IN THE COMPETITION APPEAL COURT OF SOUTH AFRICA

Case No: 70/CAC/Apr07

In the matter between:

ARCELORMITTAL SOUTH AFRICA LIMITED (formerly **Mittal Steel South Africa Limited)**	First Appellant
MACSTEEL INTERNATIONAL HOLDINGS BV	Second Appellant
MACSTEEL HOLDINGS (PTY) LTD	Third Appellant

and

HARMONY GOLD MINING COMPANY LIMITED	First Respondent
DURBAN ROODEPOORT DEEP LIMITED	Second Respondent

SUBMISSIONS BY *AMICI CURIAE*

on the interpretation of section 8(*a*) of the Competition Act

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Introduction

1. We make these submissions at the request of the Court.

2. Our submissions are limited to the interpretation and general application of section 8(*a*) of the Competition Act No. 89 of 1998, read with the definition of "excessive price" in section 1.

3. We have accordingly confined our reading of the record essentially to parts bearing specifically on this problem. We make no attempt to apply the suggested interpretation to the evidence in the case. Consistent with our non-adversarial role, while dealing generally with many of the same issues, we do not address the arguments of the litigants in terms. We have sought to avoid unnecessary repetition, but coherence would be impossible without some repetition of points also appearing in various parties' heads. As we are not economists by training, and lack the assistance of professional economists in our role as *amici curiae*, we confine our submissions in that sphere mainly to what may be derived from standard published texts.

Basic principle of statutory interpretation

4. The task of statutory interpretation is to ascertain what the Legislature intended in using the words which it chose to use. In *Commissioner for SARS v Airworld CC and Another*,[1] Hurt AJA (with whom Howie P and Lewis JA concurred), said:

> Most of the rules of interpretation have been devised for the purpose of resolving apparent ambiguity and arriving at an interpretation which accords as well as possible both with the language which the legislature has used and with the apparent intention with which the legislature has used it. In recent years courts have placed emphasis on the purpose with which the Legislature has enacted the

[1] 2008 (3) SA 335 (SCA) at par [25].

> relevant provision. The interpreter must endeavour to arrive at an interpretation which gives effect to such purpose. The purpose (which is usually clear or easily discernible) is used, in conjunction with the appropriate meaning of the language of the provision, as a guide in order to ascertain the legislator's intention.

5. The words chosen by the Legislature have to be taken seriously. When interpreting a statutory provision, and while seeking to give effect to its purpose, a court or tribunal is not at liberty to do violence to the language of the statute and impose its view of what the policy or object of the measure should be. *Standard Bank Investment Corporation Ltd v Competition Commission and Others; Liberty Life Association of Africa Ltd v Competition Commission and Others* 2000 (2) SA 797 (SCA), paras [16]-[22].[2]

Dominance and "super-dominance"

6. The prohibition against excessive pricing is the first of several provisions prohibiting the abuse of dominance. Part B of Chapter 2 of the Act is headed "Abuse of a Dominant Position". Section 8 is headed "Abuse of dominance prohibited".[3] All the particular prohibitions in section 8 are preceded by the words "It is prohibited for a dominant firm to—". The test for dominance is expressly laid down in section 7. The same test is applicable to all firms to which Part B of Chapter 2 of the Act applies, namely those meeting the threshold requirement determined under section 6. There is no warrant for confining any of the prohibitions in section 8 to firms which meet a criterion of "super-dominance".[4] To introduce such a criterion when adjudicating

[2] Cf also *Federal-Mogul Aftermarket Southern Africa (Pty) Ltd v Competition Commission* [2005] 1 CPLR 50 (CAC) at 54*e*.

[3] As to the significance of headings in a statute, see Devenish, *Interpretation of Statutes*, 107-109.

[4] The expression refers to "monopolies or, what we have termed, 'super-dominant' firms": Competition Tribunal's reasons for decision on the merits ("MD") [37], Record 1/10. For a criticism of the use of this

cases of alleged "excessive pricing" is to change the legislation as enacted by the Legislature, not apply it. That is contrary to all principles of statutory interpretation; it transgresses the separation of powers between legislator and adjudicator[5] and is at odds with the rule of law.[6]

7. The methodology employed by the Competition Tribunal to determine whether a price is "excessive" for purposes of section 8(*a*) depends fundamentally on its criterion of "super-dominance",[7] and would be untenable for that reason alone.

8. Even if policy considerations persuasive to the adjudicator[8] could override the clear wording of the statute – which they cannot – it would surely be most undesirable from the point of view of competition policy to limit the application of section 8(*a*) to situations of actual or virtual monopoly enjoyed by a single firm. In recent years the problem of oligopoly has become a central focus for competition authorities throughout the world. While in

concept, see Sutherland and Kemp, *Competition Law of South Africa* 7–34, 7–38.

[5] Cf *S v Dodo* 2001 (3) SA 382 (CC) at para [22] ("It is pre-eminently the function of the Legislature to determine what conduct should be criminalised and punished"); *Zondi v MEC for Traditional and Local Government Affairs and Others* 2005 (3) SA 589 (CC) at para [122] ("What is required therefore is for a court to endeavour to be as faithful as possible to the legislative scheme within the constraints of the Constitution"); *Foodcorp (Pty) Ltd v Deputy Director-General, Department of Environmental Affairs and Tourism: Branch Marine and Coastal Management and Others* 2006 (2) SA 199 (C) at 210D ("It is for the Executive and/or Legislature to craft policy…"); *S v H* 2007 (3) SA 330 (C) at para [39].

[6] The principle of certainty is central to the rule of law: *Veldman v Director of Public Prosecutions, Witwatersrand Local Division* 2007 (3) SA 210 (CC). "Also central to the rule of law is the principle of legality which requires that law must be certain, clear and stable. Legislative enactments are intended to 'give fair warning of their effect and permit individuals to rely on their meaning until explicitly changed'. (Per Mokgoro J at para [26].) "The rule of law embraces, among other things, the requirement that laws be 'ascertainable in advance so as to be predictable and not retrospective in its operation'." (Per Ngcobo J at para [70].)

[7] See MD [72], Record 1/25; MD [84], Record 1/28; MD [96], Record 1/32; MD [106], Record 1/38; MD [121], Record 1/44; MD [186], Record 1/69-70. We deal below with the question whether the degree of dominance or market power held by a firm, and the contestability of its market, can nevertheless be relevant to the "reasonableness" of the extent to which its actual price exceeds "economic value" (if such an excess is established).

[8] See e.g. MD [97]-[102], Record 1/33-34.

theory, even duopolists may engage in vigorous competition with each other, that is by no means necessarily the case.[9] The rational behaviour of oligopolists in a tight-knit oligopoly, where barriers to entry are high, is likely to be that they will follow each other's prices upwards to the level that will maximise their joint profits – i.e. the industry-maximising price corresponding to that which the single-firm monopolist would charge.[10] No actual collusion is necessary to produce this result. It may well, however, prove to be an abuse of the market power which each oligopolist may derive from being able to rely independently on the non-competitive pricing behaviour of the others.[11] The Tribunal's criterion of "super-dominance", if permitted to stand, would allow oligopolists to engage in excessive pricing with impunity.

9. The Tribunal's idea that a market must be "incontestable" otherwise the price charged cannot be excessive,[12] does not stand up to scrutiny. In the example of oligopoly behaviour given above, the oligopolists would be able to exercise an effective competitive constraint on each other but, as a matter of business calculation, separately choose not to do so. The market would be contestable, although not in fact contested, while excessive prices may be charged. Moreover, even in the case of a single-firm monopolist, the Tribunal's idea cannot be sustained. The market may be incontestable at the

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[9] Cf MD [150], Record 1/53, where the problem of oligopoly is simply skirted, the Tribunal contenting itself with the observation that even duopolists may engage in fierce rivalry.

[10] See the extract from Charles E. Mueller, *Antitrust Law & Economic Review*, Vol. 26, No. 4, quoted with approval and applied by this Court in *Mondi Ltd and Kohler Cores and Tubes (a division of Kohler Packaging Ltd) v Competition Tribunal* [2003] 1 CPLR 25, par [41].

[11] In the recent enquiry into competition in retail banking in South Africa (the full report of which has yet to be released by the Competition Commissioner), it was found that the major banks (at least) have market power on this basis *inter alia*. Lacking adequate costing information, however, the Enquiry Panel could not make a finding that any particular product price contravened section 8(*a*). See *Banking Enquiry, Report to the Competition Commissioner by the Enquiry Panel: Executive Overview*, June 2008, 18.

[12] MD [96], Record 1/32; MD [162], Record 1/59.

high price which the monopoly actually charges, but become contestable at a still higher price (by potentially drawing in competitors). The current price may thus be judged excessive but (on the Tribunal's reasoning) the still higher price could not be judged excessive.

10. Proof of an excessive price may itself provide proof of market power as defined in section 1 of the Act, and thus of dominance as contemplated by section 7.[13] Therefore the inquiry into dominance, while essential to the adjudication of an "excessive pricing" case, is not necessarily a prior inquiry. For purposes of the remainder of our submissions, we make the hypothetical assumption that the firm accused of excessive pricing is found to be dominant, whether in consequence of its share of a defined product and geographical market or in consequence of proof that, in the supply of the good or service in question, it has the power to control prices, or to exclude competition, or to behave to an appreciable extent independently of its competitors, customers or suppliers.

A three-step test

11. The wording of section 8(*a*), read with the definition of "excessive price" in section 1, calls unambiguously for the posing and answering of three distinct questions in sequence. Should the answer to any of the questions be in the negative, then the complaint of excessive pricing cannot succeed.

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[13] See *Natal Wholesale Chemists (Pty) Ltd v Astra Pharmaceutical Distributors (Pty) Ltd* [2001-2002] CPLR 363 (CT) (Case No. 98/IR/Dec00), 376-377: "We concur with the complainant that the purpose of defining a relevant market is to identify the exercise of market power [as] defined in the Act … and that market definition is only a tool for estimating market power, not a scientific test. … If the exercise of market power, as defined, is identified — if, for example, the firm is able to raise appreciably the price of its product without occasioning a significant reduction in demand — then a market relevant for the purposes of the enquiry will have been identified." Cf also *Patensie Sitrus Beherend Bpk v Competition Commission and others* [2003] 2 CPLR 247 (CAC) (Case No. 16/CAC/Apr02) at 256*e*-*i*.

- *Question 1*: Is the price actually charged higher than the economic value of the relevant good or service? If so—
- *Question 2*: Is the extent of the difference altogether unreasonable in the circumstances? If so—
- *Question 3*: Is the charging of the excessive price to the detriment of consumers?

The questions are formulated here in the present tense, although they would obviously have to be answered with reference to the time or times material to the complaint.

12. The Tribunal did not pose and proceed to answer these questions. In a nutshell, its reasoning was that, if a "super-dominant" firm exercises to the full its market power in setting a price, then its price is *ipso facto* excessive as contemplated by section 8(*a*),[14] and that detriment to consumers follows automatically.[15] We submit that there are fundamental fallacies in this approach, which are considered below.

13. In respect of each of the three questions posed above (as with the question of dominance) the *onus* of proof on a balance of probabilities rests throughout, and therefore ultimately, on the party advancing the complaint in the referral proceedings (i.e., the Competition Commission or the complainant itself as the case may be). However, *prima facie* proof would of course give rise to a duty on the respondent in the Tribunal to adduce satisfactory evidence to the contrary. If such evidence is not forthcoming the *prima facie*

[14] See e.g. MD [164], Record 1/60-61; MD [188]-[189], Record 1/70-71.

[15] MD [71], Record 1/24.

case becomes a conclusive one, meeting the necessary standard of proof.[16]

<u>The "economic value" of a good or service</u>

14. An answer to *<u>Question 1</u>* requires that the economic value of the relevant good or service at the relevant time or times be established. There is no way of avoiding this difficulty. Only when the economic value of the good or service has been established is it possible to determine whether the impugned price is in fact higher or not, and (if higher) to proceed to consider, under *<u>Question 2</u>*, whether the extent to which the impugned price is higher is capable of any reasonable justification in the circumstances or not.

15. The expression "economic value" is not defined. The problem of interpretation is to give this expression a definite meaning corresponding to the evident intention of the Legislature in using it – a meaning capable, moreover, of practical application. If it is impossible to do so, the conclusion would follow that the legislative provision does not pass constitutional muster; but that is a conclusion which ought to be avoided if it can be.[17]

16. Because section 8(*a*) contemplates a relation between a *price* and *economic value*, it follows that the latter expression must, as is ordinarily the case with price, refer to a quantum of money.[18] In contrast with Article 82(a) (formerly

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[16] See generally *Pillay v Krishna and Another* 1946 AD 946 at 951-953; *South Cape Corporation (Pty) Ltd v Engineering Management Services (Pty) Ltd* 1977 (3) SA 534 (A) at 548A-G; *Vasco Dry Cleaners v Twycross* 1979 (1) SA 603 (A) at 615G-616A, 620E-621B; *Sjelbreds Rederi A/S and others v Hartless (Pty) Ltd* 1982 (2) SA 710 (A) at 733F-G.

[17] See Devenish, *op cit*, 210-211; *LAWSA*, First Reissue, vol 25 Part 1, *sv* "Statute Law and Interpretation" by Du Plessis, para 330; Kellaway, *Principles of Legal Interpretation of Statutes, Contracts and Wills*, 113-114; *Minister of Labour and Others v Port Elizabeth Municipality* 1952 (2) SA 522 (A) at 533 *in fine* – 534.

[18] Price is "the amount, *usu* in money, for which a thing is sold or offered" (*The Chambers Dictionary*); "The

article 86(a)) of the Treaty of Rome,[19] our legislation does not refer simply to a price that is "unfair".[20]

17. The Legislature cannot have intended to equate "economic value" with whatever price the particular market supports — for then no question of an "excessive" price could ever arise.[21] The Legislature must have intended, by the expression "economic value", a quantum of money which would notionally be the price of the good or service if market conditions other than those actually prevailing were to prevail. But what kind of market conditions should the Legislature be taken to have had in mind? Another way to put this question is to ask: what would be the characteristics of a price corresponding to economic value?

18. It is submitted that what the Legislature must be taken to have intended by economic value is the notional price of the good or service under assumed

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money (or other equivalent) for which anything is bought or sold; the rate at which this is done or proposed" (*The Shorter Oxford English Dictionary*).

[19] Article 82 provides (in relevant part):

> *Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States.*
> *Such abuse may, in particular, consist in:*
> *(a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions.*
> *…*

[20] Section 18 of the UK Competition Act, 1998, uses the same expression as Article 82. Our Legislature chose not to adopt that expression when enacting section 8(*a*). European and UK cases, therefore, while useful as comparative references, should not simply be assumed to be directly in point when it comes to the construction of our section 8(*a*). Formulations in those cases are not always readily reconcilable with the wording of our statute. As to the appropriate use of international precedents, see generally *Standard Bank Investment Corporation Ltd v Competition Commission and Others; Liberty Life Association of Africa Ltd v Competition Commission and Others* (*supra*) at 814F-815A; *Mondi Ltd and Kohler Cores and Tubes (a division of Kohler Packaging Ltd) v Competition Tribunal* (*supra*) at 35*j*-36*b*; *Federal-Mogul Aftermarket Southern Africa (Pty) Limited v The Competition Commission and Another* (*supra*) at 53*a*-*e*.

[21] Cf *Attheraces Ltd v The British Horseracing Board Ltd* [2007] ECC 7 (English Court of Appeal), paras 210-211.

conditions of *long-run competitive equilibrium*.[22] This requires the assumption that, in the long run,[23] firms could enter the industry in the event of a higher than normal rate of return on capital, or could leave the industry to avoid a lower than normal rate of return. It does not imply perfect competition in the short-run,[24] but rather competition that would be effective enough in the long run to eliminate what economists refer to as "pure profit" – i.e. a reward of any factor of production in excess of the long-run competitive norm which is relevant to that industry or branch of production.[25]

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[22] While the concept of long-run competitive equilibrium has undergone considerable neo-classical and subsequent modern development, essentially the same idea appears in the writings of the classical economists – e.g., in Smith and Ricardo as the "natural price", and in Marx as the "production price", of a commodity. (See Adam Smith, *The Wealth of Nations*, Book I, Chapter VII; David Ricardo, *On the Principles of Political Economy and Taxation*, 3rd edition, 1821, Chapter IV, in Sraffa (ed), *The Works and Correspondence of David Ricardo*, vol 1, 88-92; Karl Marx, *Capital*, vol III, Chapter IX.) Essentially the same concept seems to be consistently employed throughout the economic literature irrespective of different writers' various theories of value (where they have one).

[23] Lipsey, Courant and Ragan, *Economics*, 12th edition, 1999, 173-174, define the **short run** as the length of time over which the firm has some fixed factors of production; the **long run** as the length of time over which all of the firm's factors of production are variable, but its technology is fixed; and the **very long run** as the length of time over which all of the firm's factors of production and its technology are variable. Samuelson and Nordhaus, *Economics*, 13th edition, McGraw-Hill Book Co., 1989, 976, define the **long run** as a "term used to denote a period over which full adjustment to changes can take place. In microeconomics it denotes the time over which firms can enter or leave an industry and the capital stock can be changed. In macroeconomics, it is often used to mean the period over which all prices, wage contracts, tax rates and expectations can fully adjust." The **short run** in contrast is a period "in which all factors cannot adjust fully" (982).

[24] A competitive equilibrium in the **short run** would imply that there is complete freedom for firms to enter or exit the market without delay; that there is a multitude of small firms in the market, all being price takers with no power to influence the market by their output or pricing decisions; that competition is accordingly "perfect", holding price down to the level at which it equals marginal cost (the incremental cost of each unit of output). This would allow only the recovery of variable costs, and not of fixed costs. It is a model which cannot realistically be applied to industries in which, of necessity, there are significant fixed costs. The difference with the **long run** is that, assuming constant technology, fixed costs have become variable costs. In **long-run** competitive equilibrium, marginal (i.e. variable) cost pricing will be at a level corresponding to the lowest **long-run average cost** at the competitive level of output.

[25] Lipsey *et al* say (*op cit*, 172):

"Economists often use the term **normal profits** to refer to the opportunity costs of capital and risk taking. When this definition is used, we would say that the firm must earn normal profits if it is to be willing to stay in the industry. …

"It is important to be clear about the various meanings of the term *profit*, not only to avoid fruitless

19. In *General Motors Continental NV v Commission of the European Communities*,[26] the European Court of Justice considered that an abuse of dominance might lie "inter alia" in the imposition of a price which is excessive in relation to the economic value of the [good or] service (para 12). It is apparent from para 22 that the Court considered "the real economic cost of the operation" to be indicative of its economic value. In *United Brands Continentaal BV v Commission of the European Communities*,[27] the ECJ considered that the lack of a reasonable relation between price and economic value could be revealed "inter alia" by establishing the firm's profit margin.[28] It is apparent from para 249 of the judgment, read in context, that the Court considered that <u>a price corresponding to economic value is one which would allow a firm to reap only those trading benefits which it would reap under conditions of "normal and sufficiently effective competition"</u>.[29] A higher price deriving simply from the use made of a dominant position would be

semantic arguments but also because a theory that predicts certain behaviour when profit is defined in one way will not necessarily predict behaviour accurately if profit is defined in another way. For example, the prediction that new firms will seek to enter an industry whenever profits are earned will not stand up if it is tested against the accountants' definition of profits. Firms may be recording accounting profits but economic losses because they are not covering the full opportunity costs of their capital. In this case, the tendency will be that firms leave rather than enter the industry.

"The definition of *economic profits* as an excess over all opportunity costs is for many purposes the most useful, but to apply it to business behaviour or to tax policy, appropriate adjustments must be made. Conversely, to apply accounting or tax data to particular economic theories requires the reverse set of adjustments."

[26] Record 10/2223-2226.

[27] Record 10/2245-2281.

[28] See para 251. "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." (Para 253.)

[29] In MD [94], Record 1/32, the Tribunal observes in a footnote: "We cite again the well known statements of the *United Brands* court and the *Napp Pharmaceutical* tribunal where equally the phrases *'normal and sufficiently effective competition' (United Brands)* and *'prices higher than would be expected in a competitive market' (Napp)* similarly do not in any way appear to connote perfect competition as the appropriate norm or comparator." (The reference is to *Napp Pharmaceutical Holdings Ltd v Director General of Fair Trading* [2002] E.C.C. 13.) See also MD [149], Record 1/54.

one bearing no reasonable relation to economic value.[30] Our section 8(*a*), read with the definition of "excessive price" in section 1, seems clearly to have had its inspiration in these ideas.[31]

20. Alfred Marshall wrote long ago in *Principles of Economics* :[32]

> §4. … [T]here is in each trade and in every branch of each trade, a more or less definite rate of profits on turnover which is regarded as a "fair" or normal rate. Of course these rates are always changing in consequence of changes in methods of trade; which are generally begun by individuals who desire to do a larger trade at a lower rate of profit on turnover than has been customary, but at a larger rate of profit per annum on their capital. If however there happens to be no great change of this kind going on, the traditions of the trade that a certain rate of profit on turnover should be charged for a particular class of work are of great practical service to those in the trade. Such traditions are the outcome of much experience tending to show that, if that rate is charged, a proper allowance will be made for all the costs (supplementary [fixed] as well as prime [variable]) incurred for that particular purpose, and in addition the normal rate of profit per annum in that class of business will be afforded. … This is the "fair" rate of profit on the turnover which an honest man is expected to charge for making goods to order, when no price has been agreed on beforehand; and it is the rate which a court of law will allow, in case a dispute should arise between buyer and seller.
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> [Here Marshall adds in a footnote:] The expert evidence that is given in such cases is full of instruction to the economist in many ways … And it almost always comes out finally that if the "customary" rate of profit on the turnover is higher for one class of job than another, the reason is that the former does (or did a little while ago) require a longer locking-up of capital; or a greater use of expensive appliances (especially such as are liable to rapid depreciation, or cannot be kept always employed, and therefore must pay their way on a comparatively small number of jobs); or that it requires more difficult or disagreeable work, or a greater amount of attention on the part of the undertaker [firm]; or that it has some special element of risk for which insurance has to be made. ...

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[30] It is evident from *United Brands* that not every price charged by a dominant firm that is higher than "economic value" could have been considered an abuse, or else there would have been no need to formulate the criterion of "no reasonable relation". Cf also *Attheraces Ltd v The British Horseracing Board Ltd* (*supra*) at para 213. In the case of our section 8(*a*) the Legislature has made it crystal clear that not every excess of a dominant firm's price over economic value will be "excessive" as defined.

[31] Subsequent European and UK cases have made it no clearer what was meant by "economic value", and there is a tendency in those cases to mix together the concept of "economic value" with the concept of reasonableness in evaluating any excess. It does not follow, therefore, that the various European precedents wrestling with the problem of determining economic value are to be invoked as if they were statutory prescriptions of the meaning of that expression in our Act. A systematic treatment of the concept of economic value, not to be found in the European and UK cases, is necessary.

[32] See 8th edition, 1920 (1930 reprint), 617-619.

> § 5. During all this inquiry we have had in view chiefly the ultimate, or long-period or true normal results of economic forces; we have considered the way in which the supply of business ability in command of capital tends in the long run to adjust itself to the demand; we have seen how it seeks constantly every business and every method of conducting every business in which it can render services that are so highly valued by persons who are able to pay good prices for the satisfaction of their wants, that those services will in the long run earn a high reward. The motive force is the competition of undertakers: each one tries every opening, forecasting probable future events, reducing them to their true relative proportions, and considering what surplus is likely to be afforded by the receipts of any undertaking over the outlay required for it. All his prospective gains enter into the profits which draw him towards the undertaking; all the investments of his capital and energies in making the appliances for future production, and in building up the "immaterial" capital of a business connection, have to show themselves to him as likely to be profitable, before he will enter on them: the whole of the profits which he expects from them enter into the reward, which he expects in the long run for his venture. And if he is a man of normal ability (normal that is for that class of work), and is on the margin of doubt whether to make the venture or not, they may be taken as true representatives of the (marginal) normal expenses of production of the services in question. Thus the whole of the normal profits enter into true or long-period supply price.
>
> …
>
> A long period of time is however needed in order to get the full operation of all these causes, so that exceptional success may be balanced against exceptional failure.

21. Mark Blaug, a renowned historian of economic theory, writes:[33]

> In long-run competitive equilibrium the reward of each factor, including the hiring factor, equals its marginal value product; there is no residual for the entrepreneur and profits are zero.

He immediately makes it clear that by "profits" here he means "pure profit" (i.e. "economic profit" as distinct from "normal profit"[34]). He goes on to define "pure profit" as —

> a residual left over after all contractual costs have been met, including the transfer costs of management, insurable risks, depreciation and payments to shareholders

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[33] *Economic theory in retrospect*, 5th edition, Cambridge University Press, 1997, 439.

[34] See n25 above.

> sufficient to maintain investment at current levels.[35]

Because of the clarity and comprehensiveness of Blaug's analysis of this complex subject – from the writings of the classical economists to roughly a decade ago – we have included an extract from his work as an appendix to these submissions, for the assistance of the Court. We return to aspects of it below.

<u>Accounting profit and economic ("pure") profit</u>

22. In *The Penguin Dictionary of Economics*,[36] it is noted that accounting profit and economic profit will be the same only where all the factors of production have been credited with their full (one should add, competitive) opportunity costs.

> The reported profits of quoted companies ... consist mainly of the return on capital for the shareholders that is not profit in the economic sense of the term. If a company is receiving a subsidized loan from the government, for example, or is paying rent below the market rate because it has a long leasehold interest, it would also be necessary for the economist to deduct fully imputed costs for these returns to factors of production, rather than simply the actual money outlays from revenue in arriving at a profit. A firm may, therefore, be making an accounting profit while operating at an economic loss.

23. Applying these observations to the general problem under consideration here, two points would seem to follow:

 23.1 The cost savings to the firm resulting from the subsidised loan or the lower than market rental – or indeed any other special advantage, current or historical, that serves to reduce <u>the particular firm's</u> costs below the notional competitive norm – ought to be disregarded when

[35] *Op cit*, 440.

[36] By Bannock, Baxter and Davis, at 312-313.

determining the "economic value" of the goods or services which it supplies. Such a special advantage cannot logically come into the answer to *Question 1*. "Economic value" is a notional objective competitive-market standard, and not one derived from circumstances peculiar to the particular firm.[37] If the firm's price is no higher than economic value, no contravention of section 8(*a*) can arise.[38]

23.2 If, however, the firm's price is in fact higher than economic value thus determined, the test of reasonableness in respect of the difference remains to be applied: i.e., *Question 2*. Here circumstances peculiar to the particular dominant firm would rationally come into the reckoning. It would seem sound, when considering whether the higher price bears a reasonable relation to "economic value" or not, to take into account the benefits flowing to the firm (and its shareholders) from the subsidised loan, long-term low rental, or other special advantage which may serve to reduce its own long-run average costs below the notional norm. Having regard to all the particular circumstances, it might then be concluded that no addition of "pure" or "economic" profit by means of a price higher than economic value could reasonably be justified, or that the extent of the excess which might otherwise be justified would fall to be reduced.

24. By parity of reasoning, accounting costs may reflect an uncompetitive inefficiency. The criterion of economic value, on the other hand, recognises

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[37] Generally low costs of inputs in the domestic market (or, conversely, generally high costs) would, of course, have to be taken into account as adjustments when using foreign comparative data to arrive at relevant "economic value".

[38] Section 8(*a*) cannot therefore serve as a means of clawing back special advantages historically granted or available to the particular firm. It cannot be expected to charge a price below the price that would earn a normal profit for firms under notionally competitive conditions (economic value).

only the costs that would be recovered in long-run competitive equilibrium.[39] Accordingly, a dominant firm's price may be substantially and also unreasonably higher than economic value even when the accounting profit of the firm reveals no such picture.[40]

25. It follows that the argument in Brassey *et al*, *Competition Law*, (Chapter 7, "The Abuse of Dominance" by David Unterhalter SC), 202,[41] needs some qualification:

> What is required is a careful analysis of the costs incurred by the dominant firm, and then, by taking those costs together with a reasonable rate of return, a comparison should be made with the prices charged by the dominant firm. Economic value is thus not the court's view as to what value should attach to the product in some idealized or hypothetical market, but rather a construction of value based on the costs actually faced by firms in the market.

It is true that the inquiry into economic value does not involve a view as to what value "should" be. It is also true that the inquiry will concern cost conditions generally relevant to the particular market in which the impugned price is charged. Nevertheless, the Tribunal or Court has to hypothesise – and to some extent idealise – that market, by postulating a long-run competitive equilibrium and the cost conditions (including normal profit) that would then prevail. While the dominant firm's own incurred or likely costs will no doubt form an important evidential ingredient in such an inquiry, they will not in and of themselves, for reasons explained above, provide a measure for arriving at economic value unless they can be shown to correspond to the competitive norm. Furthermore, in our submission, it is

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[39] It is thus correct to say that a proper comparative cost analysis ought to be based on the costs of efficient firms.

[40] Cf MD [36], Record 1/10: "an inefficient firm may charge excessive prices and still not show exceptional profits". Cf also *Lucazeau v SACEM* (Record 11/2305-2311), para 29; *Tournier v SACEM* (Record 11/2312-2321), para 42; Whish *Competition Law*, 5th edition, 692 (Record 13/2812).

[41] Record 17/3724.

confusing to refer to "reasonable profit" when dealing with economic value. The test of reasonableness applies to the excess of price over economic value, and thus only to the element of "pure profit" (over and above "normal profit") implicit in that price.

Rewards for risk and entrepreneurship

26. In the above-quoted passages from both Marshall and Blaug, the covering of insurable (i.e., calculable) risks is treated as part of the normal cost of doing business under long-run competitive conditions. Such risk obviously varies from industry to industry, and indeed from locality to locality, and would have to be assessed accordingly. If no proper allowance were made for the risk to capital, it would be impossible to estimate the relevant economic value, which includes a normal return. Thus, even where a calculable risk is not actually insured it must still be accounted for as a cost. As an element in the notional competitive price, in other words, it is comparable to an insurance premium for the assumption of risk. Since economic costs in this analysis are taken to include normal profit, it does not seem to make a crucial difference whether one says that "costs" are normally higher or lower than usual in such a case, or that "normal profit" would be higher or lower accordingly.

27. However, where incalculable risks are concerned, no allowance can be made in the determination of a long-run competitive equilibrium price, or "economic value". Blaug explains this in detail in the appendix to these submissions.

28. The explanation also enables a necessary distinction to be drawn between "rent-of-ability" (which, in long-run competitive equilibrium, is to be

treated as part of cost) and "entrepreneurship" properly so called, which may temporarily give rise to "pure profit". It would follow that neither rewards for taking incalculable risks nor rewards for entrepreneurship can enter into an assessment of economic value for the purposes of *Question 1*.[42] However, under *Question 2*, both could properly enter into an assessment of the reasonableness or otherwise of any "pure profit" implicit in the higher price.

Product differentiation, brand loyalty and patent protection

29. In the present case, evidently, no question arises of special rewards for entrepreneurship. The Tribunal notes that "there is no claim that Mittal SA's pricing is rooted in the extraction of any innovation rents or patent rights."[43] Nevertheless, we propose to deal briefly with the subject, as a way of confirming that the methodology outlined above is capable of general application.

30. Joseph Schumpeter, in his *History of Economic Analysis*, noted that,

> … [W]hatever their nature in other respects, entrepreneurs' gains will practically always bear some relation to monopolistic pricing. Whatever it is that produces these gains, it must of necessity be something that, for the moment at least, competitors cannot parallel for, if they did, no surplus over costs (including entrepreneurial 'wages') could emerge. The successful introduction of a new

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[42] Milton Friedman argued to the contrary in *Price Theory* (see Transaction Publishers edition, New Brunswick, 2007, 148-149) when dealing with the definition of cost. In his view, the best procedure was "to define total cost as identical with total receipts". Accordingly, he treated "entrepreneurial capacity" as a factor of production costing the equivalent of what would otherwise be regarded as "pure profits" of the firm. In this way all profits are made to disappear into cost. According to Friedman: "Definitions of total costs that do not require them to equal total receipts generally equate them either with contractual costs alone or with expected costs, contractual and non-contractual, and so regard all or some payments to the entrepreneurial capacity of the firm as non-cost payments. The difficulty is … that there are no simple institutional lines or accounting categories that correspond to these distinctions." It is unnecessary to dissect here the ideological underpinning of Friedman's definition of cost as being identical with total receipts. It is enough to note that it is irreconcilable with our Legislature's conception of a difference between the "economic value" of a good or service and the higher price actually charged. The difficulty posed by any lack of institutional lines and accounting categories is one that the legislation itself requires to be confronted.

[43] See MD [102], Record 1/34-35.

> commodity or brand is perhaps the best illustration of this. Moreover, there are means available to the successful entrepreneur – patents, strategy, and so on – for prolonging the life of his monopolistic or quasi-monopolistic position and for rendering it more difficult for competitors to close up on him. Obviously, this may be linked up with the elements of the case that have been glanced at in the preceding paragraph in such a way as to yield a picture of reality that may, for practical purposes, differ but little from that drawn by a straight depredation theory. Rare birds indeed are the economists who give the proper weight to this set of facts and at the same time do not overstress them. It is here rather than in the fundamental question of theory involved that ideological bias as well as political influence assert themselves.[44]

31. To arrive at the "economic value" of a good or service by determining its notional long-run competitive equilibrium price, one would have to think away any features which, by their nature, would give a particular producer an exclusive advantage that competitors cannot emulate. The "pure profit" obtained for these features would have to be assessed under the "reasonable relation" test – i.e., *Question 2*.

32. In *Competition Law of South Africa*, Sutherland and Kemp write:[45]

> While differentiation of the respondent's product may explain high prices, a patent, a winning brand or an irresistible reputation cannot spell open-season on pricing for a monopolist.

That view is consistent with the argument developed above. It would be under *Question 2* that the reasonableness of any "pure profit" arising within the context of patent protection would ultimately fall to be determined. Patent protection, while it lasts, secures a justifiable monopoly; it does not justify or secure what may ultimately be shown to be an "excessive price". The idea that, once there is a monopoly protected by a patent, the monopolist is at liberty to charge any price – or that any price charged in such circumstances is *per se* "non-excessive" irrespective of its relation to

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[44] 1954, Oxford University Press, New York; 1994 edition, 897-898.

[45] 7–40(1).

economic value – would not seem to accord with the test of reasonableness intended by the Legislature as a step in determining whether a dominant firm's price is in fact an abuse.[46]

33. However, Sutherland and Kemp go on to say:

> The Tribunal's reasoning [in the present case] leaves the following important question unanswered: If the respondent's product is differentiated by competitive methods, how will the Tribunal determine whether the price of the product is reasonably related to the value of that differentiation?

Unfortunately this way of posing the question invites confusion. Ascertaining the "value" of the product differentiation does not arise. The economic value of the product must first be determined, by a method (outlined above) which assumes competition between producers of the identical product and so necessarily thinks away any price premium which exclusivity could command. Once the economic value of the product has been determined, the extent of the price premium charged by the respondent firm can be determined. The inquiry then passes to the reasonableness of that premium. If the premium derives entirely (say) from product differentiation that is achieved and maintained by truly competitive methods, it may well be that the only sound conclusion would be that the price, although higher than economic value, is reasonable related to it – and thus no abuse of dominance in this regard could be found.

"Value to the customer"

34. It should be noted that the utility, use-value, or "value to the customer" which a particular good or service provides, enters into the notional long-run competitive equilibrium price of that good or service – i.e., its economic

[46] Cf MD [101], and see n 81 and n82, Record 1/34. It is via the "no reasonable relation" criterion that a form of the so-called "rule of reason" enters into the test under section 8(*a*).

value.[47] To attempt to assess it as a distinct factor under *Question 1* would thus involve double-counting.

35. Demand-side factors would obviously have to be taken into account if the issue arises as to whether a particular product is unique or may realistically be compared with other products in determining its economic value.[48] It does not follow, however, that demand-side factors enabling a dominant firm to charge a high price for a product in an uncompetitive market can be relevant in determining the economic value of the same product in a notional competitive market. The latter is the exercise required by *Question 1*.

36. So-called "value-based pricing" – an expression nowadays very much in vogue – is pricing designed to exploit inelasticities of demand, by consciously pricing to whatever the market will bear at the time.[49] There may obviously be short-run justifications for a price higher than economic value which go to show a reasonable relation between the two, for the purposes of answering *Question 2*. A variety of case-specific factors would enter into the assessment of the reasonableness or otherwise of any "pure profit" implied in the price. But a high price based on so-called "value to the customer" cannot claim automatic justification.

37. Price-gouging following a natural disaster would be an obvious instance

[47] See e.g. Marshall, *op cit*, 348.

[48] Cf *CICCE v Commission of the European Community* (Record 10/2282-2288) paras 7 and 24-25.

[49] The online *Investopedia* (a Forbes Media publication) defines value-based pricing as a pricing strategy in which a product's price is actively dependent upon its demand. It is a method of pricing which "allows companies to take advantage of highly demanded products by charging more. A good example is how refreshments generally cost more at sporting events."
http://www.investopedia.com/terms/v/valuebasedpricing.asp

where a price higher than economic value would fall to be condemned under section 8(*a*).[50] Similarly a dominant firm's customers may be willing to pay an excessive price in circumstances where they can simply pass the consequences on to their own customers downstream. Since section 8(*a*) is concerned ultimately with detriment to consumers, it should not be construed as though it were indifferent to high pricing whenever a dominant firm's immediate customers are willing to pay.

<u>The level of output implied in the test for "economic value"</u>

38. In notional long-run competitive equilibrium, price would correspond to the lowest point on the industry's long-run average cost curve. However, average cost obviously varies with quantity produced. One must therefore work with a definite notional level of firm <u>output</u> in order to arrive at any definite assessment of economic value.

39. Section 8(*a*) is concerned with the price which a dominant firm charges for its chosen output, and <u>does not seek to govern any firm's output choices</u>. It would seem sensible, therefore, to employ in the determination of "economic value" the level of output chosen at the relevant time by the firm whose price is the subject of the complaint. There may accordingly be unexploited economies of scale, inasmuch as a greater output might imply a lower long-run average cost, and lower equilibrium price. But that would be beside the point when it comes to determining "economic value" (<u>*Question 1*</u>). We return below to the potential relevance of unexploited capacity in connection with the test of "reasonable relation" (<u>*Question 2*</u>).

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[50] This is recognised by the Tribunal in MD n67, Record 1/27 (although it confuses such an evaluation under section 8(*a*) with "price regulation" – see further below).

The problem of changing conditions

40. Where factor costs vary in cycles, then the notional long-run competitive equilibrium price would likewise vary. Accordingly, an answer to *Question 1* would require a careful matching of the time periods within which "economic value" and the price actually charged by the firm in question would have to be compared.

41. A further, and more fundamental, complication arises where the industry concerned is undergoing dynamic technological change.[51]

42. Such change brings with it the creative destruction (to borrow Schumpeter's phrase) of old capital values. It would surely be artificial, and wrong, to approach the determination of "economic value" as if "normal profit" could continue to be earned on capital that, in a competitive market, will in fact have been destroyed.

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[51] In MD [100] and [102], Record 1/34, the Tribunal cites David S Evans and A. Jorge Padilla, *"Excessive Prices: Using Economics to Define Administrable Legal Rules"*, CEMFI Working Paper No 0416 (September 2004) (Record 17/3735-3760), regarding the care needed in using competitive benchmarks "... in dynamic industries where investment and innovation play a paramount role." This is obviously correct as far as it goes. (See also the reference to the *Napp* case as having dealt successfully with this problem: MD n82, Record 1/34.)

Unfortunately, however, the Tribunal's later quotation from Evans and Padilla in MD [145], Record 1/52, perpetuates an error which, while it does no ultimate harm to the case, ought not to be repeated by anyone who wishes to avoid distorting historical ideas. "For Marxist economists, the 'fair' price of a product is equal to the value of labor involved in its production", say these writers (on page 5), citing Marx's *Capital.* If they had actually read the book, they would have known that, in Volume I, Marx specifically disavows the idea that labour has "value" (he regarded labour – crucially distinguished from labour-power – as having no value itself, but as being the social substance and measure of the value of the commodities, including labour-power, in which it is embodied). If they had read Volume III, they would have known that Marx explains at length why price (whether "fair" or otherwise) cannot possibly correspond in general to value (socially necessary labour time) as he conceived it, but that "surplus-value" is distributed on the basis of price competition coupled with the mobility of capital so that capital actually shares *pro rata* in the surplus at the general or normal rate of profit, and not in proportion to the labour actually embodied in the different commodities produced. Generally in the passage quoted, Evans and Padilla distort the ideas of the classical economists by treating them as if they had no conception of a competitive or equilibrium price. See n22 in these submissions above.

43. Technical change causes shifts in long-run cost curves.[52] Where technical change is generalised and has been introduced in the market under consideration – or where there is no objective obstacle to its introduction – it would seem sensible to adjust the "economic value" of the relevant good or service to the notional competitive equilibrium price corresponding to the changed conditions at the relevant point in time. This in effect shortens "the long run", and may imply a price at which the cost of still-fixed factors of production are not fully recoverable by the firm concerned. However, this adjustment would be appropriate only where such would clearly be the result in a competitive market in the industry concerned. The result, in other words, should be a benchmark appropriate to rational business decision-making in a market in which competition is effective.

Import parity pricing

44. Since the Commission or complainant in a complaint referral must first establish that the price charged is higher than the "economic value" of the good or service (*Question 1*), it follows that an import parity price cannot *per se* be held to be excessive. And if that be so, then it must follow that using market power to the full to extract such a price would not *per se* show a firm to be guilty of excessive pricing.

45. For a domestic producer whose only pricing constraint is the fact that the customer may resort to imports, the import parity price[53] is obviously the upper price limit.[54] This, in and of itself, does not establish whether a price at

[52] Lipsey *et al*, *op cit*, 195.

[53] We include in this expression any "hassle factor" which may be included in calculating the price.

[54] The domestic demand curve faced by the monopolist may, of course, constrain its pricing at a lower level

that limit is higher than the economic value of the good or service or not; and nor does it establish whether any excess of the price over economic value is reasonable or not (*Question 2*).[55]

46. The Tribunal seems to have assumed that when a firm is able to price up to import parity it faces no cognisable competitive constraint. Such an assumption is surely untenable. The fact that imports become substitutable for a firm's own product at a certain price is in principle a "cognisable" competition consideration facing the firm.[56] Through the long history of globalising capitalism, various domestic industries in many countries have been put to the sword by competition from cheaper imports. The collapse of the Indian textile industry in the nineteenth century following the industrial revolution in England and the opening of the Indian market is a classic example. The "rust belt" in the United States is more recent testimony to the same thing.

47. The price constraint imposed by the potential for imports is no different in principle from the price constraint that any firm, having the advantage of an exclusive location near to its customers, faces in the form of the potential for those customers to decide rather to incur the cost of fetching alternative products from a more distant supplier or having them transported from afar. The local firm's "monopoly" is sustainable only within those bounds. It may

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than import parity. In other words, significant numbers or even all of its customers might forego the good or service at a price lower than import parity. For present purposes, we assume that this is not the case.

[55] The same reasoning would apply where a dominant firm actually prices higher than import parity and finds its market contested by imports at that price level. No conclusion can be reached *ipso facto* as to whether its price is "excessive" or not. *Question 1* and *Question 2* still have to be asked and answered. See further below.

[56] It is unsatisfactory in principle to describe a domestic market as "incontestable" when in fact it is contestable by imports. The fact that it may be unrealistic to expect the entry and establishment of a rival domestic supplier is a different point, albeit one with potentially important implications for competition.

well have appreciable market power (i.e., market power as defined) by virtue of the *degree* of its independence from its customers and competitors; and its exploitation of that power might result in a price judged to be "excessive" (as defined). But the mere fact that it prices up to the constraining limit, i.e., to the point at which the boundaries to its geographical market dissolve and an alternative source of supply becomes realistic for its customers, provides no basis for determining whether its price at that limit is higher than and bears a reasonable relation to economic value or not.

48. If (say) the whole of the South African textile industry were combined into a single firm, and thus became a domestic monopoly, it might yet prove unable to sustain profitability in the face of freely competing imports. The mere fact that it could and would price up to the limit set by such imports (import parity pricing) would by no means provide proof of an abuse of its domestic monopoly through excessive pricing.

49. The question is simply whether the actual price level at which imports constrain the price of domestic supplies is excessive or not when charged by the domestic supplier. Abuse arises where a domestic monopoly (or indeed an oligopoly in which firms have market power) employs the shelter of distance etc to extract an unjustifiable amount of "pure profit" by way of a price unreasonably higher than the economic value of the good or service concerned. Whether, in fact, it is doing this or not has to be proved.

50. If ex-works prices charged by foreign suppliers in competitive markets provide a sound comparative basis for assessing the economic value of similar products produced here, then the extent of the transport and related costs needed to bring the foreign supplies to our market will obviously provide a

measure of the price premium which a local dominant supplier could extract, over and above economic value. Knowing the extent of the transport and related costs may thus provide a basis for a finding of market power – but the premise remains that a notional competitive price (or economic value) shall first have been established. Once economic value has been established, it is the actual amount of the excess in the price charged by the local firm that has to be measured and evaluated for purposes of section 8(*a*). All that import parity pricing will indicate is that the firm is pricing fully to the constraining limit.

51. A dominant supplier which is able, and does, simply set its price at import parity without careful reference to costs would do so at its peril, for, if the Tribunal or Court were to find that the import parity price is higher than the economic value of the supply, the supplier could well have difficulty defending the excess as having any reasonable relation to economic value. However, if in fact the supplier references its price to prices prevailing in other comparable but competitive markets, then its price would be likely to approximate to economic value.

Price differentiation and market manipulation

52. Plainly a firm that is able to sustain a price appreciably higher than the notional competitive price is not only exercising appreciable market power in charging that price: if it has unutilised capacity which it could use to meet unsatisfied demand at a competitive price (a price which would return a normal profit), then its high price is serving to restrict output. Section 8(*a*), however, as has been noted, sets out to evaluate the price not the output. If, in terms of section 8(*a*), a higher than competitive price may be reasonably justifiable, it would follow that any consequent restriction of output would

also be justifiable.

53. It may be that a dominant firm charges for some of its output at a higher price and for some at a lower price. This may constitute prohibited price discrimination if the specific criteria in section 9 of the Act are satisfied. Let us suppose, however, that those criteria are not satisfied. The question remains whether the higher price constitutes an "excessive price" for purposes of section 8(*a*).

54. The mere existence of the price differentiation, or the extent of it, cannot answer the question. This can be tested against all the possible scenarios.

    54.1 The lower price may be at the level of economic value, and the higher price above it – but the level of economic value would still have to be determined independently of either actual price in order to ascertain this. Once it has been ascertained, the difference would have to be evaluated for reasonableness. The relevant difference is even then only <u>incidentally</u> the difference between the lower and higher prices. <u>Crucially</u> it is the difference between economic value and the higher price charged that is relevant. Imprecise language invites imprecise thought.

    54.2 The lower price may be below economic value (without necessarily entailing a contravention of section 8(*d*)(iv)[57]). <u>The extent of the</u>

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[57] To satisfy section 8(*d*)(iv), the conduct would have to amount to an exclusionary act as defined in section 1, namely an act "that impedes or prevents a firm entering into, or expanding within, a market". It would also be subject, potentially, to a defence requiring an evaluation of any technological, efficiency or other pro-competitive gains. Moreover, and most fundamentally, it seems clear that section 8(*d*)(iv) – which deals with predatory pricing – employs as the relevant criterion the dominant firm's own short-run "marginal or average variable cost". It is not referring to the notional average cost of firms in long-run competitive equilibrium. The essential criterion for invoking section 8(*d*)(iv) thus does not correspond to the criterion of "economic value" applicable to section 8(*a*), as we have submitted above. Contrast in this regard MD [146],

difference between the lower and higher prices is still not the relevant question for purposes of section 8(*a*). The question is whether the higher price is above economic value, and, if so, whether the extent of that difference is reasonably justifiable in the circumstances.

54.3 The lower price may itself be above economic value. Assuming that only the higher price is alleged to be "excessive", the observations in paragraph 54.2 similarly apply.

55. It cannot make any difference in principle that the lower price is an "export" price and the higher (impugned) price is an "import parity price". [58] The mere existence of the price differential, and the extent of it, cannot get us to the relevant inquiry.

56. Where a domestic supplier differentiates between domestic and export prices, the differentiation may be no more than is necessary to absorb the cost of a locational disadvantage when it comes to exports, while achieving economies of scale by putting to use plant capacity that would otherwise lie idle and so threaten the survival of the firm. On the other hand, however, it must obviously not be assumed that the price differential is explained (or fully explained) by this. The extent of the differential may result from the combined effect of the firm's lack of market power in relation to the export

Record 1/53, where the Tribunal not only seems to lose sight of the distinction between short-run and long-run variable cost, and between a firm's own and the notionally competitive level of average costs, but seems simply to dismiss any correspondence between cost and "economic value". That is most perplexing.

[58] In "The Economics of Import Parity Pricing: A Pedagogical Note", *South African Journal of Economics* Vol. 73:3 September 2005, 357, Prof Holden concludes at 362: "The critical issue is the differential between export parity and the domestic price which may or may not be the same as the import parity price. It is this differential that is the appropriate measure of the extent to which market power may have been exercised." With respect, this is not sound. A firm's export price may entail a lower than normal profit because of (*a*) productive capacity in excess of domestic demand at a price capable of realising a normal profit, coupled with (*b*) locational disadvantage in supplying the export market. A firm's ability to sustain a substantial price differential may be indicative of the existence of market power, but would not itself measure it.

market and its abuse of market power in the domestic market. Only a factual investigation into the economic value of the supply, at the relevant level of overall output, and an evaluation of the extent to which the domestic price actually exceeds economic value (if it does so), can provide an answer.

57. The fact that a dominant firm is able to manipulate or segment its supply will not prove that the price actually charged to any category or segment of customers is "excessive" as defined.[59] This can be illustrated by constructing a simple – indeed highly simplified – thought experiment.

57.1 Suppose that A decides to take the risk of setting up and running a small but state-of-the-art cinema in a remote platteland town where no cinema existed before. For her entrepreneurial risk-taking, she will be entitled to a return on her investment somewhat higher than normal, i.e. to charge a price for tickets higher than their economic value, provided that she does not abuse captive customers by charging a price so high that it bears no reasonable relation to economic value.[60]

57.2 For the sake of simplicity, suppose that the long-run average cost that A will incur will be no different from the costs that would be incurred by similar cinemas in a market where competition prevails. We may therefore take A's own long-run average costs (including notional normal profit) as representative of economic value.

57.3 In what follows, we shall disregard the number of cinema shows as a potential variable, and simply work with averages based on seat

[59] Cf MD [167]-[184], Record 1/62-69; MD [193]-[196], Record 1/73-75.

[60] We ignore, for purposes of this illustration, the fact that A's firm would probably not meet the turnover threshold requirements of section 6.

occupancy per show. Suppose that the cinema comprises 100 seats, and that it would have made no sense for A to build anything smaller.

57.4 Calculations based on empirical data indicate (let us say) the following. In order to achieve a merely <u>normal</u> profit in the long run (i.e. to cover long-run average costs including normal profit), A's cinema would have to achieve one or other of the following assumed levels of average seat occupancy (output) at the related average price per ticket:

Average seat occupancy (or output)	Average price per ticket sufficient to return normal profit at that output	Average revenue sufficient to return normal profit at that output
65	R20.00	R1,300
70	R19.00	R1,330
75	R18.00	R1,350

57.5 A's potential customers cannot realistically travel to cinemas in other towns. We may suppose further that only new releases are screened, and that neither television nor DVDs provide realistic potential substitute products. A thus faces no pricing constraint other than the willingness/ability of local consumers to pay for cinema tickets. But this willingness/ability to pay varies considerably with socio-economic group.

57.6 If she charges a uniform price of R20 (a price equal to "economic value" at an output of 65 seats) she will in fact only fill (say) 55 seats on average. Because of the highly unequal distribution of disposable income in the town, there are relatively few potential customers who could regularly afford even R18. At that average price, she would not get even near to an average seat occupancy of 75. She would therefore not even achieve normal profit, the notional break-even point in the

economic sense. In the long run at least, her cinema will fail. She decides to solve the problem by price differentiation.

57.7 Differentiating her customers by residential area, she charges the better-off part of the community (the "X-group") R25 per ticket, while charging another part (the "Y group") only R10 per ticket. The result is (let us say):

	Tickets sold	Price per ticket	Revenue
X-group	50	R25	R1,250
Y-group	25	R10	R 250
Total sold	**75**	**(Average price R20)**	**R1,500**

At the firm's average occupancy rate (or output) of 75 seats, an average price of R18 would have sufficed to return a normal profit (see paragraph 57.4 above) – and so correspond to "economic value" as contemplated by section 8(*a*). In fact A makes "pure" profit of R2 per ticket on average, or R150 overall per average show.

57.8 It would obviously be wrong to suppose that, because A charges the Y-group of customers R10, the latter price would provide any measure of "economic value" at any level of output.

57.9 A's solution of price differentiation will obviously work only if she can prevent customers who themselves might buy tickets at R10, from buying more tickets at that price than they themselves need and reselling them in the wealthier part of town. In short, she must find ways to "immunise" part of the market from arbitrage. Suppose she succeeds in doing so. The mere fact of such price differentiation cannot possibly be relevant to the question whether the higher price

of R25 is "excessive" or not in contravention of section 8(*a*).[61]

57.10 Applying ***Question 1*** to this example, it is clear that the R25 price – although charged for only 50 tickets – is higher than the economic value of a ticket (namely R18) at the cinema's output of 75 occupied seats.[62] The inquiry thus moves to ***Question 2*** : Is the price of R25, involving an excess of R7 over economic value, "excessive" in the sense that it bears no reasonable relation to economic value? In other words, is the price premium (R7 above economic value) one which has no reasonable justification?

57.11 In this regard only – i.e., in connection with ***Question 2*** – it may be relevant to consider the extent of the discount (R8 below economic value, and R15 below the X-group's price) that is implied in the lower price of R10 given to the Y-group customers. If that price is unreasonably low, it may signify that the price to the X-group customers is unreasonably high. Like all inquiries into reasonableness, this involves a social value judgement to be exercised in the light of all relevant circumstances. In the example of the platteland cinema, it may be relatively easy to come to the conclusion that there is no abuse. However, in other cases and other circumstances, the extent of price differentiation may well constitute an ingredient in an excessive

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[61] Since A's pricing is not likely to have the effect of substantially preventing or lessening competition, it would escape condemnation under section 9. Since the lower price of R10 is not now exclusionary, it would presumably not be condemned under section 8(*d*)(iv), even if it could be shown – which is not apparent from our example – that it would be below short-run marginal or average variable cost. See paragraph 54.2 and n57 above.

[62] Investigation might show that, if A limited ticket sales to 50 on average (half of the cinema capacity), she could break even (return a normal profit) at R25 per ticket. But this would surely be irrelevant. She might choose to do so, but section 8(*a*) would not require her to limit her actual output relative to capacity in order to justify a high ticket price. Under *Question 1* (i.e., the question whether the impugned price is higher than economic value or not), the price would be assessed in relation to the level of output chosen and achieved.

pricing abuse. Nevertheless, the point remains that the mere fact of price differentiation – and the mere fact that the firm is able to use, and indeed uses, its market power in carrying this out – cannot tell us whether the higher price is "excessive" or not.

57.12 In our illustration, the cinema's capacity (100 seats) exceeds demand at both the higher and lower prices charged.[63] A's output (average occupancy of 75 seats) exceeds demand at the higher price. It cannot logically be asserted that a firm's price is necessarily "excessive" because its supply (or capacity to supply) exceeds demand at that price. However, in the inquiry into reasonableness under *Question 2*, it would be appropriate to test whether the firm could achieve a reasonable profit (i.e., including any reasonable amount of "pure" profit") while charging less than the actual higher price to the group of customers concerned. In other words, what would be the effect on A's output, economies of scale and ultimate profit if (say), instead of selling 50 tickets to the X-group at R25, she offered tickets to them at R22? The answer to this could affect a judgement as to the reasonableness or otherwise of the R25 ticket price.

57.13 This is a judgement that could only be made following a careful examination of the particular facts. If A simply made all 100 tickets available to an undifferentiated market at whatever price the tickets could fetch, she might never realise even a normal profit and consequently go under. It is no part of a rational inquiry into excessive pricing to benchmark "non-excessiveness" against such a pricing

[63] It may be assumed that even a lowering of the X-group's price to R10 would not fill the cinema, as the group is too small to take up 75 seats on average at any price.

criterion.

57.14 It will also be evident from the analysis that one could not show A's R25 price to be excessive in contravention of section 8(*a*) by merely proving that she is a monopolist charging the maximum price she can extract from a restricted output. Her ability to "preselect" prices is likewise in no way decisive.

58. In summary: a dominant firm might exercise its market power to the full in achieving its pricing and yet not reach a price which both exceeds economic value and does so to an extent that is without any reasonable justification in the circumstances. Actual costing data or other evidence going to prove the level of "economic value", the extent of the excess inherent in the price actually charged, and the unreasonableness of it, remain essential to the success of an "excessive pricing" complaint.

Difficulty of precise quantification of "economic value"

59. Evans and Padilla,[64] in their discussion of various policies towards the prohibition of excessive pricing by dominant firms, place great emphasis on the "conceptual as well as practical difficulties" of determining what constitutes an "unfair" price for purposes of Article 82 of the EC Treaty.[65] Since our section 8(*a*) is differently constructed, we must address the difficulties as they arise in regard to each specified component of the test. The specified components make the test more definite[66] and somewhat more manageable, although obvious difficulties remain.

[64] *Op cit.*

[65] Record 17/3736.

[66] Cf para 19 above.

60. Difficult as the task of quantifying "economic value" may be, it should not be made into a scarecrow.[67] Courts often have to quantify things in money where only a rough estimate is possible on the basis of evidence reasonably available to the party bearing the *onus* of proof. Examples arise in the quantification of patrimonial damages,[68] and of compensation or restitution necessary to avoid unjustified enrichment.[69] A "fairly robust approach" may be adopted, so long as it is not unfair.[70]

61. If, by the application of various relevant tests and comparators, the Tribunal or Court can determine that economic value would probably not be higher than a certain amount, then that amount can safely serve as the basis for measuring the extent (if any) to which the impugned price is higher than economic value.

62. Where the accused firm itself normally charges a lower price for other products, it may be quite fair to that firm to take this price (or an adjustment of this price) as indicative of economic value – provided that the costs of the products can be realistically compared. To achieve such a comparison, it may be necessary to make systematic adjustments to the costing data. One *caveat* here is that the particular firm may be enjoying cost advantages which would not be available to firms generally in a notionally competitive market in the same area. However that, too, should not be beyond the scope of realistic adjustment.

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[67] Cf *Napp Pharmaceutical Holdings Ltd v Director General of Fair Trading* (*supra*) at para 392.

[68] See *LAWSA*, Second Edition, vol 7 para 113; *Visser and Potgieter's Law of Damages*, 2nd edition, 489-491.

[69] See *Thompson v Scholtz* 1999 (1) SA 232 (SCA) at 248I-249D.

[70] Cf also *AA Alloy Foundry (Pty) Ltd v Titaco Projects (Pty) Ltd* 2000 (1) SA 639 (SCA) at 646J-647A.

63. Where the impugned price is shown, as in the *British Leyland* case,[71] to exceed the normal price for roughly similar products to a degree which is, on the face of it, utterly exorbitant, then the need to quantify economic value more precisely before concluding that the impugned price bears no reasonable relation to it may fall away. The steps under *Question 1* and *Question 2* could in such a case collapse practically into one. At least in this way a *prima facie* case would be made out, leaving it to the accused firm to adduce evidence to the contrary if it is to avoid the case against it becoming conclusive.[72]

64. Likewise, where the dominant firm raises the normal price for its product substantially without any corresponding rise in costs, this may indicate *prima facie* that the new price is higher than economic value without the need to quantify the latter more precisely.[73]

65. Where input costs vary considerably in cycles, the dominant firm's actual costs may fall sharply without it carrying out a corresponding reduction in its price. Likewise, if the firm usually prices to import parity, it may neglect for a time to bring its price into correspondence with that (ultimately constraining) maximum, relying in the short-term on customer ignorance or inertia in order to charge more. In consequence, the firm's own accounting profits may show a considerable increase or "spike" during a certain period or periods, over and above the levels which it usually achieves. If there is no

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[71] *British Leyland plc v Commission of the European Communities* (Record 10/2289-2296) paras 25-30.

[72] See n16 above. In *United Brands* (*supra*), although the price paid by Danish customers was 2.38 times the price paid by Irish customers (para 213), it was ultimately held not to have been proved that the higher price bore no reasonable relation to economic value.

[73] Cf *British Leyland plc* (*supra*). This assumes that there is no apparent reason to think that the price previously charged has been below economic value, e.g. on account of abnormally low input costs specific to the firm.

reason to suppose that the firm's own usual levels of accounting profit would have resulted in a return on capital that is less than the notional competitive norm (i.e. enough to sustain it in business in the long run), then it would appear *prima facie* that the firm must have earned "pure" profit as a result of its pricing during the period or periods when the spike occurred. In other words, by making the most generous assumptions regarding "economic value" in favour of the accused firm in answering *Question 1*, it may be possible to proceed directly to evaluate under *Question 2* the reasonableness or otherwise of that amount of excess which is revealed during the particular period or periods of the profit spike. Thus a conviction on a narrower basis than that originally alleged may potentially be secured, without any concession that the firm's prices ordinarily charged when input costs etc. were higher were themselves legitimate.

66. Prices ordinarily charged locally in other markets by the same firm or by other firms with broadly comparable cost structures at comparable levels of output, may obviously serve as a measure of the "economic value" of the same good or service in our market – if the other markets are shown to be, or can be assumed to be, characterised by effective competition in the long run.[74] An assumption of effective competition could usually be made in such a case, without any unfairness to the firm accused, if the comparative price ordinarily charged in the other markets is shown to be lower than the impugned price, after all appropriate adjustments have been made.[75] In this way, the difficulty of directly measuring profitability (not necessarily itself

[74] Of course local prices may vary in those other markets, complicating the comparisons.

[75] Cf *Lucazeau v SACEM* (Record 11/2305-2311), paras 4, 7, and 25-31; *Tournier v SACEM* (Record 11/2312-2321), paras 4, 5, 7, and 36-44.

an insuperable difficulty[76]) may be overcome.

67. However, there may be no alternative to a detailed exercise in comparative costing. If expert evidence has been given concerning costing data, the necessary adjustments to be made for comparative purposes, the appropriate methodology needed to establish the opportunity cost of capital and allow for depreciation and replenishment of plant, etc., then the Tribunal (or Court, as the case may be) would need to make findings based on an evaluation of that evidence – if it cannot decide the case on other evidence making this route unnecessary.[77]

68. When a lower price (e.g., a rebated local price or an ex-works export price) is said to be sufficient to "cover costs", it is important to establish that the price concerned covers not merely the accounting costs but also the relevant opportunity costs of capital.[78]

69. Where a dominant domestic producer maintains price differentiation between export and domestic customers, and embarks on an expansion of its

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[76] In *United Brands* (*supra*), the Court observed (para 254): "While appreciating the considerable and at times very great difficulties in working out production costs which may sometimes include a discretionary apportionment of indirect costs and general expenditure and which may vary significantly according to the size of the undertaking, its object, the complex nature of its set up, its territorial area of operations, whether it manufactures one or several products, the number of its subsidiaries and their relationship with each other, the production costs of the banana do not seem to present any insuperable problems." As to the problem of appropriately allocating overhead costs in cases where the same firm produces several different products using the same infrastructure, many firms nowadays in practice make detailed costing allocations themselves in order to keep a check on the profitability of different lines of business.

[77] Normally, of course, disputed issues of fact and expert opinion should be decided first by the adjudicator actually hearing the evidence presented at trial, and before whom the witnesses have been cross-examined.

[78] See in this regard paragraphs 22 *et seq* above. Evans and Padilla, *op cit*, observe (Record 17/3740): "Measurement issues are the least of the concerns with using profit benchmarks, though. Accounting procedures do not provide for capitalization of R&D and advertising, do not address inflation, and do not properly adjust rates of return for risk. Thus accounting profits do not reflect economic profits except under the most unrealistic assumptions. The relationship between accounting and economic rates of return hinges on the time shape of net revenues, something that varies across industries, across firms within an industry, and even across time for a given firm."

production capacity wholly or mainly in order to increase its export sales, then it would be difficult to avoid the conclusion that its export price[79] would be at or above economic value – at the expanded level of output intended.[80] In any event, the business calculations involved in the expansion could be expected to provide important evidence regarding both the current and future positions.

Other aspects of the test

70. Having regard to the distinct conceptual elements which need to be addressed in answering *Question 1* and *Question 2*, the relevant factors and considerations should as far as possible be kept distinct, arranged systematically according to the concept to which they relate, and not simply mixed together.[81]

71. "Externalities" refer to the positive or negative impacts of a good or service on those not directly involved in the market transaction. They refer to social rather than private benefits and costs. In principle these would not enter into the calculation of the "economic value" of the good or service as defined above,[82] but could arguably be taken into account when determining whether any excess over economic value in the price charged by a dominant

[79] Where competitive local prices in different export markets vary, the supplier in this country would presumably apply different export prices ex-works.

[80] Adjustment would have to be made for any difference in output, because economic value at a higher level of output may well be lower than currently prevails.

[81] Such mixing together appears, for example, in the treatment of the subject by Sutherland and Kemp, *op cit*, 7–40(2) to 7–40(5). In this way the principles become confused, or at least difficult to distil, as is also the case with the European precedents. The latter, of course, are working with an undifferentiated statutory formulation ("unfair" pricing), unlike our own.

[82] Cf Sutherland and Kemp, *op cit*, 7–40(4).

firm is reasonably related to such value or not.[83]

72. Is the degree of dominance of the firm or the contestability of the market directly relevant, without further ado, to the "reasonableness" or otherwise of any excess of price over economic value? It is difficult to see why this should be so.[84] Obviously, if the market is readily contestable, this will tend to limit to a reasonable level any price premium obtainable by a currently dominant firm. If the market is not readily contestable, a dominant firm will have greater scope for possible abuse. While this fact will warrant constant and careful scrutiny of the dominant firm's conduct by the competition authorities,[85] it would not necessarily follow that any particular price charged that is above economic value will be unreasonable. As discussed above, the adjudicator is required to evaluate the price itself, not the market power which makes the price possible.

73. However, once it is shown that the impugned price is above economic value, then the basis upon which the higher price has been achieved and is maintained will become a relevant factor in the inquiry into the reasonableness of the relationship (*Question 2*).[86]

74. In our example of the platteland cinema, a monopoly position coupled with manipulation of supply and customer segmentation provide the means by which A is able to return an amount of "pure" profit. Yet it would be a rather blinkered Tribunal or Court that simply fixed its attention on those factors, while ignoring the entrepreneurial foundation and utility to consumers on

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[83] Cf *Attheraces Ltd v The British Horseracing Board Ltd* (*supra*) at para 214.

[84] Cf Record 1/33, and the Tribunal's quotation from the *Napp Pharmaceutical* case, in MD [96].

[85] The above-mentioned passage from the *Napp* judgment would be apposite in this context.

[86] Cf MD [154], Record 1/56.

which this power is originally based. In contrast, the mere utilisation of a dominant position to extract "pure" profit could scarcely lay claim to reasonableness.

75. Also relevant to the inquiry would be the extent of the "pure" profit and the period over which it is maintained. As time passes, if the dominant firm is merely resting on its dominance and collecting "rents", any original reasonableness in its high pricing would tend to fall away.[87] Thus competition policy considerations would enter crucially into the inquiry into reasonableness, but not in a crude or one-sided way.

76. The ability of a firm to reduce its price significantly so as to punish in the market previous or potential customers who have made purchases from other suppliers would be a factor suggesting that the relation between its previously higher price and the economic value of the good or service has not been a reasonable one. But one still has to show that the impugned price has exceeded "economic value" in the first place.

"Price regulation"?

77. The Tribunal is not called upon to assume "the mantle of a price regulator".[88] It is not called upon to involve itself in "the administrative determination of a price".[89] Its function in terms of section 8(*a*) is not to set prices but merely to constrain the price-setting behaviour of dominant firms within reasonable bounds. This it is expected to do, not in reliance on its own resources, but by

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[87] Cf *Napp Pharmaceutical Holdings Ltd v Director General of Fair Trading* (*supra*), para 407.

[88] MD [37], Record 1/10.

[89] MD [77], Record 1/26.

evaluating evidence put before it.[90]

78. The Tribunal does not wish to "adopt, by virtue of section 8(a), the methodologies of price regulation".[91] There seems to be some confusion here. In order to establish whether a price bears a reasonable relation to economic value or not, a competition authority may well have to delve into costs and profits. True, price regulators also do that. It does not follow (as the Tribunal's reasoning implies) that the competition authorities are to become in effect price regulators.[92] Price regulators determine the price, or the maximum price, to be charged; they do not determine whether a price that has been charged is so out of proportion to economic value that it is to be condemned as an abuse of dominance.[93] The two tasks are of a completely different order of scope and magnitude.

79. Although the contravention may be alleged to be ongoing, the Tribunal or Court would usually not be able to determine prospectively what the economic value of the good or service would be, or what (if any) excess in price could in future be justified as reasonable.[94] The Tribunal or Court

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[90] It will generally be vital that the Competition Commission has properly performed its own task in thoroughly investigating and referring a legitimate complaint, because the complainant itself will usually be at a severe disadvantage in terms of resources and access to information. A perfunctory investigation, relying on a mistaken methodology, will only encourage excessive pricing abuses to arise or continue.

[91] MD [37], Record 1/10. (Emphasis added.)

[92] *Id.* See also MD [87], Record 1/29, where the Tribunal criticises the European authorities for "too readily assum[ing] the role of price regulator … in their analysis of the very existence of excessive pricing… ." (Emphasis added.)

[93] Section 8(*a*) does not require the Tribunal or Court to determine a "fair" price for the good or service. The section only requires it to determine whether a price actually charged at a particular time or times was so much above economic value that, in all the circumstances then prevailing, it bore no reasonable relation to economic value.

[94] This may be a factor precluding an accused firm from invoking section 67(2) of the Competition Act in respect of a complaint under section 8(*a*) concerning its pricing in a subsequent period.

would thus rightly refuse to "assume the mantle" of a price regulator.[95] That is an entirely different matter from refusing to pass judgment on the level of a price previously charged by the dominant firm at its own instance.

80. The test for excessive pricing suggested above (*Question 1* and *Question 2*) requires dominant firms to become their own price regulators. It would not oblige dominant firms to price with reference to imaginary competitive considerations. It would, however, oblige dominant firms to have careful regard to the costs (and prices) of efficient firms in effectively competitive markets, and to hold their own prices down to a level bearing a relation to such costs (and prices) that is capable of reasonable justification.

81. A contravention of section 8(a) does not require *mens rea*. The test is an objective one, which is capable of being applied by a firm to its own conduct on the basis of information potentially available to it. Although the test involves "reasonableness" in the relation between price and economic value, this is intrinsically no more uncertain than any other requirement of reasonableness which the law imposes on human behaviour.

Detriment to consumers

82. Section 8(*a*) requires that the excessive price be charged "to the detriment of consumers". It is a well-established canon of construction that a statute should be so construed that, if it can be prevented, no clause, sentence or

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[95] The European approach of evaluating actual price levels in cases of alleged excessive pricing does not appear to have submerged the competition authorities there in price regulation, or in incessant inquiries into the appropriate pricing of innumerable goods and services. The Tribunal or Court is not required to confront the "truly massive technical difficulties" involved in determining the "right" price. (Cf MD [74], Record 1/25.) This is something which should be borne in mind when considering the appropriateness of any order that might be made pursuant to a successful referral.

word should be superfluous, void or insignificant.[96]

83. The customers to whom the excessive price is charged may be consumers (users) of the good or service concerned, but not necessarily so. Although they may overlap, "customers" and "consumers" appear to be distinct concepts in the Act.[97] There is, generally speaking, a presumption or reasonable supposition that the same words or expressions in the same Act are intended to bear the same meaning where no indication to the contrary is given.[98] Conversely, where the Legislature uses a different expression, it is presumed to have intended a different meaning.[99] Moreover, an excessive price may be charged to a single customer; in the expression "to the detriment of consumers" (our emphasis) the Legislature uses the plural.

84. Accordingly, proof of detriment to consumers appears to be a distinct requirement that must be met in order for a complaint referral under section 8(*a*) to succeed. Hence *Question 3* above.

85. Sutherland and Kemp imply in their exploration of the subject[100] that downstream consumers of the product in question or of products derived from it are the only relevant category of consumers. However, where

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[96] See *Consolidated Textile Mills Ltd v President of the Industrial Court and Others* 1989 (1) SA 302 (A) at 308C-D.

[97] The word "consumers" is used three times: in the preamble; in section 2(*b*) where it is said that one of the purposes of the Act is "to provide consumers with competitive prices…"; and in section 8(*a*). The Act also uses the word "customers" or "customer" where it is dealing with the supplier-customer connection or relationship. See the definitions of ***'essential facility'***, ***'market power'*** and ***'vertical relationship'*** in section 1; section 4(*b*)(ii); section 8(*d*)(i).

[98] *Minister of the Interior v Machadodorp Investments and another* 1957 (2) SA 395 (A) at 404D; *More v Minister of Cooperation and Development* 1986 (1) SA 102 (A) at 115C.

[99] *R v Sisilane* 1959 (2) SA 448 (A) at 453F-G; *Consolidated Textile Mills Ltd v President of the Industrial Court and others* (*supra*) at 307A-308C.

[100] *Op cit*, 7–40(1) to 7–40(2). See also 7–40(6).

customers of the dominant firm themselves consume the product – whether productively or as final consumers – it would seem artificial to exclude them from the ambit of the term.[101]

86. Whether the intended requirement is one of detriment to consumers in general, or whether it is sufficient that there be detriment to one or more consumers of the good or service in question, is not altogether clear. Section 6(*b*) of the Interpretation Act No. 23 of 1957 provides that in every law, unless the contrary intention appears, words in the plural include the singular. In this instance, the Legislature's use of the plural does appear deliberate – for otherwise the requirement would almost always be redundant. If that is correct, then a single instance of the charging of an excessive price by a dominant firm would not amount to a contravention of section 8(*a*), unless detriment to consumers downstream were proved.

87. However, the finer points in *Question 3* may not need to be addressed in the present case. It does not appear to be in dispute that, if the prices complained of are held to be excessive, detriment to consumers will have resulted.

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16 October 2008

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[101] The idea advanced by Sutherland and Kemp (*loc cit*) that there may be no detriment to consumers where the customers of the dominant firm are unable to pass the excessive element in the price on to their own customers downstream is also one which, we submit, should be treated with caution. A sustained and substantial upstream price that is unreasonably in excess of economic value will eventually distort the long-run costs of downstream industries and harm consumer welfare.

APPENDIX

Extract from Mark Blaug, *Economic theory in retrospect*, 5th edition, Cambridge University Press, 1997, 439-447:

THE THEORY OF PROFIT

In long-run competitive equilibrium the reward of each factor, including the hiring factor, equals its marginal value product; there is no residual for the entrepreneur and profits are zero. But what of those theories that speak of profit as the returns to a distinct fourth factor of production called 'organisation' or 'entrepreneurship', comprising the services of ultimate coordination and decision making, as well as risk taking and uncertainty bearing? It would seem that in this case we can simply apply standard marginal productivity theory and define 'normal profits' as the marginal product of the entrepreneur. Thus, we could say with Marshall that, in long-run equilibrium, profits are 'normal' because pure, residual profits are zero. Is this a tenable point of view?

18 The meaning of pure profit

First of all, we have to make it clear what we mean by 'pure profits'. However confused in their terminology, economists since the days of Adam Smith have always meant to exclude all necessary cost outlays from the definition of pure profit. Pure profit is a return over and above opportunity cost payments, the payments necessary to draw forth productive services from their most remunerative alternative employments. At the same time, pure profit is also a return in excess of 'real' costs, since it is not required to maintain any productive agent in existence. Pure profits are therefore perfectly analogous to Ricardian rents in cases where land has no alternative uses whatever. If land does have alternative uses, ground rent must be paid by the firm in order to secure land on which to operate. Similarly, if the transfer cost or opportunity cost of the ultimate decision maker is positive, pure profit must be defined net of the wages of management. Likewise, the fact that some businessmen earn consistently more than others might lead us to define pure profit as a 'rent of ability', an intramarginal surplus accruing to superior business talent. But in long-run equilibrium, such intramarginal rents are imputed to costs in the form of wages of superior management; the rent-of-ability theory of profit is really a theory of differential wages travelling in disguise.

Sticking to our definition of pure profit as being neither an opportunity cost nor a real cost, we can define it as a residual left over after all contractual costs have been met, including the transfer costs of management, insurable risks, depreciation and payments to shareholders sufficient to maintain investment at current levels.

19 The entrepreneur as a factor of production

If we treat the entrepreneur as a distinct factor of production, receiving his marginal product, we cannot logically equate this marginal product to pure profit. Pure profit is either the marginal product of some factor or it is a non-imputed residual. We have just concluded that it is a residual. Hence, the marginal product of entrepreneurship cannot be pure profit.

But the concept of the entrepreneur as a factor of production, separate from and in addition to the conventional triad of land, labour and capital, is itself inconsistent, as Edgeworth never tired of pointing out. We cannot precisely define the marginal product of a factor unless the factor is both infinitely divisible and strictly homogeneous. If it is not infinitely divisible, the *marginal* product can only be calculated approximately. If it is not strictly homogeneous, we are not talking about one and the same factor. In practice, the definition of a factor always represents some compromise between the twin claims of divisibility and homogeneity. All too frequently, if a factor is rigorously defined as being finely divisible, the resulting factor class has little economic significance: think of minutes or even seconds of labour. And, on the other hand, if it is defined as satisfying homogeneity in the strict sense, it turns out to be indivisible: think of men of the same age, native ability, work experience and educational attainment.[102] But in the case of entrepreneurship the usual practical compromises have to be carried to excessive lengths. If the entrepreneur is a person, a firm has room for only so many entrepreneurs, and it is straining language to speak of entrepreneurs as members of a homogeneous group; if entrepreneurship is a function, it cannot be finely divided in terms of something like entrepreneurial man hours as the fundamental unit of supply. In short, entrepreneurship is a function that fails to satisfy the conditions required to define a 'factor of production' .

What then is it? On the one hand, it appears to be a vital function in an economic system characterised by private ownership of capital and, on the other hand, it is ruled out by marginal productivity theory as playing any role in long-run equilibrium. Here is a puzzle that requires some sorting out. To understand the strange disappearance of the entrepreneur from the centre of the stage of economic theory, we must jog back a little.

20 The history of the concept of entrepreneurship

Adam Smith in the *Wealth of Nations* clearly separated the functions of the capitalist from those of the manager and emphasised the fact that the 'profits' of the capitalist exclude the 'wages' of management as a payment for 'the labour of inspection and direction'. However, Smith did not distinguish in any way between the capitalist as the provider of the 'stock' of the enterprise and the entrepreneur as the ultimate decision maker. He did use the terms 'projector' and 'undertaker' as English equivalents of the French word 'entrepreneur' but only as synonyms for the business proprietor. This failure to isolate the entrepreneurial function from that of pure ownership of capital became the standard practice of all the English classical economists. Thus, the term 'entrepreneur' or any of its English equivalents is totally absent in the writings of Ricardo and so is the concept of the businessman as the principal agent of economic change.

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[102] [Footnote by Blaug:] In *the Essay on Coordination of the Laws of Distribution,* Wicksteed tried to reduce constant returns to scale to a tautology by defining all inputs as being strictly homogeneous. Instead of accepting the crude productive triad of classical economics, he decided that 'we must regard every kind and quality of labour that can be distinguished from other kinds and qualities as a separate factor ... instead of speaking of so many £ worth of capital we shall speak of so many ploughs, so many tons of manure, and so many horses, or footpounds of power'. It follows that a proportionate increase in all these strictly homogeneous but also strictly indivisible inputs must increase output equiproportionately. But Wicksteed failed to realise that he had tacitly banished the concept of a marginal product. If one input is indivisible, the smallest increase in output that will leave input proportions unaffected is a 100 per cent increase. In that case, however, the marginal productivity principle cannot be applied. To calculate the marginal product of an input it is necessary to define an input as being finely divisible as well as homogeneous.

Some would argue that the English classical economists may be forgiven for having amalgamated the functions of the capitalist and the entrepreneur. Of course, the corporate form of business organisation, in which the capitalist role of stockholders is sharply distinguished from the decision-making role of managers and entrepreneurs, had been invented centuries before. Nevertheless, until the 'railway mania' of the 1840s, trading on the British stock exchange was largely confined to government bonds and public utility stocks and the prevalent form of business ownership in the heyday of the Industrial Revolution was the small- to medium-sized family firm, the capital funds being provided by the owner, his relatives or his friends. No wonder then that the classical economists failed to highlight the distinctive character of the entrepreneurial function.

On further reflection, however, this historical explanation of the neglect of entrepreneurship in English classical political economy appears somewhat unconvincing. The fact of the matter is that the concept of the entrepreneur as having a function quite distinct from that of both the capitalist and the manager had already been formalised by Richard Cantillon, writing some twenty years. before Adam Smith.

Cantillon observed that discrepancies between demand and supply in a market create opportunities for someone to buy cheap and sell dear and that it is precisely this sort of arbitrage that brings competitive markets into equilibrium. He named people who take advantage of these unrealised profit opportunities 'entrepreneurs', that is, individuals who are willing 'to buy at a certain price and sell at an uncertain price'. Moreover, he noted that action of this kind need not involve production and need not absorb the personal funds of the entrepreneur, although it frequently did. In short, entrepreneurship for Cantillon is a matter of foresight and willingness to assume risk, which is not necessarily connected with the employment of labour in some productive process. Cantillon therefore left no doubt of the difference between the functions of the entrepreneur and those of the capitalist.

Adam Smith read Cantillon but took no notice of his analysis of entrepreneurship. Similarly, Ricardo had the benefit of Jean Baptiste Say's writings, which leaned heavily on Cantillon in distinguishing between the provision of capital to a business enterprise, on the one hand, and the multiple functions of superintendence, direction, control and judgement, on the other. Nevertheless, there is not so much as a hint of the special role of entrepreneurship in Ricardo. It is evident that Ricardo, and for that matter virtually all the other leading English classical economists, regarded production and the investment of capital as a more or less automatic process, involving no critical decision making and certainly no risky judgement or imagination of any kind. Ricardo recognised that the first capitalist to introduce a novel improvement such as a new machine is liable to reap extra returns but this did not lead him to single out the capacity to innovate as the feature which distinguished one capitalist from another.

And exactly the same thing is true of Marx. Despite his emphasis on the constant accumulation of capital, on the remorseless pressure to innovate or to perish, Marx too treated the business process as virtually automatic once the required capital is forthcoming. According to Marx, squeezing the work force to make greater efforts is one of the two principal sources of extra profits for capitalists, the other being the introduction of new machinery. But in Marx there is never any problem about which new machines the capitalist is to introduce; likewise in Marx there appear to be no choices to make about the size of the business, or the number of products to manufacture, or the type of markets to penetrate. In other words, Marx, like all economists before him and since him, realised

that the action of competition requires differences in behaviour among economic agents – after all, if they all acted exactly the same in the face of the same circumstances, economic change and progress would be impossible to explain. Nevertheless, Marx took no interest in these individual differences among capitalists that alone account for the dynamic evolution of the capitalist system.

Marx knew perfectly well that capitalists can borrow all their capital from banks, which is why he regarded 'interest' on capital as a deduction from the 'profits' of enterprise. He also knew that the special skills of managers, including the skills of monitoring and supervising the labour force, can be hired on the labour market. But he never considered whether the residual income left over after paying the interest on borrowed capital and the wages of management corresponded to any particular economic function, for example, the function of buying inputs at certain prices and selling output at uncertain prices, as a result of which there may be losses instead of profits. He must have thought either that capitalists bear no risks, or that if they do bear risks, there is an apparently limitless supply of people in a capitalist economy willing to bear such risks. At any rate, Marx, like Smith and Ricardo, simply conflated the functions of the capitalist and the entrepreneur.

For the first entirely adequate statement of the entrepreneurial role, we must go not to Marx, not to Say or even Cantillon, but to Thünen. In the second volume of *The Isolated State* (1850), Thünen defined the gains of the entrepreneur as the income which is left over from the gross profits of a business operation after payment of (1) interest on invested capital, (2) the wages of management and (3) an insurance premium against the calculable risk of losses. The rewards of the entrepreneur, Thünen went on to say, are therefore the returns for incurring those risks which no insurance company will cover because they are unpredictable. Since novel action is precisely the condition under which it is impossible to predict the probability of gain or loss, the entrepreneur is necessarily an 'inventor and explorer in his field'. Notice: this masterful grasp of the entrepreneur as the residual income claimant of a risky, unpredictable income, typified by but not confined to the innovative entrepreneur, predates the publication of Marx's *Capital* by 17 years! Moreover, Marx had read Thünen's *Isolated State.* In short, let us not say that Marx identified the entrepreneur as the capitalist because he could not have known better.

Mill's *Principles* (1848) popularised the term 'entrepreneur' among English economists but failed to break the hold of the Smith-Ricardo tradition of the entrepreneur as simply a multifaceted capitalist. Soon, thereafter, the 'marginal revolution' shifted attention away from the internal organisation of a business enterprise, thus eliminating the role of both the capitalist and the entrepreneur. When perfect competition has done its work, when we have reached long-run equilibrium, the total product is exactly exhausted by marginal productivity factor payments; 'profits' are eliminated and the entrepreneur, as Walras said, 'neither benefits, nor loses'.

We are now at the heart of the question with which we began. So long as economic analysis is preoccupied with the nature of static equilibrium under conditions of perfect competition, there is simply no room either for a theory of entrepreneurship or a theory of profit as the residual income claims of persons who assume the risks associated with uncertainty. What the older classical economists had called 'profits', or what Marx calls 'surplus value', is now said to be 'interest' and of course perfect competition produces a positive rate of interest even in stationary equilibrium. But a permanent, positive residual over and above wages and interest can only be the result of constant technical progress disrupting the stationary state and the new economics had little to say about the

circumstances governing technical progress.

The growing popularity of general equilibrium theory set the seal on the possibility of theorising about entrepreneurship. As a matter of fact, static equilibrium analysis came increasingly to typify the study of economics as the nineteenth century gave way to the twentieth. And even in the 1930s when Keynesian macro-economics arrived on the scene, Walrasian static equilibrium analysis was refurbished, a process which reached even greater stages of refinement in the 1950s and 1960s. Despite valiant attempts to dynamise microeconomics, large parts of modern economics remain steeped in a static general equilibrium framework. No wonder then that the elementary textbook of today is rich in the treatment of consumer behaviour, the profit-maximising decisions of business firms (in short-run equilibrium), the theory of wages, the theory of interest, the theory of international trade, etc., but poor in the analysis of technical change, the growth of big business, the causes of the wealth and poverty of nations – and the theory of entrepreneurship.

This is the more remarkable in that this virtual consensus about the unimportance of entrepreneurship has been seriously questioned on at least two notable occasions in the twentieth century. The first occasion came with the publication of Frank Knight's *Risk, Uncertainty and Profit* (1921), an acknowledged but little read c1assic of modern economics.

21 Profit as a return to uncertainty bearing

Knight began by elaborating on Thünen's distinction between 'risk' and 'uncertainty'. Many uncertainties of economic life are like the chances of dying at a particular age: their objective probability can be calculated and to that extent they can be shifted via insurance to the shoulders of others. Such risks thus become an element in the costs of production, a deduction from and not a cause of profits or losses. There are other uncertainties, however, which can never be reduced to objective measurement because they involve unprecedented situations. 'The only "risk" which leads to profit', Knight remarked, 'is a unique uncertainty resulting from an exercise of ultimate responsibility which in its very nature cannot be insured nor capitalised nor salaried'.

The beauty of Knight's argument was to show that the presence of true 'uncertainty' about the future may allow entrepreneurs to earn positive profits despite perfect competition, long-run equilibrium and product exhaustion. Production takes place in anticipation of consumption, and since the demand for factors of production is derived from the expected demand of consumers for output, the entrepreneur is forced to speculate on the price of his final product. But it is impossible to determine the price of the final product without knowing what payments are being made to the factors of production. The entrepreneur resolves this dilemma by guessing the price at which output will sell, thereby translating the *known* marginal physical products of the factors of production into their *anticipated* marginal value products. Although the factors are hired on a contractual basis and therefore must be paid their anticipated marginal value product, the entrepreneur as a residual, noncontractual income claimant may make a windfall gain if actual receipts prove greater than forecasted receipts.

We cannot describe this noncontractual, windfall gain, Knight insisted, as a necessary price that must be paid for the performance of a specific service, the cost of bearing uncertainty, for that would imply a definite connection between the level of profit and the burden of bearing uncertainty. But no such connection exists. If it did exist, uncertainty-

bearing would have all the characteristics of a productive factor and marginal productivity theory would apply to it: profits would equal the marginal product of entrepreneurship and would therefore constitute a standard charge on production. But profits are the windfall difference between the expected and realised returns of an enterprise and as such would cease to exist in a stationary economy in which all future events can be perfectly foreseen. Profits are not a distinctive distributive share but are an element found in the payments to all types of productive agents. When most entrepreneurs take a bearish view of the future – expecting prices to fall – the contractually hired agents may receive less than the realised value of their marginal products and profits in this case are really drawn from the productive factors themselves. Similarly, when entrepreneurs are bullish in their outlook – expecting prices to rise – there may be losses instead of profits because the hired factors are rewarded on the basis of their anticipated marginal products and these may now exceed the value of the marginal products that are ultimately realised when output is sold.

Knight's book, although published over seventy years ago, has withstood criticism remarkably well. There was little problem about assimilating his contributions to orthodox economic ideas because Knight did not question static economic analysis so far as it went. Unfortunately, he failed to persuade orthodox economists that the uncertainty theory of profit was anything more than a footnote to mainstream analysis, tying together some loose ends that had been left lying around ever since Adam Smith. Economics was now provided with a satisfactory explanation of profits and entrepreneurship but, of course, the main focus of analysis continued to be the pricing of factors of production in accordance with marginal productivity principles under stationary conditions.

22 Profit as a return to innovations

Ten years before the appearance of Knight's book, the young Schumpeter had contributed a wholly different view of *the* economic problem in *The Theory of Economic Development* (1912). In this book, entrepreneurship and its connection with dynamic uncertainty is placed at the centre of economic inquiry. Schumpeter developed his argument by constructing a model of an economy in which technical change of any kind is absent. Such an economy, he contended, would settle down to a repetitive and perfectly routine economic process in which there is no uncertainty about the future. Hence, there would be no profits in such an economy and, moreover, even the rate of interest would fall to zero. In short, competitive long-run stationary equilibrium as visualised in traditional theory rules out both profit and interest. Schumpeter's claim that only technical innovations and dynamic change can produce a positive rate of interest has been hotly disputed (see chapter 12, section 13) but at the expense of considering his associated views on innovation and enterprise. Distinguishing between 'invention' and 'innovation' – the discovery of new technical knowledge and its practical application to industry – and defining 'innovation' broadly as the introduction of new technical methods, new products, new sources of supply and new forms of business organisation, Schumpeter traced all economic change to innovations and identified the innovator with the entrepreneur. The entrepreneur is the source of all dynamic change in an economy and the capitalist system for Schumpeter cannot be understood except in terms of the conditions giving rise to entrepreneurship.

As in all previous theories of entrepreneurship, the entrepreneur in Schumpeter is a functional role which is not necessarily embodied in a single physical person and certainly not in a well-defined group of people. The entrepreneur may be the capitalist or even a

corporate manager but whether all these different functions are combined in one or more persons depends on the nature of capital markets and on the forms of industrial organisation. But Schumpeter went even further than his predecessors in recognising that the same person may be an entrepreneur when he is an innovating businessman, only to lose that character as soon as he has built up his business and settled down to running it along routine lines. Thus, the actual population of entrepreneurs in a capitalist economy is constantly changing because the function of entrepreneurship is typically mixed up with other kinds of activity. Nevertheless, Schumpeter never managed to get away from the concept of the entrepreneur as a heroic adventurer and even his discussion of innovations is too much focused on the introduction of dramatic novelties with far-reaching consequences – the steam engine, the automatic loom, the railways, the automobile, etc. – losing sight of the fact that so much technical progress consists of small, cumulative improvements in something like the combustion engine or the zip fastener.

23 Profit as a return to arbitrage

Schumpeter's influence on entrepreneurial theory has been overwhelming and subsequent writers on entrepreneurship have usually defined their own position by contrasting it with his. In the meanwhile, however, mainstream economic theory has continued to neglect Schumpeter's writings on entrepreneurship as it continues to neglect Knight's theory of profits because neither fits in with static equilibrium analysis. The theory of entrepreneurship has however been given a new lease of life by the modern Austrian School, descending from Ludwig Mises and Friedrich Hayek. Thus, a student of Mises, Israel Kirzner, has recently sought once again to persuade his fellow economists that the properties of disequilibrium states deserve as much attention as those of equilibrium states. Disequilibria are due to intertemporal and interspatial differences in demand and supply and hence give rise to unrealised profit opportunities. The essence of entrepreneurship, for Kirzner as much as for Cantillon, consists in the personal alertness to such potential sources of gain. There is a subtle change of emphasis in Kirzner's discussion of entrepreneurship from that of Schumpeter's: Schumpeter always portrayed the entrepreneur-innovator as a disequilibrating force disturbing a previous equilibrium, whereas Kirzner depicts him as seizing upon a disequilibrium situation and working to restore equilibrium. But not too much should be made of this change of emphasis, which is no doubt a reflection of the state of contemporary economic theory in 1912 and 1973: in the days before World War I, economists needed convincing that an achieved state of general equilibrium is the exception and not the rule, whereas nowadays economists need convincing that the process of arriving at general equilibrium has never been satisfactorily explained.

Unfortunately, the new Austrian theory of entrepreneurship reduces entrepreneurship to any kind of arbitrage and in so doing wipes out most of the crucial questions that have been traditionally posed about entrepreneurship. The popular stereotype of the entrepreneur as a swashbuckling business tycoon may take too narrow a view of entrepreneurship but, on the other hand, the Austrian conception of the entrepreneur as anyone who buys cheap and sells dear perhaps errs on the side being too general. But perhaps we have now said enough to show that the theory of entrepreneurship begins where marginal productivity theory leaves off: there is more to distribution than is dreamed of in the static analysis of factor pricing.