

## 2 Excessive Pricing in Competition Law: Never say Never?

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### 2.1 Introduction

In an article written for the European Competition Law Conference in 2003,<sup>1</sup> we discussed the treatment of excessive pricing in the European Union, commented upon the case-law, and indicated which exceptional circumstances might in our view justify resorting to excessive pricing actions. We proposed a four-condition test: (1) high and non-transitory barriers to entry leading to a monopoly or near monopoly; (2) this (near) monopoly being due to current or past exclusive or special rights; (3) no effective means to eliminate the entry barriers; and (4) no sector regulator being competent to regulate the excessive prices.

Since 2003, our paper has been followed by many others, some proposing a more lenient test for the competition authority to intervene<sup>2</sup> while others suggesting a stricter test of intervention.<sup>3</sup> Excessive pricing has been discussed more and more for at least two reasons. The first one is that the European Commission is reconsidering its policy on Article 82 of the EC Treaty, and although exploitative practices have not been addressed yet in its policy

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<sup>1</sup> See Motta and de Stree (2006).

<sup>2</sup> Among others: Fletcher and Jardine (2007), Paulis (2007), Röller (2007).

<sup>3</sup> Among others: Evans and Padilla (2005).

documents, it is well known that the Directorate General for Competition plans to deal with them in the future Guidelines on Article 82 enforcement.<sup>4</sup> The second reason is that dissatisfaction with the outcome of the liberalisation process (more particularly with the high level of prices in many recently privatised and de-regulated sectors, as for instance energy),<sup>5</sup> which has taken place in Europe has led many policy-makers – both at the level of Member States and at the EU level – to call for drastic measures of intervention, including structural remedies (for instance unbundling in energy and telecommunications) and price controls.

In this paper, we come back to the issue by summarising our previous contribution and especially by discussing our policy proposal, in the light of recent developments. We limit our analysis to excessive prices which directly exploit the consumers where, as we show, the conditions for antitrust intervention should be very strict. We do not deal with exclusionary excessive prices (which often take the form of price squeezing) where the conditions for antitrust intervention may be less strict.

The paper is organised as follows. After these introductory remarks, Section 2.2 sets very briefly the legal framework of exploitative abuses. Then Section 2.3 proposes a three condition screening test to determine the markets that are candidates for intervention of excessive pricing actions. Section 2.4 deals with the standard of proof for the excessive pricing. Section 2.5 deals with the choice of the efficient remedy. Finally, Section 2.6 concludes with some recommendations for an efficient dealing of excessive pricing.

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<sup>4</sup> Lowe (2007).

<sup>5</sup> Communication from the Commission of 10 January 2007, Final Report of the Sector inquiry into the European gas and electricity sectors, COM(2006) 851; van der Woude (2007).

## 2.2 The legal framework

Article 82(a) of the EC Treaty explicitly prohibits a dominant firm<sup>6</sup> from “directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions”. Since most Member States’ competition laws are borrowed from the EC Treaty, similar provisions exist throughout the EU’s national jurisdictions as well. Since in the US the case law excludes the possibility of using excessive pricing actions,<sup>7</sup> this is an area of antitrust where there is a wide divergence between the two sides of the Atlantic.

Although excessive price actions have been relatively rare, the case law of the Court of Justice helps understanding what an excessive price is and how it can be proved.

Since its well-known *United Brands* case, the Court of Justice established that a price is unfair when a dominant firm has “exploited” its dominant position so as to set prices significantly higher than those which would result from effective competition. Hence, a price is excessive and unfair when it is significantly above the effective competitive level, or above the economic value of the product. This should correspond, in the Court’s view, to the normal competitive level. Indeed, in *United Brands* the Court stated that:

249. It is advisable therefore to ascertain whether the dominant undertaking has made use of the opportunities arising out of its dominant position in such a way to reap trading benefits which it would not have reaped if there had been normal and sufficiently effective competition.

250. In this case charging a price which is excessive because it has no reasonable relation to the economic value of the product would be an abuse.

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<sup>6</sup> A firm holds a dominant position if it possesses enough market power to behave to an appreciable extent independently of the competitors, customers and ultimately consumers. Case 27/76 [1978] ECR 207, para. 65.

<sup>7</sup> *United States v. Trans-Missouri Freight Ass.*, 166 U.S. 290 (1897); *United States v. Trenton Potteries Co.*, 273 U.S. 392 (1927); *United States v. Aluminium Co. of America*, 148 F.2d 416 (2d Cir. 1945).

## **2.3 A screening test to take an excessive price action**

In this section, we discuss which markets are candidates for intervention of excessive pricing actions. First, we briefly recall the pros and cons of using excessive pricing actions within competition law. Second, we review the main tests that have been proposed so far by different commentators. Third, we identify some exceptional circumstances under which it may make sense to resort to competition law's provisions on excessive prices. Fourth, we check whether our exceptional circumstances test corresponds to the case-law and decisional practice in the European Union.

### **2.3.1 The Pros and Cons of using excessive pricing actions**

There are several well known objections against the application of competition law to excessive pricing cases.<sup>8</sup>

- i. Excessive price actions may undermine the investment incentives of new entrants. Indeed, competition law applies to sectors where in principle market forces are free to operate. Unlike sectors characterised by legal barriers to entry or where market failures are such that one cannot assume that competition works, competition authorities deal therefore with sectors where one can presume that free entry should be able to erode over time dominant positions. To some extent, prices also play an important role in this process, as they convey signals to potential entrants: in particular, high prices may indicate that a market is profitable, and trigger entry into the industry, thereby reducing the market power of a

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<sup>8</sup> See also Fletcher and Jardine (2007), O'Donoghue and Padilla (2006: 621-628), Röller (2007).

dominant firm and decreasing prices. Excessive pricing actions may therefore have the effect of breaking this process, and while in the short run they might be beneficial in that they could reduce prices, in a long run perspective they would be detrimental because they may impede entry that could otherwise take place (the objection is all the more important if one considers that excessive price actions are unlikely to be repeated over time). Furthermore, this may also have the effect of depriving consumers of more variety, to the extent that new entrants would supply substitutable but different products and services with respect to those of the dominant firm.

- ii. Excessive price actions may also undermine the investment incentives of the dominant firms. High prices and profits should be seen in general as the reward for a firm's efforts, innovations and investments, and firms indeed invest and innovate precisely because they are able to appropriate the benefits from their risky investments. Hence, however beneficial excessive price interventions may be *ex post*, if a competition authority pursued a policy of resorting to excessive pricing actions, this policy would have important negative effects *ex ante*, by lowering expected returns, and therefore discouraging firms' investments in all the economy.<sup>9</sup> This objection is particularly relevant in highly dynamic industries where innovation plays a crucial role.
- iii. Another common objection to the use of excessive pricing actions by competition authorities is that it is extremely difficult to determine whether a price is excessive. This leads to unclear criteria for the standard of proof (see section 1.4) and therefore, an important legal uncertainty for the firms, which may in turn undermine investments incentives.

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<sup>9</sup> This important conflict between *ex ante* and *ex post* approaches has been explicitly recognised by the Advocate General Jacobs in his Opinion in Case C-7/97, *Bronner* [1998] ECR I-7791.

- iv. In addition, price regulation may have a strong “political” dimension, in the sense that politicians, under the pressure of consumers/electors, may want to have low prices for basic goods or services. They may then require that the Administration or the independent antitrust authority regulates the prices, although there is no market failure justifying such intervention. Some may argue that it is better for the antitrust authority to come in because it would create less damage to the market mechanisms than the Administration which may be less in tune with market economics. We disagree and consider that, outside market failure, an antitrust authority lacks political legitimacy to intervene on the market.
- v. Finally, US law focuses solely on exclusionary abuses (being by a dominant company or not) and does not intervene in case of mere exploitative abuses. In order to harmonise competition policy across jurisdictions, EU law may then ignore exploitative abuses.

An additional common objection against excessive price action is that it would lead to price regulation, which is difficult to implement. Indeed, intervening in an occasional way on the price set by a dominant firm does not solve the problem forever (on the contrary, to the extent that it may discourage entry, it may even exacerbate it and make it permanent). As a result, either the competition authority or the Court continues to monitor the industry – but in this way it would convert itself into a *de facto* regulator and would have to sacrifice important resources – or would have to resign to see its intervention as ineffective, since market conditions change over time and the dominant firm would adjust its prices to them. Moreover competition authorities – unlike sectoral regulators – have no experience and no role in telling firms which prices they should charge. However, the objection is not always convincing as the finding of an abuse and the choice of remedy should be kept separate. Indeed, there are other ways – and often more easily

implemented and efficient ways- to deal with an excessive price abuse (see section 1.5 on remedy).

On the other hand, there are also arguments in favour of the application of excessive pricing cases.<sup>10</sup>

- i. Exploitative abuse is the most direct violation of the consumers' interest that antitrust policy aims to protect and there are some exceptional circumstances where the structure of the market and the institutional design would lead to an excessive price that could only be remedied by competition law.
- ii. With a carefully calibrated policy, it is possible to alleviate some of the difficulties mentioned above. In particular, it might be possible to avoid that intervention could undermine the investment incentives of the new entrants and of the dominant companies.

Thus,<sup>11</sup> those Pros and Cons imply that an antitrust excessive price action presents a *high risk* of type I (false condemnation) and a *high risk* of type II (false acquittal) errors. At the same time, such action presents a relatively *high cost* of type I error (because the market may self-correct and error will lead to dynamic inefficiency: low investments and innovation) and a relatively *low cost* of type II errors (allocative inefficiency). Thus, an optimal competition policy should provide for strict conditions to determine candidates markets for intervention as well as a high standard of proof.<sup>12</sup>

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<sup>10</sup> See also Fletcher and Jardine (2007), Lyons (2007). Choné points to us an additional argument in favour of excessive price action. In markets where there is a risk of excessive entry because of expected very high return (due for instance to network effects), it may be efficient for the antitrust authority to commit ex ante to regulate price, hence limiting the incentive to enter.

<sup>11</sup> See Evans and Padilla (2005).

<sup>12</sup> Because of the important cost of type I error, in particular in terms of deterrence effects, Fletcher and Jardine (2007) suggest (in addition to strict

This is even more the case because the resources of the competition authorities are limited and are in general more efficiently allocated when dealing with exclusionary abuses rather than the exploitative abuses.

### 2.3.2 The different tests proposed so far

Several commentators have recently proposed conditions for an antitrust authority to take anti-competitive price actions.

The strictest test has been proposed by Evans and Padilla (2005:119) who suggest that three conditions should be met for the antitrust authority to intervene (1) the firm enjoys a (near) monopoly position in the market, which is not the result of past investments or innovations and which is protected by insurmountable legal barriers to entry; (2) the prices charged by the firm widely exceed its average *total* costs; and (3) there is a risk that those prices may prevent the emergence of new goods and services in adjacent markets.

O'Donoghue and Padilla (2006: 638) suggest a slightly less restrictive three-condition test. For them, intervention should be restricted to industries: (1) protected by high barriers to entry; (2) where one firm enjoys considerable market power; and (3) where investment and innovation play a relatively minor role.

Röller (2007) proposes a five-condition test: (1) there are significant entry barriers, (2) the market is unlikely to self-correct, (3) the dominant position was due to exclusionary abuse or government actions, (4) there is no regulator or there is a regulatory failure, and (5) no (structural) remedy is available.

Along the same vein although more nuanced, Fletcher and Jardine (2007) suggest a policy approach which would (1) limit intervention when there is no possibility of successful new entry

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rule for intervention and high burden of proof) to limit available remedies by excluding the possibility of fines and private damages in case of excessive price actions.

within a reasonable period and commit to no intervening during the patent period, (2) consider carefully the pricing and competition in the other markets of the dominant firm's portfolio and the effect of any *ex post* intervention on *ex ante* investment incentives, (3) seek alternative structural remedies to price regulation and, in any case, exclude fines and private damages.

Paulis (2007) proposes the least restrictive test arguing that there is only one reasonable criterion to identify markets that could be candidates for interventions against excessive prices: the presence of very high and long lasting barriers to entry and expansion.

### **2.3.3 A three condition screening test for using excessive pricing actions**

Because of the high risk and cost of type I error, we believe that extreme caution should be exercised in the use of excessive pricing actions. Yet, there may be some very exceptional circumstances where such actions may be justified. Those exceptional circumstances may be captured in a three condition screening test: the two first conditions relate respectively to the level and the origin of the market power of the investigated firm whereas the third one relates to institutional design of the sector.

**Condition 1: High and non-transitory entry barriers leading to a super dominant position**

To start with, consider that most of the arguments made above follow from the assumption that a sector subject not to regulation but to general competition law is a sector where market forces are free to operate and one expects the competitive process to work more or less well. Yet, there may be sectors where, for different reasons, this may not be the case.

This leads us to the *first necessary (but not sufficient) condition* for using excessive pricing actions in competition law, that is, *the*

*presence of high and non-transitory barriers to entry.* Given the objections against excessive price actions, the threshold for intervention should be higher than a mere dominant position and close to a super dominant position where the undertaking should have very important market share.<sup>13</sup> In this case, we would have a monopolist (or quasi-monopolist) whose position is not likely to be challenged by entrants. Since one cannot expect market forces to operate normally, some of the objections against excessive price actions may therefore not apply.

In this context, a particular question is whether excessive prices actions could be taken in case of joint or collective dominance. Lately, there has been a temptation to use such actions to deal with cases where firms are engaging in tacit collusion. We feel this is not appropriate because it would add two instances where the risk and cost of type I errors are particularly high. Indeed, it is very difficult for an antitrust authority to discriminate between collusive and non collusive outcomes when there is no agreement or facilitating practices, and it is very difficult to discriminate between competitive and excessive prices. Thus when the market structure is unsatisfactory and leads to presumed excessive prices, the government may want to set up a regulator to change the market structure or permanently regulate the prices, but the antitrust authority should always refrain given the high risk of costly errors.

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<sup>13</sup> The super dominance concept has been explicitly recognised by in Point 136 of the Opinion of the Advocate General Fenelly in Joined Cases C-385/96P and C-396/96P *Compagnie Maritime Belge* [2000] ECR I-1365. The Court itself has never recognised the concept but refers several times to quasi or near monopoly: in *Compagnie Maritime Belge*; Case C-333/94P *Tetra Pak II* [1996] ECR I-5951, para 28-31; Case T-228/97 *Irish Sugar* [1999] ECR II-2969, para 185

Condition 2: The super-dominant position is due to current/past exclusive/ special rights or to un-condemned past exclusionary anticompetitive practices

Another important objection to the use of excessive price actions moved from the consideration that high prices and profits should be seen as the reward for firms' risky investments and innovations (and, which is the same, that it is the expectation of charging high prices and earning high profits which push firms to invest and innovate). Therefore, dominant firms should be treated in a different way according to the source of its market power and whether such power is due to their effort, business acumen, and risky investments, or is instead due to current or past protection and legal barriers or un-condemned past exclusionary anticompetitive practices.<sup>14</sup> In our opinion, therefore, the *second necessary (but not sufficient) condition* for using excessive pricing actions in competition law, is that *the dominant position is due to current or past exclusive or special rights or un-condemned past exclusionary anticompetitive practices*.

Our second condition eliminates all those possible cases where entry barriers are high and non-transitory (that is, the first condition fulfils), but where the persistence of a monopoly situation is the result of innovations or investments made in the past. It is no mystery that the existence of large endogenous sunk costs, switching costs, and network effects might allow a firm to enjoy a dominant position over time.<sup>15</sup> However, our second condition states that we should treat differently a firm which enjoys such a position because of risky investments made in the past or because of legal protection or un-condemned past exclusionary anticompetitive practices.

In the former case, which may well be the case of industries characterised by network effects, it is likely that the dominant firm is

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<sup>14</sup> Along the same line, Vickers (2005) arguing that the appropriate public policy towards firms with actual or potential market power depends on the cause of market power, and Röller (2007).

<sup>15</sup> See for a discussion chapter 2 of Motta (2004).

the winner of a competition *for* the market, where there has been an earlier phase of the market characterised by low prices and a battle to win the market, followed by a phase where the market has tilted in favour of a firm, which then enjoys a dominant position. In such a case, high prices in the later phase of the market are part of the normal competitive process, and it is indeed what moved rivals to fight for the market in the earlier phases of it. Intervening with an excessive price action does not seem to be justified.<sup>16</sup>

In the latter case where the dominant firm has been sheltered from competition, it would be impossible to argue that high prices are the reward for past investments or efforts, and there would accordingly be the conditions for an excessive pricing action.

This second condition is divided in two alternative tests. Under the first limb of the test, the super-dominance should be caused by current or past legal barriers and access in the market has not been granted in a fair and non discriminatory way. Those barriers may be due to the scarcity of indispensable resources (like spectrum for mobile telephony services), to natural monopoly characteristics, or – more critically- to lobbying efforts to get legal protection and create an economically unjustified rent.

In this context, a particular and difficult case is whether an excessive price action may be taken in case of an Intellectual Property Rights. In most cases, IPR laws protect worthy investments made by a firm, which in exchange enjoys a monopoly over the product or process for a certain length of time. Allowing excessive price action would undermine the very object of those IPR. Thus, we think with Fletcher and Jardine (2007) that any good or service

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<sup>16</sup> Paulis (2007) proposes a much more lenient condition. He argues that antitrust excessive pricing actions should be possible in case of legal but also natural monopolies. It is only when determining whether the price is excessive that the authority should then take into account the investment risks. For us, given the many objections against excessive prices actions, the condition should be stricter.

protected by Intellectual Property Rights should in principle not be subject to an excessive prices action.

The problem of course is when the antitrust authority thinks that the IPR is not justified because there is no investment to protect. Even in those exceptional cases, we think that allowing an excessive price action is not appropriate given the high risk and cost of type I error (but an exclusionary abuse action may be appropriate because it carries lower risk and cost of type I error). At the minimum, we think that if the antitrust authority intervenes, it should prove, in addition to the excessive price, that the allocation of the IPR was manifestly unjustified.

Under the second limb of the test, the super-dominance should be caused by un-condemned past exclusionary practices. Those may be due to the fact that company did not had a dominant position when doing its anticompetitive practices (hence under EU law, the antitrust authorities could not intervene) or that antitrust authority commit a type II errors and did not intervene where it should have done. Röller (2007) speaks of “gap cases” and “mistake cases”<sup>17</sup> respectively. However, analyzing whether the super-dominance was due to past exclusionary abuses should remain exceptional as it is extremely difficult to do.

**Condition 3: No sector-specific regulator has jurisdiction to solve the matters**

The two necessary conditions that we have identified so far (presence of high and non-transitory barriers; current/past exercise of special/exclusive rights or un-condemned past exclusionary anticompetitive practices) often apply to industries where there is a sectoral regulator. When this is the case, it is the regulator, rather

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<sup>17</sup> See also Paulis (2007) noting that “the fact that the EU statute does not prohibit the acquisition of dominance through unilateral abusive behaviour justifies a higher protection (than under US law) against direct exploitation of consumers by dominant firms.”

than the competition authority, which should be best placed for an intervention if competition does not work properly.

Nevertheless, in some cases there may be conflicts between the regulator and the competition authority, with the former being satisfied that prices are the 'right' ones and the latter arguing that they are too high. It would be difficult to say *a priori* who is right and who is not: the sectoral regulator may admittedly suffered a bias from a regulatory capture, but it may also have a longer-run perspective and see relatively high and stable prices as necessary to stimulate investments.

Such conflicts do occur, and are resolved in different ways across jurisdictions. For instance, in the US the prevailing view – after a more interventionist approach during the Seventies and the Eighties when Courts tended to show scepticism about the possibility that sectoral regulators would be able to constrain abusive antitrust practices on regulated firms – seems now to be that there is no additional role for antitrust intervention in industries where there is a sectoral regulator.<sup>18</sup>

The situation in Europe is very different because the competition law has a constitutional value that sector-specific regulation does not have and because the Commission may be tempted to use antitrust action to discipline and harmonise the actions of the national regulators.<sup>19</sup> Thus to decide how the conflict should be resolved, two views are opposed.<sup>20</sup>

Some argue that there is a need for a clear division of competences between antitrust and sectoral authorities to avoid

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<sup>18</sup> See *Verizon v. Trinko* 540 U.S. 398 (2004) and the discussion in Kovacic (2007),

<sup>19</sup> The Commission has recently taken two decisions against telecommunication incumbents for anti-competitive price squeeze, although those incumbents were partly regulated by national regulators: Commission Decision of 21 May 2003, Case 37.451 *Deutsche Telekom*, O.J. [2003] L263/9; Commission Decision of 4 July 2007, Case 38.784, *Telefonica*.

<sup>20</sup> On this issue, see Geradin (2004).

multiple layers of intervention against dominant firms. Following that view, the Commission or the national competition authority should not take an antitrust case when the national regulator has decided to intervene or not to intervene. That does not mean that antitrust law may be violated by sectoral regulator. Indeed if it were the case, the Commission may open an infringement procedure against the Member State of the national regulator for violating EU competition law. Moreover, the exploited consumers, or national competition authority when permitted by national procedural laws, may appeal to the national regulator's decision before a national Court.

Others argue that competition between antitrust authorities and sector regulators may be good. Moreover, infringement procedures are relatively long (three to four years) and there is a need for efficient way to ensure that antitrust law is respected.<sup>21</sup> Following that view, the Commission should intervene directly against the regulated dominant firm (provided the latter enjoys some margin of discretion within the regulatory limits imposed by the national regulator). However, this view is not fully convincing because when there is a disagreement between a competition authority and a sectoral regulator, one of the involved party has always an incentive to bring the matter before a Court. Thus, an antitrust decision will only delay the matter before it goes to the Court.

Thus we submit that in case of exploitative abuses (but not necessarily in case of exclusionary abuses), antitrust authority should abstain when a sectoral regulator has jurisdiction to act. At the minimum, we think that if the antitrust authority intervenes, it should prove, in addition to the excessive price, that the decision of the sectoral regulator was manifestly wrong.

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<sup>21</sup> Along those lines, Paulis (2007), Röller (2007).

Thus our *third condition to take an antitrust excessive price would be that there is no sectoral regulator having the jurisdiction to solve the matter.*<sup>22</sup>

### Comparison with the tests proposed so far

Thus the test we propose is less strict than the one of Evans and Padilla (2005) as we do not require that the excessive prices prevent the emergence of a new product or service. To us, this condition would be extremely difficult to implement and its restrictive role is not justified.

On the other hand, our proposed test is stricter than the one advocated by Paulis (2007) which focus only high and long lasting entry barriers and expansion. To us, this “qualified dominance” test is not sufficiently limitative given the importance of the risk and the cost of type I error as well as the scarce resources of the competition authorities that are often better allocated to exclusionary abuses.

Thus we are close to the test proposed by Röller (2007) or Fletcher and Jardine (2007) with one notable difference however. We think that if a sector regulator has the competence to intervene, there should be no antitrust intervention that would increase the regulatory burden on the dominant firms.

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<sup>22</sup> We take the existence of a sector regulator as exogenous. We think that the criteria to decide whether a regulator should be set up may be inspired by those that the Commission used to decide whether regulation is justified in the electronic communications sector: (1) high and non-transitory entry barriers, which may be of a structural, legal or regulatory nature, (2) no competition dynamic behind those barriers, (3) no efficiency of antitrust remedies to solve the market failures identified with the first two criteria: Article 2 of the Commission Recommendation of 13 November 2007 on relevant product and service markets within the electronic communications sector susceptible to *ex ante* regulation.

### 2.3.4 The proposed screening test and the case law

It is worth asking to what extent our proposed screening test above fits with the existing EU practice on excessive prices. The answer can only be preliminary because the practice so far is very rare but, at this stage, our test describes well the characteristics of the markets in which the Commission and the Community Courts have adopted excessive price actions,

Up to now, the Commission has only adopted six formal decisions as it does not want to behave a price regulator.<sup>23</sup> Most of those decisions related to exclusionary abuse. *General Motors* and *British Leyland*,<sup>24</sup> dealing with the price of motor vehicle certificate, are about preventing parallel imports and intra-brand competition. *United Brands*, dealing with the price of bananas in several European countries, is about discriminatory pricing.<sup>25</sup> *Deutsche Post*, dealing with the price of some international mail, is about preventing re-mail companies to enter the market.<sup>26</sup> Thus few Decisions (Port of

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<sup>23</sup> V<sup>th</sup> *Commission Report on Competition Policy* (1975), para. 76; XXIV<sup>th</sup> *Commission Report on Competition Policy* (1994), para. 207: "(...) the existence of a dominant position is not in itself against the rules of competition. Consumers can suffer from a dominant company exploiting this position, the most likely way being through prices higher than would be found if the market were subject to effective competition. *The Commission in its decision-making practice does not normally control or condemn the high level of prices as such.* Rather it examines the behaviour of the dominant company designed to preserve its dominance, usually directly against competitors or new entrants who would normally bring about effective competition and the price level associated with it" (emphasis supplied); XXVII<sup>th</sup> *Commission Report on Competition Policy* (1997), para. 77.

<sup>24</sup> Commission Decision of 19 December 1974, *General Motors*, O.J. [1975] L29/14; Commission Decision of 2 July 1984, *British Leyland*, O.J. [1984] L207/11.

<sup>25</sup> Commission Decision of 17 December 1975, *Chiquita*, O.J. [1976] L95/1.

<sup>26</sup> Commission Decision of 25 July 2001, *Deutsche Post II*, O.J. [2001] L331/40.

Helsingborg)<sup>27</sup> are about pure exploitative pricing. All those 6 Commission Decisions, except *United Brands*, relate to the existence of legal monopoly.

The Commission opened also several cases in the telecommunication sector.<sup>28</sup> They did not lead to formal decisions because the case was passed to the national telecom regulator when it had jurisdiction to act or otherwise settled between the Commission and the dominant operator.

The Court has decided about fifteen cases, more than the Commission because of the preliminary question from national Courts. Again, most of the cases related to exclusionary abuses and few cases (*Ahmeed Saeed*, *Tournier (SACEM I)*, *Lucazeau (SACEM II)*, *Centre d'insémination de la Crespelle*)<sup>29</sup> are about pure exploitative prices. In all those cases, except *United Brands*, the dominant company enjoyed a legal monopoly or an IPR. More crucially, in all cases of pure exploitative abuses, the dominant company enjoyed a legal monopoly and there was no competence sector regulator.

Thus as Community judge Wahl (2007) observes: “the prohibition against excessively high prices has its primary scope of application in situations of legal monopolies or regulated markets. In free markets it may principally be used when the pricing strategy focuses on something other than exploiting its customers on that particular product, for example by trying to prevent parallel imports”.

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<sup>27</sup> Commission Decision of 23 July 2004, Case 36.570 *Sundbusserne v. Port of Helsingborg*, and Commission Decision of 23 July 2004, Case 36.568 *Scandlines Sverige AB v. Port of Helsingborg*.

<sup>28</sup> For a description of those cases, see our previous paper Motta and de Streel (2007:105-108).

<sup>29</sup> Case 66/86 *Ahmed Saeed* [1989] ECR 803; Case C-323/93 *Centre d'insémination de la Crespelle* [1994] ECR I-5077; Case 395/87 *Tournier (SACEM I)* [1989] ECR 2521; Cases 110, 241 & 242/88 *Lucazeau (SACEM II)* [1989] ECR 2811.

Interestingly, in other jurisdictions as well the same criteria have more or less explicitly been followed. In the *Harmony v. Mittal* South African case, the Tribunal took into account both the fact that Mittal's quasi-monopolistic position was not contestable (unlikely that entry would have occurred by exercising a constraint on Mittal's pricing policy) and that it had not been contested in the past (of recent privatisation, Mittal Steel South Africa is the new name of Iscor, the public monopoly in flat steel which has dominated South Africa for a very long time).<sup>30</sup>

## 2.4 The standard of proof for the excessive pricing

### 2.4.1 Different possible tests to prove an excessive price

The next question is to understand how to recognise and prove an 'excessive' price in practice. To this effect, the Court has indicated that several methodologies may be used. In *United Brands*, the Court held that:

251. This excess could, *inter alia*, be determined objectively if it were possible for it to be calculated by making a comparison between the selling price of the product in question and its costs of production, which would disclose the amount of the profit margin (...).

252. The questions therefore to be determined are whether the difference between the costs actually incurred and the price actually charged is excessive, and, if the answer to this question is in the affirmative, whether a price has

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<sup>30</sup> For a discussion, see Roberts (2007), who also argues that market size characteristics matter when assessing the likelihood that entry may discipline a dominant incumbent. In a small and isolated country, it may be unlikely that new entry occurs in sectors characterised by large sunk costs. Similar remarks have been made in the past by Fingleton (2006), referring to Ireland.

been imposed which is either unfair in itself or when compared to competing products. (...)

253. *Other ways* may be devised – and economic theorists have not failed to think up several - of selecting the rules for determining whether the price of a product is unfair (emphasis supplied).

And indeed over time, the Court of Justice (and the European Commission) have made use of different methods to determine whether a price is excessive.<sup>31</sup>

A first method is based upon a *comparison between costs of production and prices*.<sup>32</sup> The idea is that there should exist a threshold price which guarantees a sufficient margin with respect to costs, and that above such a threshold the price charged by a dominant firm would be excessive.

Of course, there are several difficulties with this approach. First, a competitive price is not only determined by supply-side factors (in particular the cost of production), but also by demand side factors (demand elasticity, willingness and ability to pay,...).<sup>33</sup>

Second, the threshold price and the ‘reasonable’ margin over costs would be to a large extent arbitrary, and it is not clear how it should be fixed. Although the Court may have indicated in particular cases that a certain margin was reasonable and another was not, this should not be taken as a rule which holds across sectors. For instance, in sectors where fixed costs are very important relative to variable costs of production, one could not apply the same threshold margins as in sectors where the burden of costs falls upon variable ones.

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<sup>31</sup> For a detailed account of those methods, see Williams (2007).

<sup>32</sup> This method was followed, for instance, in , Case 298/83 *CICCE* [1985] ECR 1105, paras. 24-25; Joined Cases 110, 241 & 242/88 *Lucazeau/SACEM (SACEM II)* [1989] ECR 2811; and Case 66/86 *Ahmed Saeed* [1989] ECR 803.

<sup>33</sup> This point has been explicitly recognised by the Commission in the recent *Port of Helsingborg* Decision, point 185.

Third, the calculation of the relevant costs is often problematic, for several reasons. (i) There are often divergences between accounting costs and economic costs because firms normally record cost in a way that is most useful for financial and tax purposes. (ii) Risk should be taken into account, hence an *ex post* high profit may in fact correspond to a normal *ex-ante* return. (iii) When the dominant firm is a multi-product or multi-market firm, an additional difficulty lies in the allocation of common costs among the different products.<sup>34</sup> (iv) When the dominant firm is operating in a two or multi-sided market, the competition authority should consider the system price on all markets and not the price of a single market. In those markets, the side that conveys the most positive externalities on the others will naturally be “subsidised” by the other sides, who may then (wrongly) appear to pay an excessive price.<sup>35</sup>

Fourth, in some cases it is not even the actual costs of the dominant firm, but the costs of a hypothetical efficient firm which should be considered. In the *SACEM* cases,<sup>36</sup> the Court of Justice considered that the production costs to be taken into account are those of an efficient firm, and not necessarily those of the investigated firm which may have inflated production costs because of its dominant position (X-inefficiency). Indeed, the Court stated that a firm may not justify its unfair price with high production costs because the possibility may not be ruled out that it is precisely the lack of competition on the market in question that accounts for the high costs.

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<sup>34</sup> In *Ahmeed Saeed* at Point 43, the Court of Justice provides that a competition authority may rely on the accounting methodology (in particular regarding the apportioning of common costs) used in sector regulation to determine whether a price is excessive.

<sup>35</sup> See for a discussion: Wright (2004)

<sup>36</sup> Joined Cases 110, 241 & 242/88 *Lucazeau/SACEM (SACEM II)* [1989] ECR 2811, para. 29. Based on empirical research, Röller (2007) argues that in the European airlines industry, the prices are excessive although the price-cost margins are “normal” because the costs (particularly the wages) are excessive.

Thus assessing production costs is a difficult exercise even for sectoral regulators which have a deep knowledge of the industry, let alone for Competition Authorities or Courts which have a much more imperfect knowledge of the sector. Moreover unlike predatory pricing cases, where there is at least a substantial convergence on which particular cost measures should be taken into account when carrying out price/cost tests,<sup>37</sup> neither the doctrine nor the case law offer much guidance on the relevant cost measures to be analysed.

A second method to prove excessive pricing is based upon a *comparison between prices charged by the dominant firm in different markets*.<sup>38</sup> Suppose for instance that it was established that the firm sets a price in market A which is well above the price it sets for the same (or comparable) product and service in market B, and that in the latter market the firm is profitable. Then this can be considered as proof of unfair pricing. Furthermore, it could even be considered as a discriminatory abuse, prohibited under Article 82(c) of the EC Treaty.

Note that under this method *de facto* discriminatory pricing and unfair pricing coincide, something that economists would find it difficult to approve of. We know there are several reasons why firms might want to set different prices in different markets (production or distribution costs as well as consumer demands or market structures, may differ), and that there is little justification from the point of view of economic efficiency to establish that price discrimination by a dominant firm might be *per se* prohibited. Economic theory<sup>39</sup> suggests that even if price discrimination was done by a

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<sup>37</sup> (1) Price below average variable costs or (2) price below average total cost but above average variable cost with evidence of an exclusionary plan are considered as predatory: Case C-62/86 *Akzo* [1991] ECR I-3359, para 71 and Case C-333/94P *Tetra Pak II* [1996] ECR I-5951, para 44.

<sup>38</sup> This method was followed, for instance, in , Case 26-75 *General Motors* [1975] ECR 1367 and Case 226/84 *British Leyland* [1986] ECR 3263, para. 28.

<sup>39</sup> See the discussion in Chapter 6 of Motta (2004) and Swedish Competition Authority (2005).

monopolistic firm, it would not necessarily be welfare detrimental, as price discrimination might increase sales and allow for consumption by people who would not otherwise buy the product. Also, it may be an efficient way to recover fixed costs of investments and innovations. Furthermore, in a market where the dominant firm is facing competition (that is, when it does not have monopolistic or quasi-monopolistic power), prohibiting price discrimination would amount to chill competition.

A third method to prove excessive pricing, the so-called benchmarking, consists of a *comparison between the prices charged by the dominant firm and those charged by other firms, either (i) in the same market, or (ii) in other market.*

The variant (i) in this method involves comparing the price charged by the dominant firm and those charged by competitors in the same relevant market.<sup>40</sup> This test involves some difficulties. Firstly, the very fact that in the same relevant market there are other firms offering the same product or service suggests that entry in the market is possible, and that competitive forces may possibly erode the dominant position over time. Secondly, the fact that the dominant firm can command a higher price than the rivals for products which belong to the same relevant market may simply be the effect of a higher perceived quality of the dominant firm's product. To the extent that this superior quality is the result of past innovations and investments, particular caution should be made to avoid penalising a firm for having innovated and invested.

The variant (ii) of this method involves comparing the price charged by the dominant firm in the relevant market with prices arising in other markets which operate in competitive conditions.<sup>41</sup> This method has been used by the Commission to compare prices among different EU countries and boost the internal market with

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<sup>40</sup> This method was used in , Case 24/67 *Parke, Davis* [1968] ECR 55, Case 53/87 *Renault* 53/87 [1988]

<sup>41</sup> This method was used in Case 78/70 *Deutsche Grammophon*, [1971] ECR 487; Case 30/87 *Bodson* [1988] ECR 2479.

antitrust actions. Here, as well, caution should be used in order to avoid that unduly inferences are taken from the fact that one is comparing markets that operate under very different conditions of costs and demands.

A fourth method consists of concentrating *on the profits of the dominant firm and comparing such profit either with (i) a normal competitive profit or (ii) the profits of other firms.*<sup>42</sup>

The variant (i) considers a product's price excessive when the firm's return on capital for that product is greater than its weighted average cost of capital (WACC). However this approach, which has been used by some national competition authorities,<sup>43</sup> is fraught with conceptual difficulties (accounting profit reflect economic profit only in very specific, and often unrealistic, assumptions) and practical difficulties (vulnerability to accounting complications).

The variant (ii) compares the profit rates of the dominant firm to the profits obtained by similar companies in other geographic markets.<sup>44</sup> The practical application of such approach is also very difficult as it is almost impossible to find a relevant comparator.

## **2.4.2 A proposed standard of proof rule: the convergence of indicators**

Since excessive pricing actions should be taken only in exceptional circumstances and since all the methods to prove a case have some weaknesses, it is recommendable that antitrust authorities and courts should carry out excessive pricing tests according to as many of the methods indicated above as possible. In other words, the authorities should look for robust evidence that prices are indeed excessive.

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<sup>42</sup> See OXERA (2003).

<sup>43</sup> For a description of those cases, O'Donoghue and Padilla (2006:629-631).

<sup>44</sup> This approach has been considered by the Commission in the *Port of Helsingborg* Decision but was not followed because of the insuperable difficulties in establishing valid benchmarks (see Point 156).

They should not limit themselves to a mere comparison between prices or prices and costs, but should instead complement it with a deep investigation of the market and of the reasons why prices may diverge or be considerably above the competitive level. In any case, authorities should drop the case if different tests provide different results or if the price does not deviate significantly from the different used benchmarks.<sup>45</sup>

### **2.4.3 The proposed standard of proof rule and the case-law**

The recent practice in the EU is in line with this recommendation. In the recent *Port of Helsingborg* Decisions,<sup>46</sup> the Commission rejected a complaint of excessive price arguing that a mere cost-plus approach was not sufficient to prove an excessive price. In this case, the ferry-operations fees charged by the Port of Helsingborg to the complainant were above their costs, but were not unfair when compared with the fees charges by the Port to other users than the complainant (there was no discrimination) or when compared to fees charged by other similar Ports. The Commission also considered that some demand-side elements (like the premium that customers would be ready to pay for the unique service offered by the Helsingborg port) should be taken into account when proving an excessive price.

Similarly in the UK, the Competition Appeal Tribunal endorsed the Office of Fair Trading *Napp Pharmaceutical* Decision because it resorted to a number of tests (which can be reconduced to the

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<sup>45</sup> Also Paulis (2007) arguing that only very large deviations from competitive conditions may be indicative of abusive pricing and O'Donoghue and Padilla (2006:619).

<sup>46</sup> Commission Decision of 23 July 2004, Case 36.570 *Sundbusserne v. Port of Helsingborg*, and Commission Decision of 23 July 2004, Case 36.568 *Scandlines Sverige AB v. Port of Helsingborg*.

general methods indicated above) to prove that the pharmaceutical company had engaged in excessive pricing.<sup>47</sup> Conversely in *Attheraces*, the Court of Appeal overturned a judgment of the Chancery Division that proved an excessive price on a mere cost-plus basis and that did not take into account the value of the good to the buyer.<sup>48</sup> In *Veraldi/Alitalia*, the Italian Autorità Garante della Concorrenza e del Mercato also resorts to different methods, but to arrive at the conclusion that there was insufficient evidence that Alitalia had charged excessive prices on the route between Milano and Lamezia Terme.

Finally, there is an important legal point to clarify. Some commentators (including Commission officials and Community judge)<sup>49</sup> argue that that Court of Justice imposed in *United Brands* (Point 252 mentioned above) a cumulative two-stage test to prove an excessive price: (1) the price should be above the cost, and (2) this price-cost margin should be either excessive in itself or by comparison to competitors' products. This is also the approach followed by the Commission in its *Port of Helsingborg* Decision. Thus those commentators disagree with the view that we, among others,<sup>50</sup> defended in our 2006 paper. For us, the test imposed by the Court is not necessarily cumulative and both parts of the test aimed to prove the same thing: that a price is above its competitive level.

To clarify our view, we think that the Court is extremely pragmatic in its standard of proof. It requires a price-cost analysis

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<sup>47</sup> Competition Appeal Tribunal Decision of 15 January 2002, Case 1001-1/1/01 *Napp v. DGFT*

<sup>48</sup> Court of Appeal Decision of 5 February 2007, Case A3/2006/0126 *Attheraces Limited v. The British Horseracing Board Limited*.

<sup>49</sup> Esteva Mosso et al. (2006:399), O'Donoghue and Padilla (2006:611), Wahl (2007).

<sup>50</sup> Like Gal (2004).

when it is feasible and otherwise requires other indicators.<sup>51</sup> Thus the Court does not impose price-cost analysis in all cases, but more pragmatically suggest relying to several different indicators to prove excessive prices. As mentioned by Green (2006: 90), “the more comparable which, in a given case, are used the more likely it is that the Courts will, on appeal, accept any inferences which are drawn from comparisons that the prices under review are abusive.”

## 2.5 The choice of the most efficient remedy

The last issue to address when dealing with excessive prices is the choice of the best remedy. Often, excessive price abuse is associated with price regulation remedy. However, the two questions should be kept separate as other remedies exist. More critically, price regulation is not always the most efficient remedy to deal with excessive prices. On the one hand, price regulation may highly distort investment incentives and is difficult to implement. On the other hand, excessive price reflect more a problem in the structure of the market than in the behaviour of the firm, hence the appropriate remedy should change the market structure for the future and not punish the firm for the past. Thus, the choice for the best remedy (or the most proportionate remedy according to the European competition law),<sup>52</sup> will always depend on the cause of the excessive pricing. Thus it is only as a last resort remedy, that price regulation should be imposed.

If the excessive price is due to a combination of strong past market power and consumer inertia (as it is often the case in newly

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<sup>51</sup> At Point 253 of *United Brands*, the Court explicitly recognised that, to prove an excessive price, there are other ways than price-cost comparison. In *SACEM II* and *Bodson*, the Court recognised that a price cost comparison would be impossible given the nature of the product.

<sup>52</sup> Article 7 of the Council Regulation 1/2003.

liberalised sectors), the best remedy may be to encourage consumers switching towards less expensive offers of new entrants, providing them with more comparable information.

If the excessive price is due to important strategic entry barriers, the best remedy would be to remove and prohibit such entry barriers. For instance, price may be excessive and competition may not work because of important artificial switching costs created by a dominant firm (think for instance of frequent-flyer programmes which helped incumbent airlines at the beginning of liberalisation, or of the large fees required by the Italian banks to close bank accounts). In such cases, a competition authority may want to solve the problem at its roots by asking for the removal of artificial switching costs (opening the frequent-flyer programme to entrants, scrapping fees for closing bank accounts). Similarly, excessive prices may be due to externalities caused by particular price structures (for instance, in the mobile telecommunication sector, high termination rates may be due to the externality imposed by receivers on callers). In such case, the appropriate remedy is partly applying a receiver-pays principle.<sup>53</sup> Note that those cases are more about exclusionary abuses than exploitative abuses.

If the excessive price is due to important structural entry barriers, the competition authority should try to remove the entry barrier. When the barrier is of legal nature, the authority should use its advocacy power and persuade governments to remove those legal barriers and effectively liberalise the sector. When the barrier is of economic nature, the competition authority may impose vertical restructuring, by separating the key stages of production at which scale economies are the most important.

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<sup>53</sup> Arguably, though, such interventions may take time and may not necessarily be a substitute, but rather a complement to excessive pricing actions, in the sense that the latter may provide a credible threat that a competition authority may use in order to persuade industry and government to accept or enforce the necessary changes.

## 2.6 Which Guidelines for excessive pricing?

The European Commission will soon propose guidelines for Article 82 EC, including excessive prices. Those guidelines will not only guide the practice of DG-Competition but also, and more importantly because they have less experience and are often less prepared, the practice of the Member States' National Competition Authorities and possibly the National Courts' judges.

It is important that in those guidelines, the Commission commits itself to limit the use of its broad legal power and make explicit that excessive pricing actions should be an option of last resort for antitrust authorities,<sup>54</sup> and that they should be used only when other routes fail. Hopefully, the guidelines will deal with three issues: a test to screen the markets that are candidates for intervention of excessive pricing actions (to provide safe harbour for the firms), the standard of proof of such actions, and the proportionate and most efficient remedy to impose.

The screening test should contain three cumulative conditions. The first condition is the existence of high and non-transitory barriers. It tells us that it is only "super-dominant" or "quasi-monopolistic" firms which should be the object of excessive price actions. A dominant firm which has, say, 50-60% of the market, is a firm which does have competitors and therefore operates in a market where entry is possible (since it has occurred). In our view, guidelines should explicitly exclude the use of Article 82(a) EC to firms which have, say, less than 80% of the market.

The second condition suggests to limit action in those sectors where the quasi-monopolistic position has been achieved through

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<sup>54</sup> The Director General of DG Competition noted recently that : "There was a strong consensus on relatively limited conditions under which Article 82 could be used for exploitative conduct (...) There was equally a recognition on both the EU and US side that sectoral regulation can sometimes be quicker and more effective than long, drawn-out antitrust investigations": Lowe (2007).

special and exclusive rights or to un-condemned past exclusionary anticompetitive practices rather than market competition. Accordingly, firms should be reassured that whenever they derive their position from risky investments, they will not be deprived of the benefits of their investments.

The third condition is that there is no sectoral regulator having the jurisdiction to solve the matters. Indeed when a regulator has jurisdiction, it should intervene and if it fails to do so, the Commission or the national competition authority should not condemn the dominant firm but open an infringement procedure against its Member State.

Then with regard to the standard of proof, the competition authority should rely on a convergence of indicators to show excessive prices, complemented by a deep investigation of the market structure and the reasons why prices may be above their competitive level.

Finally, the antitrust authority should choose the most efficient means to solve the excessive price problem and relate remedy to the cause of market power. Thus it should address demand side problems and activate competition in the market, and only rely on price regulation on a last resort.

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