimination. Indeed, public perception tends to reinforce the idea that it is small firms who are treated unfairly and receive higher prices from suppliers relative to their larger counterparts who can negotiate lower prices.

52. As a result, it has been argued that section 9 should place particular emphasis on the protection of small and medium-sized enterprises. Indeed, this was the rationale behind the approach advocated by the *Tribunal in Nationwide Poles v Sasol (Oil) Pty Ltd,* where it argued that section 9 should be regarded as "*a hybrid of public interest and anti-trust*".[34] However, at the time the approach adopted by the Tribunal was rejected by the Competition Appeal Court.

53. It is within this context that the amendments have sought to explicitly incorporate public interest concerns into section 9. It does so through three changes:

    53.1. First, a lowering of the threshold in the first part of the test from pricing that is likely to have the effect of "*substantially* *preventing or lessening competition*" to simply the effect of "*preventing or lessening competition*". The Memorandum on the Objects of the Bill makes clear that this reduction in the threshold is aimed at making it easier for SMEs to bring a price discrimination case where their smaller size may mean that it is more difficult to demonstrate a substantial effect.

    53.2. Second, the provision now incorporates in the test a requirement for the dominant firm to show that "*its action does not impede the ability of SMEs or HDP firms to participate effectively*".

    53.3. The proposed amendment to section 9 also incorporates a discriminatory buying clause whereby this provision applies to "*a dominant firm as a purchaser of goods and services.*" We have dealt with the issue of buyer power in the previous section and are of the opinion that this clause is removed from section 9. We therefore do not deal with that amendment further in this section, but rather discuss the first two amendments with proposals on how to achieve the same outcome but without unnecessary distortions from over-enforcement.

[34] 72/CR/Dec03, para. 142.

THE REDUCTION IN THE THRESHOLD

54. As our submission on the initial draft Bill outlined in detail, economic theory is unequivocal that there are substantial benefits to price discrimination and it is only in particular circumstances that there is anti-competitive harm. A full economic discussion of these benefits appears in our original submission, but can be summarised as follows.

    54.1. First, the use of price discrimination is widespread and is not necessarily reflective of market power. Indeed, it often occurs in markets that are considered competitive and hence cannot, in and of itself, be considered to be evidence of market power or the abuse thereof.[35] Indeed, volume discounts which may not always be explicitly linked to specific costs are the most common cause of price differentials and considered a norm for all businesses.

    54.2. Second, where a company does possess market power and engages in bilateral negotiations with downstream customers, price discrimination can in fact be pro-competitive. This is because in such circumstances most customers will attempt to negotiate a price cut, particularly if they are concerned that other firms may be securing lower prices. However, where a supplier can plausibly commit to charging the same price to all customers, these customers will likely accept the higher price since they know that their competitors will also face such a price.[36] Importantly, requiring the firm to charge a uniform price to all customers prevents such customers from being able to negotiate better prices – a natural and important part of many competitive negotiation processes.

    54.3. Third, price discrimination is often welfare-enhancing and efficient, even in concentrated markets. This is because when a supplier is able to sell at a lower price to more price-sensitive customers than it would under a uniform pricing regime, the overall level of output in the market increases as these customers are then serviced where they would not otherwise have been. This increase in output benefits not only the consumers but the economy as a whole due to increased employment and greater value added to the economy in manufacturing and raw input material markets. In the case of industrial customers, price sensitivity and volumes purchased may be the result of the particular markets they serve or products they produce.

55. The often pro-competitive effects of price discrimination and the non-trivial possibility that competition interventions could result in negative, albeit unintended, outcomes has led competition authorities in the European Union to adopt a cautious approach when pursuing price discrimination cases. This approach is summarised by O'Donoghue and Padilla as follows:

"At EU level, findings of discrimination based only on differences in prices or terms offered to two or more similarly-situated customers have been an extreme rarity under Article 102 TFEU… The EU institutions' reluctance to apply Article 102(c) in cases where the only conduct alleged is a difference in price or terms to similarly-situated customers most likely reflects the fact that price discrimination is ubiquitous (including by non-dominant firms) and probably efficient in most cases, as well as the concern that a strict non-

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[35] O'Donoghue, R. and Padilla, J. 2013. *The Law and Economics of Article 102 TFEU*. 2nd ed. Hart Publishing: Oxford and Portland, p. 782.

[36] See Papandropoulos, P., 2007, How should price discrimination be dealt with by competition authorities? Droit & économie, *Concurrences* N° 3, p. 37 and [36] O'Donoghue & Padilla. 2013, p. 786.

discrimination rule would likely have the perverse effect of raising prices overall, increasing scope for collusion, and preventing firms from negotiating better prices and terms. For this reason the EU institutions have never suggested that a dominant firm is under a strict obligation to offer similar prices and terms to all trading parties active at the same market level." [37] [emphases added]

56. This caution is echoed by Areeda and Hovenkamp in the leading US antitrust treatise, where they state:

    "… antitrust tribunals can rarely have confidence that a decree enjoining price discrimination will benefit consumers or encourage competition in any market. Such a decree ipso facto does not restore competitive pricing; it merely forces the defendant to charge a single price, which will be its profit-maximizing price given the amount of monopoly power it has. Such a decree can be justified only if the tribunal has confidence that single pricing will (1) benefit consumers as a group; or (2) hasten rivals' expansion or new entry that would reduce or destroy the monopolist's power or destroy the monopolist's power. If the monopolist's price discrimination scheme before the decree issues was output-increasing, then the decree would generally injure consumers as a group…" [38]

57. In this context, it is highly problematic that a narrow concern related to SMEs results in a reduction in threshold that is extended to apply to all firms. This is especially in the context where there is a recognition that larger firms do not face the same problem of demonstrating substantial harm to competition were the price discrimination to result in their exclusion.

58. This extension is problematic since the increased risk associated with differential pricing by business is likely to significantly chill price competition and eliminate the substantial consumer welfare benefits associated with price discrimination. This is because not only will the amendments curtail competitive price negotiations, but the increased risk to price discriminate will also likely result in higher prices on average, lower output and fewer customers being served.

RECOMMENDATION

We are of the opinion that a better approach to dealing with the specific concerns in respect of SMEs is to restrict the lower threshold to such firms and leave the higher threshold in place for all other firms. This may be achieved through simply an amendment to section 9(1)(a) to incorporate a lower threshold specifically for SMEs (and firms owned by historically disadvantaged persons) in addition to the overall test as applied to all other firms. This may look something like the following:

"(1) An action by a dominant firm, as the seller of goods and services is prohibited price discrimination, if –

> ***(a) It is likely to have the effect of substantially preventing or lessening of competition or has an appreciable effect on the ability of small and medium businesses and firms controlled or owned by historically disadvantaged persons to participate effectively;"***

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[37] O'Donoghue & Padilla. 2013, pp. 811-812.

[38] Areeda, P. and Hovenkamp, H. 2016, *Antitrust Law.* Aspen Publishers, at para. 721e.

59. In this manner the Bill can achieve its objectives but without the unintended consequences of chilling legitimate competition. The inclusion of the word “appreciable” is necessary in order to ensure that any effect on participation is at least non-trivial. This can also be extended to firms controlled or owned by historically disadvantaged persons to the extent that it is deemed necessary to achieve the objectives. If such firms are large then they may not have difficulty demonstrating substantial harm and if such firms are small then they would be covered by the SME provision.

REVERSE ONUS

60. The proposed new section 9(3) seeks to not only incorporate a focus on the ability of SMEs and firms owned/controlled by historically disadvantaged persons to participate in markets, but also imposes a reverse onus on the demonstration of a lack of effect.

61. The first objective would be achieved through the type of amendment that we propose above, namely that the test in section 9(1)(a) include a separate test for prohibited price discrimination in the context of SMEs and HDP firms.

62. Shifting the burden of proof from the complainant to the dominant firm is usually only appropriate where the conduct in question can by its very nature be assumed anti-competitive or otherwise harmful to consumers or firms (such as excessive pricing, for example). This is not the case for price discrimination which is legitimately and beneficially employed in a diverse number of ways and across a vast array of industries.

63. Furthermore, this provision is not simply a shift in evidentiary burden once a *prima facie* case has been established (as with section 8(2)), but a full reverse onus on the respondent to show that is conduct does not impede small or HDP firms from effective participation.

64. Imposing a reverse onus therefore risks a number of undesirable unintended consequences, including:

    64.1. A likelihood of generating a large number of meritless complaints that will need to be investigated, using up considerable Commission and business resources. This is because the complainant need only overcome the hurdle of demonstrating a price difference before the onus shifts to the dominant firm to demonstrate that such a difference does not impede SMEs and firms owned/controlled by HDPs from participating in the market.

    64.2. The very real difficulty of a dominant firm being able to undertake such a defence given that much of the relevant information may not lie within their control or knowledge. This may include the extent to which the dominant firm’s product is an important cost driver for the downstream firm, but also whether any difference is the cause of the downstream firm’s difficulty participating in the market.

    64.3. These perverse outcomes may result in firms moving to uniform pricing policies simply to reduce resource costs and risks, and the widely accepted benefits associated with the ability to price discriminate as outlined above would be lost.

65. It is also not clear that removing the reverse onus will reduce the efficacy of the amendments. The introduction of an offence for impeding SMEs and HDP firms with the

risk of a substantial fine will certainly focus the mind of business on compliance with that provision, which is what the amendments ultimately intend to achieve.

RECOMMENDATION

We propose that section 9(3) is scrapped.

EXCESSIVE PRICING

66. The amendment to the excessive pricing provision is broadly two-fold:

    66.1. The first is a change to section 8(1)(a) by adjusting the requirement to show that such prices are *"to the detriment of consumers"* to incorporate all customers (i.e. intermediate firms as well as final consumers)[39]. This is essentially how the provision has been interpreted and the change only provides legal clarity on that.

    66.2. The second and more major change has been to remove the definition of excessive pricing (as a price which bears no reasonable relation to the economic value of a product or service), and to rather incorporate a new section 8(3) which lays out that in determining whether a price is excessive that: a) the price must be compared to a competitive price, and b) the competitive price must be determined by taking account all relevant factors. This is followed by a list of factors including price-cost margins, respondent's prices elsewhere and comparator prices. It also includes factors such as the length of time the prices have been charged and the structural features of the market (including past state support).

    66.3. The third change is the inclusion of section 8(2) which shifts the evidentiary burden to show a price is reasonable to the respondent once a *prima facie* case has been made.

67. The use of a 'competitive price' as the benchmark against which to compare the pricing of a respondent and a range of factors in determining what such a price level may be is broadly in line with existing case precedent, and therefore largely reflects a codification of law.

    67.1. Whilst the existing definition requires a comparison to economic value, the CAC held that this concept is defined as "*the notional price of the good or service under assumed conditions of long-run competitive equilibrium.*"[40]

    67.2. One means of determining a potentially competitive price is to make use of the price-cost test, on the assumption that firms are constrained to costs in a competitive equilibrium. However, the use of comparators to make inferences about the competitive level of pricing is recognized in both EU and SA case precedent. These comparators tend to be: (i) prices charged by competitors in the same market, (ii) prices charged by the dominant firm over time, (iii) prices charged by the dominant firm in other geographic markets, or (iv) prices charged by firms selling similar products in other geographic markets.[41] Often the comparators are used to establish a *prime facie* case requiring further investigation and may not always be determinative in themselves.

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[39] It is true that such a requirement is often seen as tautologous: when would excessive prices not be to the detriment of consumers? In fact, there are some instances when prices significantly above observable costs are 'in the interest of consumers' – for example if the prices are rewarding large sunk costs and the risks borne in bringing a valuable new product to market. We note this to make the point that in some markets, particularly those with a high degree of dynamism, excessive pricing cannot be reduced to an accounting exercise. It is therefore advisable to consider the impact of the pricing from the perspective of customers.

[40] Competition Appeal Court of South Africa, Mittal Steal South Africa vs Harmony Gold Mining Company, Case 70/CAC/Apr07, para. 40 Ibid para 40. In line with the approach in the EU and UK, this means that economic value would be inclusive of all economic costs, not just accounting costs. Economic cost includes a "*normal rate of return*" on assets that allows the firm to be sustainable in the long run.

[41] Opinion of Advocate General Wahl, April 2017, Biedriba v Konkurences padome, Case C-177/16, para 19.

67.3. Indeed, it is the case that certain factors may not be relevant (or reliable) at all in certain cases and therefore should be disregarded in the assessment. As articulated in the recent opinion of Advocate General Wahl on an excessive pricing case related to musical copyright fees[42]:

"36. It can be safely stated that, at the current stage of legal and economic thinking, there is no single method, test or set of criteria which is generally accepted in economic writings or across jurisdictions for that purpose [assessing excessive pricing]. Different authorities as well as lawyers and economists have suggested a number of methods of analysis (as well as a variety of criteria, tests or 'screens') to that end. However, in point of fact, each of those methods reveals some inherent weaknesses.

37. In the first place, none of those methods can be used in all circumstances, since their suitability (and, at times, the very possibility of applying them) depends very much on the specific features of each case. To give but one example, a cost-price comparison makes little sense with regard to the supply of certain intangible goods such as — as is the case in the main proceedings — copyrighted musical works."

THE LACK OF AN UNREASONABLE RELATIONSHIP TEST

68. However, whilst the benchmark and means of determining it are in line with case law, what is missing from the current formulation in the amendment is the requirement that a price need not just be in excess of the competitive price, but must be so in excess as to be unreasonable. This is a critical part of the settled case law and for good reasons.

The unreasonable relationship test

69. The case precedent in the EU and consequently SA requires that an excessive price is not only one that is higher than the competitive price, but also sufficiently higher such that the difference is unreasonable.

69.1. The seminal case in the Europe which considered Article 102(a) was that of *United Brands* where the conduct of concern was that prices were unfairly high. In this case the Court determined that *"charging a price which is excessive because it has no reasonable relation to the economic value of the product supplied"* constitutes an abuse since it represented *"the imposition by an undertaking in a dominant position directly or indirectly of unfair purchase or selling prices."*[43]

69.2. Consequently, assessments in understanding unfair pricing necessarily require an assessment of reasonableness and proportionality of the excess. In Europe this is determined via a two-step test. The first step in this test is to establish if the price is in excess of the costs incurred whilst the second step of the test seeks to establish whether the difference is unfair. In this case, unfairness is only established when the difference between the costs (or competitive benchmark prices) and price is so substantial that the latter is deemed to bear no reasonable relationship to the

[42] Opinion of Advocate General Wahl, April 2017, Biedriba v Konkurences padome, Case C-177/16, para 106-107.
[43] United Brands Company and United Brands Continental BV v Commission of the European Communities [1976] Case 27/76, ECR 425; par 248-250.

former. This is confirmed in the *Scandlines* decision where the commission states the following:

"A comparison between the price charged and the costs incurred (in the present case, the approximate incurred costs) can only serve as a first step in an analysis of excessive or unfair pricing. The United Brands judgment made clear (in paragraph 250) that such an abuse can only be established where the price bears no reasonable relation to the economic value of the product concerned." [44]

69.3. The first excessive pricing case in South Africa was *Mittal*[45] where the CAC outlined a four-step enquiry into whether a price can be deemed excessive based on the definition contained in the South African Competition Act:[46]

69.3.1. *"First, the determination of the actual price of the good or service in question and which is alleged to be excessive."*

69.3.2. *"Secondly, the determination of the 'economic value' of the good or service expressed in monetary terms, as an amount of money."*

69.3.3. *"Thirdly, if the actual price is higher than the economic value of the good or service, is the difference unreasonable or, to put it in another way, is there 'no reasonable relation' between the actual price and the economic value of the good or service?"*

69.3.4. *"Fourthly, is the charging of the excessive price to the detriment of the consumers?"*

70. What is clear from this approach is that a difference in price alone is insufficient to conclude that a higher price is unfair. The reasonableness of this difference must also be established. This applies even more so to the use of comparators to demonstrate unfairly high prices as it does to the use of price-cost, simply because there is greater uncertainty that the comparator is a truly representative benchmark by which to compare prices. Hence, for legal certainty a greater margin of error is required.

71. In this respect, the EU courts have consistently found that the differences cannot be small but rather must be 'appreciably higher' in order to fall foul of the unfairness element. In the case of United Brands a 7% difference was not deemed to be significant enough to constitute an unfair price.[47] This approach is summarized in the recent opinion by Advocate General Wahl[48]:

"*106. That is why — in line with the approach adopted by the relevant authorities and courts both at the EU level and at the Member States level, and as suggested in economic writings — I take the view that a price can be qualified as excessive under Article 102 TFEU only if two conditions are fulfilled: it ought to be both significantly and persistently above the benchmark price.*

107. As regards the first aspect, I would emphasise that not any price difference should be regarded as relevant under Article 102 TFEU but only important deviations. That

[44] Scandlines Sverige AB v Port of Helsingborg (2004), COMP/A.36.568/D3, para 150.
[45] Competition Appeal Court of South Africa, Mittal Steal South Africa vs Harmony Gold Mining Company, Case 70/CAC/Apr07.
[46] Ibid para 32.
[47] United Brands v Commission, 1978, Case 27/76, para 266.
[48] Opinion of Advocate General Wahl, April 2017, Biedriba v Konkurences padome, Case C-177/16, para 106-107.

approach has been expressly endorsed by the Court: for example, in Tournier and Lucazeau, the Court referred to scales of fees 'appreciably higher' than those to which they are compared. That viewpoint is also widely supported in economic writings." [emphasis added]

Rationale for the unreasonable relationship requirement

72. The rationale behind the unreasonableness approach is coherently laid out in the same Opinion by Advocate General Wahl[49]:

103. First, as explained in points 36 to 42 above, the calculation of a benchmark price is a rather complex and uncertain exercise. Were a competition authority to intervene in respect of any difference — however small — between those two prices, the risk of having false positives would simply be too high. That is not only a problem because a large fine may be imposed on the undertaking responsible, but also because neutral — or possibly procompetitive — conduct might be prohibited. In that regard, it has been correctly argued that type I errors in competition decisions concerning unilateral conduct involve a much larger cost for the society than type II errors: 'the economic system corrects monopolies more readily than it corrects judicial errors … A practice once condemned is likely to stay condemned, no matter its benefits. A monopolistic practice wrongly excused will eventually yield to competition though, as the monopolist's higher prices attract rivalry.'

104. Second, because of those difficulties and uncertainties, it must also be acknowledged that it may often be difficult for a dominant undertaking to estimate in advance, with a sufficient degree of likelihood, where the line between a legitimate competitive price and a prohibited excessive price may be drawn. Thus, for reasons of legal certainty, that threshold cannot be set too close to the benchmark price.

105. Third, a strict approach would require competition authorities essentially to become price regulators which ought continuously to monitor and intervene in (potentially all) regulated markets. Clearly, unlike sectoral authorities, competition authorities have neither the resources nor the expertise to do that. Moreover, the loss of consumer welfare may at times be minor and not justify a complex, time consuming and costly intervention by the public authorities. Indeed, how consumers react to a price increase differs widely from market to market, and not even a monopolist can set prices independently of its customers. Thus, the degree of damage made to consumers' welfare by high prices may vary."

73. In respect of the difficulties in accurately determining the benchmark price referenced by the Advocate General in these paragraphs, he had this to say earlier in the ruling:

38. In the second place, the information required to perform the operations necessary to calculate the benchmark price may be missing or incomplete, or its value controversial. For instance, identifying costs and linking them to a particular product is highly complex in most types of businesses and for many undertakings. Calculating profit margins is thus a rather uncertain exercise. It should not be overlooked that accounting standards and rates may change across industries or countries, due to different legal provisions or accounting conventions, and, furthermore, they may not always reflect the relevant economic concepts.

[49] Ibid, para 103-105.

39. In the third place, comparing prices across different geographic markets, competitors and/or time periods also presents risks. Markets are rarely so homogenous that a meaningful comparison can be made immediately and automatically. A number of 'adjustments' to the data which emerges from the market(s) used as a point of comparison may be necessary before that data can be used to determine the benchmark price.

40. To start with, so far as concerns geographic comparisons, elements such as — to name but a few — domestic taxes, the particular characteristics of the national labour market and local consumers' preferences may significantly affect the final prices of the relevant product or service. With regard to comparisons across competitors, it should not be overlooked that differences in prices may simply reflect different qualities: a more expensive product may objectively be (or be merely perceived to be) of superior quality.

74. This highlights the fact that aside from a range of other factors that warrant a price being 'appreciably higher' before an abuse is identified, the calculations required by such enquiries will inevitably be subject to a margin of error or a confidence interval based on the range of plausible assumptions. As a result, it is necessary to establish a material or substantial difference as only in such instances can courts be confident of the existence of an offence. This is illustrated in the box below.

BOX 2: SOURCE OF CONFIDENCE INTERVALS IN EXCESSIVE PRICING CALCULATIONS

Conducting an excessive pricing assessment necessarily involves a degree of judgement, even when applying a price-cost test, which results in a range of plausible results depending on the assumptions made or technique adopted. Given that there is this "confidence interval" around the determination of the competitive price (or economic value), it is entirely appropriate to include a higher threshold than simply a difference between the price charged and the calculated proxy for the competitive price.

Price-Cost test

Under a price-cost test, the price charged is compared to economic costs, which comprise of operating costs and a fair return on capital employed (and are different to accounting costs). Determining the value of these components with a high degree of confidence is often not possible. For example:

- *Operating costs*: - most firms produce a range of products and, as a result, incur common costs that need to be allocated to each individual product. There are a range of accepted allocation methodologies from revenue share, cost share, volume share, staff share, etc., all of which may result in slightly different operating cost numbers. In addition, intra-company purchases from other divisions or subsidiaries may not be costed at all and acceptable arms-length transfer prices may need to be determined. Here too are a range of possible methodologies from which to select that will generate slightly different cost figures. Indeed, this was a feature of the recent Sasol case where a wide range of valuations were provided for the main raw material sourced from a related party.

- *Capital employed*: - it is accepted that fixed assets need to be valued at replacement costs rather than historic cost. Again there are a number of accepted methodologies

for determining replacement cost, including making use of insurance values, current asset prices or inflating historic costs by different indexes including the CPI, or the construction price index. Capital employed will also include intangible assets, some of which are not reflected on the balance sheet, such as brand value. There are several plausible approaches for valuing intangible assets, each requiring some level of judgement.

- *Return on capital employed*: - the most common approach is to make use of the Weighted Average Cost of Capital (WACC) but consideration has also been given to internal hurdle rates to justify investments that might exceed WACC. However, even in the determination of WACC, there is some judgement as to the use of pre- or post-tax WACC, the value of the equity beta and the equity risk premium, and the calculation of industry wide WACCs (including which firms to incorporate in such a measure).

Comparators

Comparators are rarely perfect and therefore again confidence intervals exist around these estimates.

- Prices in other countries might reflect different cost and demand conditions in addition to competitive market conditions which would influence the price levels. This would apply equally to the dominant firm's products.
- Prices of alternative suppliers might also reflect differences in product quality, functionality or brand value to the dominant firm.
- Prices of the dominant firm in other markets might reflect sales at incremental cost to develop scale, or market development pricing, which can account for differences.

RECOMMENDATION

We propose that section 8(3) is altered to either make direct reference to the unreasonableness test, or the general interpretation of such a test as being "significantly and persistently higher" than the benchmark as outlined in the recent opinion of Advocate General Wahl in the EU. Such redrafting of section 8(3) prior to the sub-sections may read as follows:

> ***"8(3) An excessive price is one which is both higher and bears no reasonable relation to a competitive price, determined by taking into account all relevant factors, including:"***
>
> ***OR***
>
> ***"8(3) An excessive price is one which is significantly and persistently above the competitive price, determined by taking into account all relevant factors, including:"***

75. For the reasons above we are of the opinion that section 8(3) should be changed to reflect the unreasonableness component of the excessive pricing test if its role is to codify settled law. Whilst the reference to reasonableness is included in section 8(2) which shifts the burden to the respondent when a prime facie case is made, we do not think this is sufficiently clear to ensure that 'unreasonable relation' forms part of the test. It will only be clear and offer legal certainty to firms if it is included in the definition of section 8(3).

OTHER COMPONENTS OF THE AMENDMENT

Structural and other characteristics of the market (section 8(3)(e))

76. The inclusion of a consideration of structural characteristics of the market (incl. barriers to entry and contestability) as well as whether the respondent is a beneficiary of state support or holds an advantage that is not due to its own commercial endeavours is also welcome. Whilst these factors contain elements that relate to determining if the difference in returns are due to efficiencies of the firm or not, they also have the potential to bring excessive pricing enforcement more in line with a narrowing of enforcement priorities as in other jurisdictions. In particular, in the EU there is a stronger focus on markets where high prices will be durable and/or are the result of prior state support or advantage.

    76.1. On the durability of prices, the rationale is that if the markets are contestable or not subject to insurmountable entry barriers, then high prices are an important market signal for entry. Such entry will ultimately resolve the higher prices as they are bid down, but also represent a preferred outcome to price regulation as it is a durable market solution. It is only when such entry is unlikely that price regulation may be deemed an attractive option from the perspective of the economic literature.

    76.2. On the prior state support or advantage point, the rationale for often limiting the scope on this basis is the desire not to blunt incentives for firms to innovate, invest and take risks in order to gain a competitive advantage, as it is precisely such incentives which drive efficiency and product improvements to the benefit of consumers. Over-zealous excessive pricing enforcement may stifle such incentives if firms believe that they cannot ultimately reap the rewards of such risk-taking or investments through better prices in future.

77. This thinking is articulated in the erstwhile UK's OFT guidelines around conduct:[50]

    "Prices and profits of a dominant undertaking which, at first sight, might appear to be excessive will not always amount to an abuse. First, high prices will often occur for short periods within competitive markets. For example, an increase in demand that could not be met by current capacity or a supply shock that reduced production capacity would lead to higher prices. Where high prices are temporary and/or likely to encourage substantial new investment or new entry, they are unlikely to cause concern.

    ….

    It is important not to interfere in natural market mechanisms where high prices and profits will lead to timely new entry or innovation and thereby increase competition. In particular, competition law should not undermine appropriate incentives for undertakings to innovate. Concern about excessive prices will be more likely in markets where price levels are persistently high without stimulating new entry or innovation."

78. Whilst the current list of factors is not exhaustive, excluding some of the factors cited above in the OFT guidelines such as temporary demand or supply shocks or innovation, the fact that the legislation does not make this a closed list means it is unnecessary to recommend their inclusion in the final amendments.

[50] UK Office of Fair Trade (April 2004), Assessment of Conduct: Draft competition law guideline for consultation, pp. 7-8.

Shift in evidentiary burden section 8(2)

79. The requirement of section 8(2) is that once a *prima facie* case is established, that the evidentiary burden shift to the respondent to show the reasonableness of prices. A *prima facie* case has meaning within the legal context, which in short is the position where sufficient evidence has been provided in order to support the legal claim[51]. However, such evidence may of course be rebutted by the respondent in their defence.

80. As outlined in our previous submission, the shift in evidentiary burden to the respondent to show reasonableness once a *prime facie* case of excessive pricing has been made already resonates with case precedent and can be appropriate for this type of offence.

    80.1. The typical situation is that a case is built by a complainant on the basis of comparators alone for the simple reason that a complainant does not have access to the internal costs of the respondent and is therefore unable to construct a price-cost assessment.

    80.2. Practically, the respondent may then seek to put up a price-cost assessment of their own in order to meet a case made on comparators alone, or critique the use of particular comparators based on their relevance.

81. The legal practice will in due course determine what is sufficient to establish a *prima facie* case in the context of excessive pricing. However, from the economic perspective and construction of the amendments, it would seem to be that establishing such a case would require at the very least the following:

    81.1. First, a consideration of a range of relevant factors to determine the competitive comparator price would be required. As the proposed section 8(3) already acknowledges, in excessive pricing one cannot have regard to a single factor as a) that factor may not be relevant, and b) it might not provide a correct perspective in the context of other factors considered.

    81.2. Second, the consideration of any factor should be substantive if it is to credibly provide sufficient evidence to support a legal claim of abuse. For example, if making use of a comparator price it is generally acknowledged that the selected product and geographic markets must be sufficiently homogenous so as to provide a meaningful comparison.[52] If such a comparator is used to support a *prima facie* case then the onus should still lie with the Commission to demonstrate the comparator is appropriate. Similarly, a price-cost test that does not conform to the accepted standards of practice could not constitute evidence in a *prima facie* case.

Guidelines

82. Section 8(3)(f) enables the Commission to make guidelines on excessive pricing but does not require them to do so. This seems redundant in the context of s79 which empowers the Commission to do so in any event. If guidelines are produced, we would recommend that they reflect law, and not seek to make law, and provide the enforcement priorities of the Commission to provide meaningful guidance to firms.

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[51] The online Wex Legal Dictionary defines a prima facie case as "*A prima facie case is the establishment of a legally required rebuttable presumption. A prima facie caseis a cause of action or defense that is sufficiently established by a party's evidence to justify a verdict in his or her favor, provided such evidence is not rebutted by the other party.*"
[52] Opinion of Advocate General Wahl, April 2017, Biedriba v Konkurences padome, Case C-177/16, para 19.

SECTION 4/5 GUIDELINES AND EXEMPTIONS

83. We welcome the amendments requiring guidelines to be issued in respect of sections 4 (horizontal agreements) and 5 (vertical agreements), as well as the extension of the exemption provision to permit an exemption on the basis of improving competitiveness and efficiency gains.

GUIDELINES

Section 4

84. Section 4(1)(a) covers a range of collaborations between firms that may be in a horizontal relationship but which do not constitute hard-core collusion as covered by section 4(1)(b). The EC Guidelines on horizontal co-operation agreements includes in this list the following:

    "*research and development agreements, production agreements including subcontracting and specialisation agreements, purchasing agreements, commercialisation agreements, standardisation agreements including standard contracts, and information exchange.*"[53]

85. Whilst such agreements may result in harm to competition under certain circumstances, these types of co-operation agreements can also provide substantial economic benefits. As the same EC Guidelines state:[54]

    "Horizontal co-operation agreements can lead to substantial economic benefits, in particular if they combine complementary activities, skills or assets. Horizontal co-operation can be a means to share risk, save costs, increase investments, pool know-how, enhance product quality and variety, and launch innovation faster." [emphasis added]

86. In our opinion, the lack of guidelines to date coupled with a very literalistic approach to the provisions of section 4(1)(b) and the absence of the ability to grant exemptions on the basis of efficiency grounds has stifled the adoption of beneficial types of horizontal co-operation in the South African economy. This is because there are increased risks for firms that such arrangements get incorrectly thrown into the basket of hard-core cartel arrangements and with no option of seeking an exemption to reduce that risk (as the current exemption basket is narrowly focused on public interest grounds).

    86.1. In respect of section 4(1)(b), whilst much of the behaviour that does fall within the ambit of express collusion is relatively clear and uncontroversial, the Supreme Court and Competition Appeal Court ("**CAC**") have determined that our Act still incorporates as element of characterization and a literalistic approach to issues such as price-fixing may unduly broaden the cartel provisions beyond what economic theory classifies as anti-competitive collusive behaviour. As the CAC stated in *Commission v SAB and others* in response to the literalistic approach adopted by the Commission in seeking to prosecute distribution agreements under section 4(1)(b) due to the existence of internal distribution capabilities:

[53] EC Guidelines on the applicability of Article 101 of the Treaty on the Functioning of the European Union to horizontal co-operation agreements, par 5.
[54] Ibid par 2

"The purpose of the characterisation principle, in the manner in which we have outlined it, is reflective that the per se prohibitions contained in s4(1)(b) are the most serious legislative prohibitions against a defendant. There is no defence which can be offered, if the requirements of the section are met. The animating idea of the characterisation principle is to ensure that s4(1)(b) is so construed that only those economic activities in regard to which no defence should be tolerated are held to be within the scope of the prohibition. Whether conduct is of such a character that no defence should be entertained is informed both by common sense and competition economics."[55] [emphasis added]

86.2. In this respect, the CAC found instructive the following passage from the US Supreme Court judgement in the *BMI* case which warns against taking a literal approach to 'price-fixing'. In that case, the US Supreme Court explained the term 'price-fixing' is shorthand for describing certain business behaviour as understood in competition economics and therefore has content and meaning beyond the literal interpretation of that term.

"To the Court of Appeals and CBS, the blanket license involves "price fixing" in the literal sense: the composers and publishing houses have joined together into an organization that sets its price for the blanket license it sells. But this is not a question of simply determining whether two or more potential competitors have literally "fixed" a "price". As generally used in the antitrust field, "price fixing" is a shorthand way of describing certain categories of business behavior to which the per se rule has been held applicable. The Court of Appeals' literal approach does not alone establish that this particular practice is one of those types or that it is "plainly anticompetitive" and very likely without "redeeming virtue." Literalness is overly simplistic and often overbroad…"[56][emphasis added]

87. Despite the fact that characterization is part of our Act, all too often a literalistic approach is adopted which might capture potentially efficiency enhancing horizontal co-operation arrangements. Indeed, this has led to the bizarre situation whereby legal advisors contrive to place such arrangements under merger control in order to receive express approval given the lack of alternative ways to reduce risk. This was evident in the recent spate of alliance arrangements between the larger construction firms designed to assist smaller HDP firms as part of the package of remedies following the cartel investigations, and which were all processed as mergers[57]. For each "merger" the following is recorded which makes plain it is a mentoring arrangement and not a merger:

"*This alliance is the result of a settlement agreement concluded between construction companies and the South African government following the Commission's investigation into cartel conduct in the construction industry between 2009 and 2013. In terms of the agreement, the construction companies could either elect to sell a portion of their equity to historically disadvantaged persons (HDPs) or commit to mentoring and developing up to three companies owned, managed and controlled by HDPs. [Firm X] elected to enter into alliances with emerging contractors, thereby agreeing to participate in transformative initiatives aimed at improving competitiveness, innovation and entrepreneurial*

[55] Competition Appeal Court, case no. 129/CAC/Apr14, *Commission v SAB and others*, par 44.
[56] United States Supreme Court, *Broadcast Music Inc v Columbia Broadcasting System Inc*, 441 US 1 (1979) as quoted in the Competition Appeal Court judgement, case no. 129/CAC/Apr14, *Commission v SAB and others*, par 33.
[57] See Commission Statement of Decisions 3 January 2018 where the alliances were processed as mergers approved by the Commission.

opportunities in the construction industry. The alliance will be active for a period of between 7 and 10 years during which [Firm X] will have to meet certain targets."

88. This hindering of beneficial horizontal co-operation agreements is even more concerning in the context of pursuing the public interest goals of increasing participation in the economy for SMEs and HDP firms, as non-collusive collaborations with other firms represent a potentially important means through which such firms may grow and develop. This includes collaborations with existing larger firms as well as with each other. Again the mentoring arrangements undertaken by the construction firms is a case in point as these arrangements were not simply exempt or cleared as not anti-competitive by the Commission but had to be subject to merger control to get clearance.

89. Subjecting section 4(1)(a) to a penalty on a first time offence can only result in a further stifling of such beneficial arrangements unless this risk is reduced through comprehensive and clear guidelines.

Section 5

90. As with horizontal co-operation agreements, economic theory also holds the view that most vertical agreements provide substantial economic benefits without any risk of anti-competitive outcomes. Whilst there has probably been less inhibition of vertical agreements as has been the case with horizontal co-operation agreements historically (in large part due to the absence of any *per se* offences), the move to permit penalties for first-time offences for section 5 risks chilling these pro-competitive agreements if business is left uncertain as to how the Commission may seek to assess such agreements going forward.

RECOMMENDATION

As a matter of practice, the guidelines to be developed by the Commission should be comprehensive and provide clear guidance to business on what agreements are likely to fall foul of section 4 and 5, including guidelines on characterization of section 4(1)(b), and the enforcement priorities of the Commission. The Commission would be well served by taking similar guidelines from the EC and adapting them where appropriate for the South African legal context.

91. We make this recommendation because the recent information sharing guidelines issued by the Commission were heavily criticized for not providing any real guidance to business on what types of arrangements would be considered anti-competitive (per se prohibitions), which are likely to be of little concern to the Commission (an enforcement priority issue) and which may be subject to a rule of reason (with the factors that might be considered). The draft guidelines focused more on the latter, simply listing a range of economic factors that may be relevant to any rule of reason assessment.

92. If such guidelines are to serve the purpose of providing guidance to business and facilitating the conclusion of genuinely beneficial co-operation arrangements, then the guidelines have to be substantive and provide a decisive framework that can be used by business. As the EC Guidelines indicate, the guidelines should provide a proper framework for how arrangements will be analysed with the purpose of guiding business.

"The purpose of these guidelines is to provide an analytical framework for the most common types of horizontal co-operation agreements; …. This framework is primarily

based on legal and economic criteria that help to analyse a horizontal co-operation agreement and the context in which it occurs. Economic criteria such as the market power of the parties and other factors relating to the market structure form a key element of the assessment of the market impact likely to be caused by a horizontal co-operation agreement and, therefore, for the assessment under Article 101.

Given the potentially large number of types and combinations of horizontal co-operation and market circumstances in which they operate, it is difficult to provide specific answers for every possible scenario. These guidelines will nevertheless assist businesses in assessing the compatibility of an individual co-operation agreement with Article 101."

93. The approach of drawing on existing EU guidelines is premised on the fact that the richer case law in the EU means that such guidelines are reflections of law and the underlying economic principles. As the Commission's guidelines should similarly aim to reflect law and not make law, drawing on a richer history of precedent in a jurisdiction that has a similar philosophy around enforcement enables the Commission to issue guidelines despite the limited case law on these issues domestically.

EXEMPTIONS

94. Exemptions have been incredibly scarce in SA historically. This may be the result of a new regulator which lacks the confidence to be decisive as to which arrangements may warrant exemption once weighing up the anti-competitive effects against the potential benefits. The lack of advisory opinions historically is also consistent with the view that the Commission has lacked the confidence in their own technical ability to be decisive on matters such as exemptions and guidelines. As a matter of practice this needs to change if beneficial arrangements are not to be stifled once penalties are extended to all provisions in the Act.

95. However, it may also be a result of the narrower set of criteria for exemption than is typically present in both economic thinking and other parts of the Act which engage in a weighing up process. For this reason we welcome the adjustments to subsection 3, and especially the addition of subsection 3(v) which expands the basis for exemption to include arrangements that are on balance pro-competitive. This brings it in line with economic thinking which suggests a weighing up should take place in order to determine the net effect on competition. After all, such weighing up is present in all other parts of the Act (such as merger control and abuse of dominance) except hard-core cartel activity. This would also bring it in line with best practice globally where a rule of reason approach is adopted in an exemption process.

96. However, the exemption regime still needs changes if it is to serve the important purpose of permitting arrangements that are beneficial to economic development and support for public interest objectives.

RECOMMENDATIONS

The practice of the Commission needs to change such that it is more willing to consider and grant exemptions where appropriate.

97. The Commission has always had the powers to grant exemptions albeit on more limited grounds and yet has elected not to do so. Changes to the legislation may remove one

source of inaction but a beneficial exemption regime outcome also relies on removing the other blockage which is the Commission's reticence to grant such exemptions.

There should be scope for the Commission to issue block exemptions within section 10 in the event that the section does not support such a practice. It is not apparent whether section 10 can accommodate block exemptions given that such exemptions are initiated by the Commission to a whole class of arrangements unlike the application process envisaged in the amendments.

98. Block exemptions are capable of creating legal certainty for whole classes of agreements which are typically not considered problematic. Such provisions have historically been used extensively in other jurisdictions such as the EU, especially to permit arrangements amongst firms that may lack market power and therefore pose little risk of substantial lessening of competition.

99. Such exemptions are typically (and appropriately) set extremely conservatively, involving market share thresholds where considered economic opinion is that no possible lessening of competition can occur. However, in doing so it provides legal certainty to a large number of firms which enables them to proceed with such type of arrangements if they are beneficial and not be held back by risk or the need to go through a lengthy and costly exemption exercise.

100. <u>As a matter of practice, the Commission should consider starting with the EC block exemptions as these are informed by a longer history of competition law and the economics literature, and then engage in a process of adjusting these to appropriately reflect the specific South African economic context and public interest objectives as contained within the exemption provisions.</u>

The provision contained in section 10(10) which provides the Minister with the power to grant exemptions is both unnecessary and undesirable, and should be removed.

101. It is <u>unnecessary</u> as the Commission process is able to process any such exemption applications. If the Minister has in mind some class of exemption that would fall outside of the Commission process then this needs to be clarified. However it is not apparent to us this is the case. If the rationale is that the Commission has been reticent to grant exemptions then the solution lies in facilitating a change in practice at the Commission as outlined above.

102. It is <u>undesirable</u> because it creates a parallel process to that of the Commission exemption process for businesses. This can only result in unhealthy forum shopping by business, and is also open to abuse as a Ministerial decision is neither transparent nor subject to the same disciplines that would apply to an independent regulatory agency such as the Commission.

OTHER ECONOMIC PROVISIONS

SECTION 4 - COLLUSIVE BEHAVIOUR

104. The only proposed amendment is the addition of ‘market shares’ to the list of market division activities. Whilst this may provide greater clarity from a legal perspective, it has always be considered a form of collusion in the economics literature and formed part of enforcement practice in our experience. Indeed, such a practice is primarily seen as a means to soften price competition (aggressive pricing would result in market share growth) and therefore may be seen to already be catered for under section 4(1)(b)(i) – directly or <u>indirectly</u> fixing a purchase or selling price. There is therefore no objection to its inclusion.

SECTION 8 – ABUSE OF DOMINANCE

Refusal to supply scarce goods

105. This provision is extended to include services as well as goods, and to include all customers and not just competitors. Our understanding is that the extension to all customers is designed to include instances where the upstream dominant supplier is not present downstream but its behaviour still has a distortionary effect on competition in the downstream market. Whilst economic theory suggests that the upstream firm is unlikely to have such an incentive and therefore such cases are likely to be extremely rare, its inclusion is not objectionable in itself.

Predatory pricing

106. The proposed amendment seeks to replace the use of marginal cost with average avoidable cost (“**AAC**”) as one of the tests for predation. As our submission on the draft Bill indicated, the use of average avoidable costs is in line with both economic thinking and practice in other jurisdictions such as the EU. It also provides more protection for smaller firms as it requires prices to reflect product-specific fixed costs, which average variable costs do not.

107. <u>However, the definition of AAC contained in the amendment does not align to the definition commonly applied by the economics literature in the context of predation assessment, and in fact aligns more with a Long Run Average Incremental Cost (“**LRAIC**”) standard which our initial submission demonstrated was not appropriate.</u>

108. In particular:

    108.1. The proposed definition of AAC under section 1 is "*the sum of all costs, including variable costs and product specific fixed costs, that could have been avoided if the firm <u>had not</u> produced an identified amount of <u>additional</u> output*". The problematic words are underlined.

    108.2. A possible interpretation of this definition is that costs are calculated assuming a scenario of output moving from zero to an identified level. In other words, the incremental costs of establishing production of the product or service <u>in the first</u>

place. Under this interpretation, costs could then include unrecoverable sunk costs incurred in initially establishing production (which is a component of LRAIC).

108.3. However, the correct approach to determine if the dominant firm has engaged in a profit sacrifice that is predatory is to start from a position where production is already occurring (and therefore at an identified level already) and to assume that output moves from the current identified level to zero. This is correct because it starts from the correct position, namely that the dominant firm is already active in the market. The difference is that this measure correctly excludes the unrecoverable sunk costs in producing the output which would not factor into a profit sacrifice.

RECOMMENDATION

Accordingly, the definition of AAC in section 1 should be revised as follows:

"Average avoidable cost" means the sum of all costs, including variable costs and product specific fixed costs, that could have been saved if the firm ceased producing the identified amount of output.

Margin Squeeze

109. The amendment includes margin squeeze as a named abuse under the section 8(1)(d).

109.1. The EC states that a margin squeeze occurs where "*a dominant undertaking charges a price for the product on the upstream market which, compared to the price it charges on the downstream market, does not allow even an equally efficient competitor to trade profitably in the downstream market on a lasting basis.*"[58]

109.2. Similarly, the OECD defines a margin squeeze as "*when the margin between the price at which the integrated firm sells the downstream product and the price at which it sells the essential input to rivals is too small to allow downstream rivals to survive or effectively compete, to the detriment of downstream consumers.*" [59] The competition problem is that downstream rivals are excluded and competition reduced.

110. Furthermore, in order for a margin squeeze to occur, it is generally accepted that three preconditions need to be present, namely:

"First, an upstream firm must produce an essential or bottleneck input with no substitutes and no scope for other firms to provide the essential input themselves. Second, that firm must sell that essential input to one or more downstream firms which seek to use that input in the provision of some downstream product or service. Third, the upstream firm must itself use its own input to compete against those downstream firms in the market for that downstream product or service."[60]

111. Margin squeeze has always been recognized as an abuse in the economic literature and other jurisdictions. Indeed, margin squeeze is considered a relatively common abuse in recently liberalised markets because of the existence of a former state monopoly as sole

[58] European Commission — Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings (2009/C 45/02), par 80.
[59] OECD Policy Roundtable, Margin Squeeze, DAF/COMP(2009)36 09-Sep-2010.
[60] OECD Policy Roundtable, Margin Squeeze, DAF/COMP(2009)36 09-Sep-2010.

supplier of essential upstream infrastructure inputs to newly introduced downstream retail firms. Furthermore, the Tribunal has already dealt with a number of margin squeeze cases, but has done so under section 8(c) which deals with unspecified exclusionary acts.[61] In so doing, the Tribunal has also endorsed the nature of the offence and the preconditions as outlined above.[62] Therefore the inclusion of margin squeeze as a named offence is itself nothing novel or objectionable.

112. However, the definition of margin squeeze incorporated into the amendments is incorrect and incorporates a far broader possible range of foreclosure strategies than the actual economic definition of the offence as is also articulated in other jurisdictions.

112.1. The proposed amendments define margin squeeze as "*the exploitation by a vertically integrated firm of its position of dominance in an input market to restrict competition in a downstream market*".

112.2. This definition can reasonably be interpreted to encompass any action by a vertically integrated firm to exclude downstream rivals and is not limited to a squeeze on the downstream rival's margin through wholesale and retail pricing practices.

113. We do not understand the rationale for the amendments failing to define margin squeeze in the manner commonly understood as such a definition was no doubt available to the drafters. However, whatever the reason, we consider it both inappropriate and unnecessary to use the current definition in the amendment.

113.1. It is inappropriate because the offence of margin squeeze does specifically relate to a squeeze on the margin of downstream rivals as opposed to any other actions taken by a vertically integrated firm.

113.2. Furthermore, a broader definition is unnecessary as other known abuses by vertically integrated firms are already captured by other parts of section 8(1)(d) or serve to be captured under the general exclusionary provisions of section 8(1)(c).

RECOMMENDATION

We therefore recommend that the definition of margin squeeze be amended to be aligned with the accepted economic understanding of the offence as reflected in the definitions used by the EC or OECD above. For instance, it may be formulated as follows:

"*Margin squeeze" means that the margin between the price at which a vertically integrated firm sells the downstream product and the price at which it sells the essential input to rivals is too small to allow downstream rivals to survive or effectively compete.*

SECTION 12 - MERGER CONTROL

114. The amendments to the merger control provisions seek to clarify the weighing up of public interest provisions as per settled case law, add certain further considerations to the list of factors to be considered in the competitive assessment, likewise for the public interest assessment and finally to deal with creeping mergers.

[61] Competition Commission v Senwes Case NO: 110/CR/Dec06 par 168.
[62] Ibid par 117 and 139.

115. **Cross-shareholding and common directors.** To the extent that the addition of cross-shareholding and common directorships provide for greater disclosure and transparency of these factors in merger filings, and ensure systematic analysis by the Commission and Tribunal then they are to be welcomed. These factors have the potential to restrict competition and hence should form part of merger assessment (and in our experience already are), but they also may not result in competitive harm and hence are factors to take into account in an SLC assessment as per section 12A(2) but not determinative in any way.

116. **Merger creep.** The consideration of '*any other mergers engaged in by a party to a merger*' as a factor in merger assessment is designed to address the concern that merger control is not effective in dealing with many small merger transactions which may individually fail the SLC test (as each acquisition is not substantial) but cumulatively may have a material effect on the structure of a market. This concern is likely to be isolated to some fairly unique circumstances, such as markets where substantial numbers of small market players may exist making such a strategy possible (e.g. hospital markets).

117. We agree that there needs to be a means to address such 'merger creep' where it arises, even if it is only in exceptional cases. However, it is also important that such analysis is subject to proper disciplines and rigorous analysis in order to isolate effectively where there is a genuine concern from where there is not. This is important as the intention is to effectively halt merger activity of particular firms even if the incremental merger may not lessen competition.

118. <u>Such disciplines are probably best left to emerge through case precedent as guidelines at this stage may simply reflect the intentions of the Commission and not settled law.</u>

119. **Public interest factors.** The additions to the public interest provisions seek to align the factors for consideration more closely to the wording in the purpose of the Act (s2). The challenge will be how these factors are given specific expression in the merger provisions rather than as part of a general purpose to be addressed by the full suite of competition law provisions. Our presumption is that this will develop through case precedent and it is unnecessary to provide more clarity or guidelines at this stage.

SECTION 21A - IMPACT STUDIES

120. The proposed amendments seek to include a new s21A in order to provide the Commission with powers to request information in order to undertake impact studies of previous decisions by any of the competition institutions (Commission, Tribunal and Appeal Court). The proposed amendments stipulate that these studies must then be submitted to the Minister, who in turn must submit them to the National Assembly.

121. Impact studies are capable of providing valuable insights into the functioning of certain markets and the efficacy of different types of remedies deployed in both merger and abuse cases. It is for this reason that we have actively encouraged greater use of such *ex-post* assessments in order to improve future decision-making by the competition authorities.[63] As the insights to be gained from such studies depends on the quality of information and data available, providing some powers to source such information may be appropriate.

[63] Alves, P. and Fiandeiro, F. 2016. Ex-Post Evaluations As Learning Opportunities, *Prepared for the 10th Annual Conference on Competition Law, Economics and Policy (University of Cape Town, South Africa)*

RECOMMENDATIONS

We do think this provision should incorporate some procedural requirements in order to strengthen the credibility of such studies. In particular we are of the opinion that a draft impact study should be provided to the firm (or group of firms) that form the focus of the study to permit them to comment on the study before it is finalised and published. Such a practice is already in place for market inquiries and is formally included in the new section 43E(4) & (5).

122. The purpose of such a provision would not only be about due process.

122.1. Such quality control measures do not impinge on the right of the Commission to its own interpretation of data or events, but does ensure that the contents of the study are substantially sound, free from incorrect assumptions, data or analysis prior to finalisation. It is typically the case that firms in the industry are in a position to identify such errors, or provide further context to certain outcomes that might otherwise be inferred without insider knowledge.

122.2. This is important in the context of an impact study because such a study may well influence the views and hence future decisions of the Commission or Tribunal, and therefore should reflect a high quality of output.

In addition, we think the practice (rather than the legislation) could be strengthened by the Commission (and Minister) having some form of selection process for determining which impact studies to undertake.

122.3. This is desirable in order to provide some prioritisation and efficient allocation of Commission resources to impact studies that are likely to deliver important insights on material issues for future decision-making by the authorities. Such a process not only ensures appropriate prioritisation, but it may also provide a sound basis for any information requests and their assessment by the Tribunal as per the new s21A(7).

122.4. Factors may include where the market dynamics in an industry are poorly understood or contested making merger control difficult, or where concerns have been expressed over the efficacy of certain types of behavioural remedies.

SECTION 43A - MARKET INQUIRIES

123. The stated objectives of the proposed amendments to the market inquiries provision is to enhance the process, in large part through strengthening the powers of the Commission to impose remedies, and also to bring a more explicit focus on the effect of market features on SMEs and HDP firms.

124. As we noted in our submission on the draft Bill, many of the proposed changes relating to substantive economic issues such as what the Commission must decide in a market inquiry, and what competition test to apply are clearly and in several instances very closely based on the UK Enterprise Act (2002, Part 4, Chapter 1), and the UK's 2013 guidelines for market investigations.[64] As such, the proposed amendments would place on the Commission a set of obligations that are very similar to those applicable to the

[64] UK Competition Commission. 2013. "Guidelines for market investigations: Their role, procedures, assessment and remedies."

UK's CMA. As the UK CMA has been a leader in market inquiries to improve competitive outcomes, such provisions would therefore largely be unobjectionable.

125. Our primary concerns of a substantive economic nature with the initial draft Bill was the lack of a definition for an appreciable effect on competition ("**AEC**"), a lack of clarity as to how the concerns around SMEs/HDP firms were to be incorporated into an AEC test, the requirement to remedy every AEC found, and no strong proportionality requirements for remedies proposed.

125.1. The first issue is largely one of both certainty as to the test, but also that the test is appropriately one of protecting competition not competitors even when applied to SMEs / HDP firms.

125.2. On remedies, it is well accepted in economics and the field of regulation that remedies may result in unintended consequences or impose significant implementation costs (on the regulator or the regulated). It is for this reason that in many instances the requirement for a regulatory impact assessment is stipulated on a regulator or administrative department. The purpose of such an exercise is to precisely determine whether a remedy is appropriate considering a full cost-benefit and risk assessment. In some cases the treatment is worse than the disease and regulation is not appropriate. However, even where a remedy is imposed, additional disciplines such as being no more restrictive than necessary are also advocated by economic theory.

126. The Bill before Parliament incorporates changes that essentially address these concerns.

126.1. The AEC test (section 43A(1)) as well as what has to be decided by the Commission (section 43C(1)) are taken almost directly from the UK CMA Guidelines with the only modification being the replacement of "prevent" with "impede". This appears to be largely semantics rather than real substance. The UK CMA Guidelines state the following:

"28. The CC is required to decide 'whether any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of goods or services in the United Kingdom or a part of the United Kingdom'.

29. If that proves to be the case, under the Act this constitutes an AEC (see paragraphs 19 and 26). The CC interprets the phrase 'prevents, restricts or distorts' in the Act broadly to cover any adverse effect on competition, whether actual or potential. It will therefore consider features that affect potential competition in a market (for example, by preventing entry and expansion) as well as those that affect the existing market situation.

30. The Act does not specify a theoretical benchmark against which to measure an AEC. In its market investigation reports the CC uses the term 'a well-functioning market' in the sense, generally, of a market without the features causing the AEC, rather than to denote an idealized, perfectly competitive market."

126.2. Section 43C(2) now makes clear that the same AEC standard is applied to SMEs and HDP firms, but that the Commission is directed to specifically consider these.

126.3. Section 43D(1) now only stipulates that the Commission "may" take remedial action rather than "must" take such action.

127. Our remaining submissions are targeted at making the market inquiry process more effective.

RECOMMENDATIONS

We think the practice (rather than the legislation necessarily) could be strengthened through a more robust selection process that prioritises markets where there is likely to be greater impact on consumer welfare than others, and which also gives much greater consideration to the scope of the inquiry prior to being initiated. This is essential given the limitation on Commission resources and the need to generate an impact quickly. Some examples are useful in illustrating this need.

128. Our initial submission highlighted a few considerations that might be relevant to the selection process.

128.1. Are competition problems likely to exist given the structure of the market, the nature of barriers to entry, the existence of a history of collusion, or other standard competition screening measures? Has the Commission received a substantial number of complaints about the market concerned?

128.2. Would the benefits of intervention be material? Some considerations relevant to this question include the size of the market, its importance into the future, and the consumer groups affected by potential competition problems (e.g. low income consumers).

128.3. Would intervention promote the economic policy objectives of the government, including the acceleration of growth and the reduction in inequality, poverty, and unemployment?

128.4. To these we would also add, whether other regulators are in the process of assessing these markets with the intent to take appropriate regulatory action. For instance, the recent data inquiry substantially overlaps with the work programme of ICASA which is finalising its own priority market study. Furthermore, as ICASA has its own legislated process requirements for imposing regulations, any recommendations from the Commission inquiry on regulations would still need to go through an ICASA process to be enacted.

129. The scope of the inquiry also deserves careful prior research and consideration. This is because overly broad terms of reference can sometimes waste resources investigating large parts of an industry where there are few issues and limited potential to impact on outcomes, and in so doing also delay the important outcomes.

129.1. For instance, it is not necessary that an inquiry investigate entire industries rather than quite specific narrower markets. The Health Market Inquiry ("**HMI**") is a case in point where the scope may have been overly broad in the context where it was known that the key issues were in certain provider markets. The result has been an extremely lengthy process that ultimately focuses recommendations on such provider markets. The vast coverage of the Public Passenger Transport Market Inquiry means it risks going the same way as the HMI.

129.2. Similarly, in the context where the Commission is bound to finish market inquiries within 18 months, inquiries that have not been properly considered prior to initiation may spend a considerable time and resources in the beginning trying to determine the relevant issues. The Data Market Inquiry is such a case where it seems to have been initiated quickly in response to consumer pressure but with no real consideration of the issues involved or the fact that ICASA was essentially embarking on a similar path.

We believe that as a matter of practice (or law), other regulators or government departments should publicly respond to recommendations that require their action, including whether or not action will be taken and if not, to explain why not.

130. Whilst the market inquiry provisions provide scope for the Commission to impose remedies, it cannot empower the Commission to require other entities (departments or regulators) to implement any recommendations that lie within their domain. This does affect the effectiveness of market inquiries as existing regulations are often the source of many of the AECs found in market inquiries, which similarly require action by other regulators or policy-makers to change or remove.

131. Despite the jurisdictional challenges that exist between the Commission and other organs of state, it may still be possible for the proposed amendments to create or encourage a structure whereby other regulators, or policymakers, are required to at least engage publicly with the Commission's recommendations. For example, in the UK the following commitment was made[65]:

"*The Government has made a commitment to give a public response to any recommendation made to it within 90 days of the publication of a CC report. In its response, the Government will set out where it does or does not propose to make changes in light of the report, or where it proposes to consult on options. The Government will take into account all public policy and welfare considerations, including considerations of Better Regulation, in making its assessment.*" [emphasis added]

[65] UK Competition Commission. 2013, para. 95.