RBB| Economics

South Africa: price-cost margin calculation guidelines

Comments and recommendations

RBB Economics, 8 July 2025

1 Introduction and summary

1 In February 2019, the South African Competition Act No. 89 of 1998 (the "Act") was amended by the Competition Amendment Act No. 18 of 2018 (the "Amendment Act").

2 One of the primary proposals behind the drafting of the Amendment Act was to "*strengthen the provisions of the Act that prohibit abuse of dominance*". The Minister of Economic Development at the time noted that "*cases involving the abuse of dominance through charging excessive pricing have not to date been successfully prosecuted*", and that *"the determination of excessive pricing cases is complex*".[1]

3 In light of these proposals and observations, the Amendment Act revised the framework for the consideration of allegations of excessive pricing. *Inter alia,* the revisions:

- formalised some of the existing case law into an expanded definition of excessive pricing (in particular, a price that is unreasonably higher than "a competitive price");[2]
- introduced a reverse onus such that dominant firms must show that a price is "reasonable" where a *prima facie* case of excessiveness has been established;[3]

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1 Background note on the Competition Amendment Bill, 2017. Government Gazette No. 41294, pages 18-19, available at: https://www.gov.za/sites/default/files/gcis_document/201712/41294gon1345.pdf.

2 Amendment Act, Section 8(3). Before the Amendment Act, the Act considered a price to be excessive if it was unreasonably higher than "economic value" (while the concept of "economic value" was not defined in the Act).

3 Amendment Act, Section 8(2).

- set out a list of factors that may be considered when deciding cases of excessive pricing.[4]

4 Among the relevant factors introduced in the Amendment Act is "*the respondent's price-cost margin, internal rate of return, return on capital invested or profit history*". This appears to be largely reflective of earlier case law, with the Competition Appeal Court (the "CAC") having provided the following interpretation of a competitive (i.e., non-excessive) price in *Mittal Steel*:

> *"[T]he notional price of the good or service under assumed conditions of long-run competitive equilibrium. This requires the assumption that, in the long run,[63] 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".*[5]

5 In a notice gazetted on 19 December 2024, the Competition Commission (the "Commission") published draft guidelines pertaining to the calculation of price-cost margins for public comment ("the draft guidelines").[6] In February 2025, RBB Economics responded to the Commission's call for public comments on the draft guidelines.

6 Thereafter, in March 2025, the Commission published the final version of the price-cost margin guidelines (the "guidelines"), which outline "*how the Commission intends to undertake … calculations for the price-cost test*" in the context of excessive pricing investigations (although the Commission also notes that a price-cost test "*may not always be relevant*").[7]

7 In practice, assessments of excessive pricing allegations are highly complex, and the findings of such assessments can have significant ramifications (both for the firms under investigation, and for the markets in which such firms operate). Accordingly, in an effort to continue contributing to this important discourse, in this note we summarise the comments contained in our initial submissions to the Commission, and which in our view continue to be relevant in this context.

8 At the outset, we note that we support four features of the guidelines.

9 First, we support the Commission's decision to publish the guidelines. This is because guidelines have the potential to provide helpful transparency for consumers and producers alike.

10 In particular, in a modern-day South Africa that has been shaped by a unique socio-political and economic history, we recognise that consumers face substantial challenges related to high levels of unemployment, poverty, and inequality. There are many contexts in which consumers are sensitive to the prices set by suppliers, and more information about how the

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4 Amendment Act, Section 8(3)(a)-(f).

5 *Harmony Gold Mining Company Ltd and Durban Roodepoort Deep Ltd v Mittal Steel South Africa and MacSteel International BV* (70/CAC/APR07), paragraph 40.

6 The Government Gazette Notice can be accessed here: https://www.gov.za/sites/default/files/gcis_document/202412/51790gon5716.pdf, and the draft guidelines can be accessed here: https://www.compcom.co.za/wp-content/uploads/2025/01/Price-cost-Margin-Computation-Guidelines-Draft-.pdf.

7 The final guidelines can be accessed here: https://www.compcom.co.za/wp-content/uploads/2025/03/Price-cost-Margin.pdf.

Commission intends to assess cases of alleged excessive pricing will no doubt be helpful from the perspective of such consumers.

11 Transparency and predictability in respect of how the Commission intends to enforce the Amendment Act in practice are also important from the perspective of businesses. Indeed, greater business certainty can be expected to reduce the extent to which businesses are deterred, as a result of uncertainty, from engaging in procompetitive and economically beneficial activities that promote investment, create jobs, and drive economic growth. Such an outcome can also be expected to advance the objectives of the Amendment Act.

12 Second, we support the suggestion in the guidelines that the Commission intends to conduct price-costs tests on the basis of economic costs, and that such an approach will be prioritised above an approach that relies on book values / accounting records. Accounting records (as typically produced in the ordinary course of business) often do not fully reflect the substantive economic reality that is likely to be more relevant for the robust application of price-cost tests.

13 Third, we support the guidelines' focus on considering prices against the full economic costs of supply, including a fair return on capital employed, commensurate with risk. In our view, it is important to recognise that business investments and operations involve (often substantial) risks that need to be appropriately rewarded if businesses are to be incentivised to contribute towards economic activity, growth, job creation, and the reduction of poverty.

14 Fourth, we support the guidelines' statement that the Commission will assess alleged contraventions of excessive pricing on a case-by-case basis. Indeed, although it is helpful to provide guidance on the general principles that will be applied in matters involving potential instances of excessive pricing, a case-by-case approach is likely to allow for a more robust assessment of factors relevant to price-cost tests (while a blanket approach may risk penalising behaviour that is consistent with normal competition on the merits).

15 The above notwithstanding, we believe that parts of the guidelines raise potential concerns. If not properly managed, we believe that such areas of the guidelines may increase the risk of future applications of price-cost tests leading to unreliable or erroneous conclusions, and hence adverse unintentional consequence for the South African economy. While we do not seek to provide an exhaustive review of every statement in the guidelines, we observe the following about certain elements.

- In our view, the guidelines do not sufficiently identify or describe the contexts in which the Commission is likely to apply price-cost tests for the purposes of excessive pricing investigations (and by implication when such tests are likely to be appropriate, and when they are not).

- The guidelines do not appear to contain direction in respect of the time period over which price-cost tests might be applied. In our view, there are strong policy reasons, as well as separate qualitative and quantitative economic reasons, why such tests are unlikely to be meaningful if applied over a short time period.

- The guidelines do not appear to contain direction regarding by how much prices would need to exceed (some proxy for full economic) costs to trigger a contravention of the excessive pricing provisions in the Act. While we appreciate that the scope of the guidelines is limited to describing how the Commission intends to compute price-cost margins, we nonetheless believe that market participants would benefit from a better understanding of what factors the Commission is likely to consider when evaluating, interpreting, and acting on the results of such calculations.
- Moreover, in several places the guidelines appear to underappreciate the difference between (i) accounting records as often captured in the ordinary course of business, and (ii) substantive economic reality that is likely to be more relevant for the practical application of price-cost tests.
- Finally, at the core of the Commission's intended approach to assessing required returns for equity capital is the capital asset pricing model (the "CAPM"). We agree that this model is a useful starting point for assessing a firm's cost of capital. However, in some scenarios it may be necessary to account for additional risk factors in addition to those which are captured in the CAPM, especially where such factors may be particularly relevant to South Africa's economic context.

16 We expand on these views in the balance of this document, which is structured as follows:

- In Section 2, we set out a brief background to excessive pricing regulation in South Africa.
- In Section 3, we reflect on how contextual considerations might inform the methodology and application of price-cost tests.
- In Section 4, we discuss situations in which recorded accounting data might deviate from substantive economic reality.
- In Section 5, we canvas the consideration of risk, and the returns required by investors.
- Finally, we provide a set of concluding remarks in Section 6.

2 Enforcement of excessive pricing provisions in South Africa

2.1 Overview

17 In order to provide context to our comments on the guidelines, in this section we first set out a brief background to the enforcement of excessive pricing provisions in South Africa. In particular, we provide a short history of how the relevant excessive pricing provisions have evolved, and of the excessive pricing cases that have been investigated by the South African competition authorities. We then discuss the underlying rationale for excessive pricing regulation, as well as the potential pitfalls associated with over-enforcement.

2.2 Brief history of excessive pricing enforcement

18 The enforcement of provisions that prohibit excessive pricing is a challenging topic. In some jurisdictions, such as the United States, purely exploitative conduct is generally not considered to be an abuse of market power. Many other agencies have been reluctant to bring excessive pricing cases, and courts have been even more reluctant to uphold the few complaints that have been heard. Advocate General Wahl summarised this position in the first sentence of his opinion on the Latvian Collecting Societies case (which was heard before the European Court of Justice), when he asked: *"Is there any such thing as unfair prices?"*.[8]

19 South African jurisprudence shows a stronger appetite for prosecutions in this area. Before the Amendment Act was promulgated in law, the Act prohibited dominant firms from *"charging an excessive price to the detriment of consumers"*, and defined an excessive price as a price for a good or service that *"bears no reasonable relation to"*, and is *"higher than"*, the *"economic value"* of that good or service.[9]

20 In the first South African complaint concerning excessive pricing enforcement (which related to the pricing of steel products by Mittal Steel), the CAC undertook to unpack the relevant provisions of the existing Act. It set out the meaning of excessive pricing with reference to the benchmark of "economic value", which it interpreted to refer to the notional price of the good or service under conditions of long-run competitive equilibrium. Long-run competitive equilibrium is, in turn, a notional objective competitive-market standard, in which competing firms can enter the industry in the event of a higher than normal rate of return, or exit the industry to avoid a lower than normal rate of return.[10] Under long run competitive equilibrium, rival firms can earn enough revenues to recover their prudently incurred economic costs, including investments costs (i.e., the costs associated with the risk of investing capital). However, profits beyond this point would be competed away by new entry.

21 The second South African complaint concerning excessive pricing enforcement was related to the pricing of propylene and polypropylene by Sasol Chemical Industries ("SCI"), and largely

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8 Opinion of Advocate General Wahl, 6 April 2017, Case C-177/16, Biedrība 'Autortiesību un komunicēšanās konsultāciju aģentūra – Latvijas Autoru apvienība' v Konkurences padome.

9 Act, Section 1(1)(ix) and Section 8(a).

10 *Harmony Gold Mining Company Ltd and Durban Roodepoort Deep Ltd v Mittal Steel South Africa and MacSteel International BV* (70/CAC/APR07), paragraph 40.

focussed on the assessment of SCI's particular cost advantages (although the overall logic of the test was largely undisturbed). The CAC observed once again in its decision that the translation of even clear ideas about what constitutes an "excessive price" into law is *"immensely complex"*.[11]

22 It is within this complex and uncertain context that, early into the onset of the COVID-19 pandemic in South Africa, the Government introduced new regulations and directions targeted at the pricing of essential items. These regulations set out the definition of *"a material price increase"*, and directed that such a material price increase is a relevant factor for determining whether a price is excessive or unfair.[12] The Commission applied these regulations in the prosecution of a number of matters, and ultimately referred 34 COVID-19 related cases to the Competition Tribunal (the "Tribunal").[13] Of these cases, two were ultimately heard before the Tribunal, with the others being settled.[14] The Tribunal upheld both complaints, and one was later confirmed on appeal to the CAC.

2.3 The economic rationale for and potential pitfalls of excessive pricing regulation

23 In economic terms, excessive pricing refers to a situation in which a dominant firm persistently exercises its market power by unilaterally raising prices to levels that are significantly in excess of competitive levels. Since such conduct is usually associated with a reduction in output (either as the cause or as the result of the excessive prices), economic theory posits that excessive prices can lead to a loss of economic welfare (often termed a "dead-weight loss"). Excessive pricing regulation is aimed at mitigating this type of harm to society, and is also usually targeted at ensuring that consumer welfare specifically is not unduly undermined.[15]

24 However, high prices are also sometimes associated with dynamic benefits, such as increased incentives for entry, competition, investment, and innovation, which might far outweigh the static welfare losses noted above. Accordingly, as we expand upon below, it is generally accepted that attempts to regulate prices should be contemplated only in particular circumstances.

25 From an economic point of view, competition policy seeks to foster conditions that are conducive to an effective process of rivalry. This is typically achieved through interventions that focus on pre-conditions that might be expected to give rise to monopoly pricing, such as the accrual of significant market power through mergers or coordinated conduct. The regulation of exclusionary abuses of dominance (such as predatory pricing and margin squeeze) seeks to prevent dominant firms from manipulating the features of markets in a way that excludes competition.

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11 *Competition Commission v Sasol Chemical Industries Ltd* (48/CR/Aug10 and 131CACJun14).

12 Government Notice No. 350 of Government Gazette No. 43116, published on 19 March 2020, Section 4.

13 Competition Commission Media Statement dated 20 August 2020, "*Competition Tribunal confirms an order against medical product distributor and manufacturer for excessive pricing of respiratory masks during Covid-19 disaster*".

14 *Competition Commission of South Africa v Babelegi Workwear and Industrial Supplies* (CR003Apr20) and *Competition Commission of South Africa v Dis-Chem Pharmacies Limited* (CR008Apr20).

15 We note that in some situations high prices might not result in any material reduction in output, and hence no significant deadweight loss (e.g., in contexts characterised by binding capacity constraints or where demand is entirely inelastic). Excessive pricing concerns may still arise in such cases, where high prices nevertheless lead to a reduction in consumer welfare.

26 In contrast, prohibitions against excessive pricing (which is an exploitative and not an exclusionary abuse) do not have regard to encouraging effective competition or creating market conditions that facilitate self-correction. Instead, they seek to directly regulate a firm's pricing and production decisions. Consequently, the enforcement of provisions aimed at excessive pricing behaviour can carry a number of material risks.

27 First, a static comparison of monopoly prices against theoretical prices under perfect competition risks ignoring the role that prices play in signalling profitable opportunities to competitors, potential entrants, and investors. Specifically, prices that are significantly in excess of economic costs can signal the availability of returns that are necessary to attract new investment and innovation, and to incentivise investment and expansion by dominant firms. They can also prompt investors to switch their capital to the relevant industry by investing in additional capacity in order to capture the available returns. This type of activity, in turn, is likely to have a positive impact on competition, including in relation to pricing outcomes.

28 These signals are a central part of normal competition, and they are especially important in industries (or contexts) subject to capacity constraints. The over-enforcement of excessive pricing provisions runs the risk of muting such signals, thereby potentially undermining dynamic competition in the form of entry and expansion, and leading to under-investment. Over the long term, such under-investment would be likely to cause markets to be under-supplied, and cause consumers to face lower output, lower quality, and less variety than they otherwise would.

29 The views above are echoed by Motta and De Streel (2007), who state the following:

> *"[P]rices […] convey signals to potential entrants: in particular, high prices may indicate that a market is profitable, and trigger entry into the industry, thereby reducing the market power of a dominant firm and decreasing prices. Excessive pricing actions may therefore have the effect of breaking this process, and while in the short run they might be beneficial in that they could reduce prices, in a long run perspective they would be detrimental because they may impede entry that could otherwise take place".*[16]

30 In addition, when faced with upward pressure on prices, even dominant firms may be expected to invest in expanding capacity and output, so as to maximise their profits at the new, higher price levels. The over-enforcement of excessive pricing provisions would thus not only risk deterring potential new entry and investment (thereby entrenching the dominant position of the already dominant firm), but it may also risk reducing the incentives of dominant firms to supply at the higher level of output than they may have done otherwise (to the direct detriment of consumers).

31 Second, the over-enforcement of excessive pricing provisions can lead to a decrease in investment in the economy more generally, especially in cases where the future returns of

[16] Massimo Motta and Alexandre De Streel (2007), "Excessive Pricing in Competition Law: Never Say Never?" in *The Pros and Cons of High Prices*, eds. Konkurrensverket – Swedish Competition Authority.

potential investors are rendered more uncertain. In particular, when potential investors believe that there is a significant possibility that their future returns will be curtailed through the over-enforcement of excessive pricing provisions (or more generally through regulatory intervention), they are likely to revise their projections of expected returns downwards. More importantly, if excessive pricing enforcement places a cap on the returns of successful investments, then this would significantly dampen the incentives to invest in new ventures (which are inherently uncertain).

32 Notably, this logic does not only apply to firms that, based on their current position, might be at risk of being found to be dominant. It also applies to firms that are considering entry or expansion, where there is a risk of them being found to be dominant in the future.[17]

33 These potential deleterious effects are also recognised by Motta (2004):

> *"[T]he firm might have acquired its market power through investments, innovations and advertising (and maybe even a good share of business luck) […] Intervening by imposing lower prices would be tantamount to depriving it of its risky investments, and discourage it and other firms from investing in the future".*[18]

34 Third, the availability of remedies for excessive pricing that are both efficient and readily enforceable can be limited.

35 One possible option is for the competition authority in question to determine the price at which the relevant dominant firm should sell its product. However, in some cases competition authorities may be reluctant to adopt this role, as it might require continuous assessments of a multitude of complex factors so as to arrive at regulated prices that are the least harmful to the economy.

36 Another possibility is for the competition authority to sanction the dominant firm by imposing an administrative penalty. However, in practice such an approach would be likely to give rise to similar effects as directly regulating prices (though potentially with even higher levels of uncertainty). This is because, in seeking avoid a fine, dominant firms may set prices (far) below the level at which the prevailing supply and demand conditions would otherwise dictate. In this way, such a remedy may similarly fail to relieve the risks of curtailing expected returns and dampening the prospects of expansion and new entry (as discussed above).[19]

37 For these reasons, Fletcher and Jardine (2007) propose a number of demand-side interventions with the aim of overcoming any structural features of the market that hinder entry

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[17] This may apply even in a situation where a firm might be considered to possess a position of residual dominance, such as where the market in question is capacity constrained.

[18] Massimo Motta (2004), *Competition Policy, Theory and Practice*, page 69, Cambridge University Press.

[19] The administrative penalty may also impose a cost on the firm's financing decisions. The administrative penalty may negatively affect the firm's ability to finance additional projects by reducing its retained earnings, and it may compel the firm turn to alternative, and relatively more costly, sources of finance such as third-party lenders. Those third-party lenders will also likely be alive to the possibility that the potential for an administrative penalty may negatively affect the expected returns of the proposed investment, thus increasing the lender's risk.

or expansion, as opposed to interventions such as fines or price-setting regulation aimed at the firm under scrutiny.[20]

38 Fourth, remedies may give rise to an allocative inefficiency among prospective customers when capacity is constrained, as the price would no longer be a good signal of the relative scarcity of the product in question. For instance, an artificial price ceiling may create a shortage of the relevant product, in the sense that the quantity of the product demanded by customers at the artificially low price would be greater than the quantity supplied by the firm at that price. In this case, the artificial price ceiling is likely to lead to the inefficient allocation of the available supply, as well as inefficient incentives for further investment, expansion and entry.

39 Bishop and Walker (2010) summarise this problem as follows:

> *"Indeed, it is optimal for changes in demand to be reflected in prices as this allows the price mechanism to ensure that those who value the product most highly are the ones who purchase it. It would not be economically optimal to seek to stop such price changes, even if prices were substantially above costs in the short run".*[21]

40 Importantly, the above is not to say that excessive pricing interventions by competition authorities are never warranted or necessary. Rather, our submission is that certain conditions ought to be met in order for the potential upsides of such intervention to outweigh the potential downsides. We turn to discuss these conditions in the next section.

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20 Amelia Fletcher and Alina Jardine (2007), "Towards an Appropriate Policy for Excessive Pricing" in *European Competition Law Annual 2007: A Reformed Approach to Article 82 EC*, eds. Ehlermann and Marquis, Bloomsbury.

21 Simon Bishop and Michael Walker (2010), *The Economics of EC Competition Law: Concepts, Application and Measurement*, pages 238-239, Sweet & Maxwell.

3 The relevant application of the price-cost test

3.1 Overview

41 Due to the risks associated with over-enforcement of excessive pricing provisions (see above), in our view excessive pricing interventions should only be applied in a subset of situations that fulfil certain criteria.[22] Such an approach minimises the risks of inefficient and unintended adverse consequences of over-enforcement, especially those associated with the blunting of incentives for investment and innovation (which are key to the very process of competition).

42 Limiting excessive pricing enforcement to a subset of situations is further justified when one compares the likely effects of erroneously prosecuting a firm that has not engaged in excessive pricing (a false positive) with the likely effects of not prosecuting a firm that has engaged in excessive pricing (a false negative). False positives may carry a risk of producing deleterious effects, including lower investment and an inefficient allocation of resources. In contrast, in most circumstances the likely costs of false negatives are small. This is not only because excessive pricing enforcement can have limited prospects of sustainably producing lower prices, but also because permitting higher prices in the short term can, in many cases, be expected to give rise to efficient signals that encourage further investment, innovation, and more vigorous competition in the longer term.

43 In this regard, the guidelines do not appear to provide direction in regard to the types of contexts in which the Commission might undertake excessive pricing assessments (involving price-cost tests). While we appreciate that the guidelines *"focus purely on the computation of a price-cost [margin]"* (and thus may not be designed to address questions relating to the specific contexts in which such a test might be applied), we nonetheless believe that questions of relevance or context are likely to affect the proper consideration and application of price-cost tests (in particular in light of the potential risks of over-enforcement, as set out above).[23]

44 As we expand upon below, suitable candidates for excessive pricing investigations and interventions are likely to be limited to situations characterised by durable market power, such that the firm in question is able to persistently charge prices significantly above competitive levels.

3.2 Durable market power

45 When considering which situations would be suitable for excessive pricing regulation, a number of different sets of criteria have been proposed in the literature. The most important of these criteria, and the one that is most consistently cited, is that the industry in question must be subject to high and non-transitory barriers to entry and expansion, such that high prices are not likely to constitute efficient signals for new investment and entry. The motivation

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22 See also Robert O'Donoghue and A Jorge Padilla (2006), *The Law and Economics of Article 82 EC*, Bloomsbury; Lars-Hendirk Röller (2007), "Exploitative Abuses", in *European Competition Law Annual 2007: A Reformed Approach to Article 82 EC*, eds. Ehlermann and Marquis, Bloomsbury; David S. Evans and Jorge Padilla (2005) "Excessive Prices: Using Economics to Define Administrative Legal Rules", *Journal of Competition Law and Economics* 1(1), pages 97-122; and Patrick Rey *et al.* (2005), "Report by the EAGCP on An economic approach to Article 82", available at: https://ec.europa.eu/dgs/competition/economist/eagcp_july_21_05.pdf.

23 Guidelines, paragraph 1.3.

here is that excessive pricing enforcement is only likely to be appropriate where dynamic competitive processes cannot be expected to produce new entrants and/or expansion, and hence lower prices.

46 Notably, this condition does not merely require the existence of barriers to entry that are high in monetary terms, and which might therefore be expected to delay entry or expansion to some degree. Instead, the barriers to entry must be of a non-transient or structural nature, such that there are no foreseeable prospects for new entry or expansion. If this condition is not met, even where barriers to entry are perceived to be high in monetary terms, excessive pricing enforcement is likely to delay or prevent efficient entry that might otherwise take place, thereby subjecting consumers to lower levels of investment, higher prices, lower quality, and less variety, in the long run.

47 The importance of the incontestability requirement is highlighted in the economic literature, having been proposed (in various forms) by Motta and de Streel, Evans and Padilla, O'Donoghue and Padilla, Röller, Fletcher and Jardine, and Paulis. For example, Paulis (2007) states that competition authorities should not intervene "*in markets where it is likely that normal competitive forces over time will eliminate the possibilities of a dominant company to charge high prices*".[24] Motta and de Streel (2007) similarly explain that the threshold for intervention should be higher than a mere dominant position, and instead "*close to a super dominant position where the undertaking should have a very important market share*".[25] According to these authors, intervention should only be considered where there is *"a monopolist (or quasi-monopolist) whose position is not likely to be challenged by entrants"*.[26]

48 In a similar vein, the explicit reference to a competition benchmark in the South African context highlights the relevance of the requirement to apply excessive pricing tests only in situations that are subject to persistent dominance, which clearly distinguishes a situation of excessive pricing from one in which prices are set as a result of reasonably effective competition in the long run. Evidently, a firm that is not able to act substantially independently of its competitors cannot hold a dominant position (in the economic sense of enjoying substantial and persistent market power, whatever the level of its market share).

49 To summarise, when considering which situations might be suitable candidates for excessive pricing regulation, the most important criterion, and the one that is most consistently cited, is the durability of market power. Importantly, this involves two factors. First, dominance, assessed not only on market share thresholds, but in the economic sense of substantial and persistent market power. Second, high and non-transitory barriers to entry and expansion, such that high prices are not likely to constitute efficient signals for new investment and entry. In our view, excessive pricing intervention in the absence of these factors risks giving rise to substantial inefficiencies and unintended adverse consequences.

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[24] Emil Paulis (2007), "Article 82 EC and Exploitative conduct" in *European Competition Law Annual 2007: A Reformed Approach to Article 82 EC*, eds. Ehlermann and Marquis, Bloomsbury.

[25] Massimo Motta and Alexandre De Streel (2007), "Excessive Pricing in Competition Law: Never Say Never?" in *The Pros and Cons of High Prices*, eds. Konkurrensverket – Swedish Competition Authority.

[26] Massimo Motta and Alexandre De Streel (2007), "Excessive Pricing in Competition Law: Never Say Never?" in *The Pros and Cons of High Prices*, eds. Konkurrensverket – Swedish Competition Authority.

3.3 Time period

50 The guidelines do not appear to contain direction on the time period over which price-cost tests might be applied. However, there are, in our view, strong policy reasons, as well as strong qualitative and quantitative economic reasons, why such a test is not meaningful if applied over a short timeframe.

51 Confining excessive pricing cases to situations that are subject to high and non-transitory barriers to entry means that it is difficult to imagine a situation of excessive pricing arising on a temporary basis. If market power (and any resulting price rises) only emerge for a very short period, then normal competition on the merits (which is most likely to give rise to economic efficiency and enhanced consumer welfare) is likely to be best served by allowing those price signals to efficiently incentivise existing or potential rivals to offer lower prices, invest, and innovate. Prosecuting temporary price changes may, in contrast, cause harm to the competitive process, ultimately leading to substantial inefficiencies.

52 Moreover, it is difficult to see how a finding of dominance might arise when only considering a transitory period. Indeed, the assessment of dominance would typically first require the definition of a relevant market, with the standard approach to market definition involving the consideration of substitution behaviour in response to non-transitory changes in relative prices. As such, even the pre-cursor to a dominance assessment is not well suited to considering responses to price changes that only occur over a very short timeframe.

53 Further features of practical pricing behaviour provide additional reasons to focus excessive pricing enforcement only on cases where prices have deviated from competitive benchmarks for a sustained period of time.

54 For instance, in dynamic contexts where demand and supply factors change substantially over short periods, there may be significant differences between historical costs, replacement costs, and anticipated future costs. As such, even competitive markets may be characterised by significant differences between prices and one or more of these cost metrics at a given point in time. Accordingly, the relevant question is not whether such differences exist *per se*, but rather whether they persist due to a position of durable market power (as discussed above).

55 In addition, firms may have to make investments, decide upon capacity, incur costs, undertake procurement, and set prices, under uncertainty. As a consequence, actual realised costs may differ from a firm’s forecasts, and even competitive firms may agree to prices that later appear to deviate substantially from actual realised costs.

56 This dynamic is commonly observed in many competitive markets. By way of illustration, farmers may sow crops without precise knowledge of their likely selling prices at harvest time. They may also sell their output of commodity grains (such as maize and soybeans) at the prevailing spot prices at the time of sale, rather than with reference to their historical costs of procuring seed, fertilizer, and irrigation. Mines and mineral refineries, oil refineries, and fuel retailers similarly incur historical procurement costs in one market context, and then often sell

their outputs at prevailing market prices in a different market context. In these scenarios, output prices are linked to immediate market conditions, even if inputs have been procured in different, historical market conditions.[27] In situations of effective competition, temporary misalignments between prices and costs are likely to even out over time.

57 As a final point on this topic, we note that, in the section titled *"Intangible assets"*, the guidelines state that internally generated goodwill will not be considered as part of capital employed. According to the guidelines, this is because costs related to activities that typically build this goodwill are deductible in firms' income statements, and so should form part of the firm's operational costs. In particular, the guidelines state the following on this score:

> *"8.7.3 Internally generated goodwill will not be considered as part of capital employed. This includes goodwill created from building of brands, customer relationships, a unique skilled workforce and route development activities will not be considered. Usually, costs related to these activities are deductible in the income statement when they are incurred, and they form part of the firm's operational costs. As a result, the price-cost test also takes account of these expenses in the operational cost allocation. Therefore, recognizing these expenses as internally generated goodwill will be double counting and incorrectly also adding an additional capital return on those items.*"

58 In this regard, we agree that it would be incorrect to double count costs. However, we also submit that it is important not to ignore costs that might have been incurred in the building of a firm's brand, customer relationships, workforce, or other intangible assets, even if those costs were incurred over a long period of time in the past. This further highlights the importance of applying price-cost tests over a reasonably long time period, in order to make sure that all relevant costs are properly captured in the analysis. An approach that focuses on a short time period after such costs have been incurred would instead be expected overstate the degree to which prices deviate from (true economic) costs.

59 In our view, these considerations strongly motivate towards price-cost tests being applied to data spanning a sustained period of time.

3.4 The extent of deviation

60 The guidelines also do not appear to contain direction regarding by how much prices would need to exceed (some proxy of full economic) costs to trigger a contravention of the excessive pricing provisions in the Act. More specifically, the guidelines suggest that such a consideration does not belong in the application of the price-cost test itself, but rather to a separate assessment of "reasonableness". Here the guidelines appear to be referring to the fundamental test under Section 8(3) of the Amendment Act, which states that, in determining

[27] While it may therefore appear attractive to consider firms' forecasts or budgets as a way to establish whether or not pricing is indeed driven at least by anticipated costs (if substantially different from actual costs), it is likely to be very difficult, in practice, to account for undue pessimism, prudence, or caution that may have been applied in some budgeting processes.

whether or not a price is excessive, one must examine whether the difference between the actual price and the competitive price is "*unreasonable*".[28]

61 By way of example, paragraph 9.4.1 of the guidelines state that *"[o]ther risk premiums such as the firm specific risk premium, marketability premium, and small stock premium, should not be included in the determination of the reasonable rate of return to be earned on capital employed, but may rather be considered as part of the reasonableness assessment"*. Similarly, the guidelines suggest that "*hurdle rates should not be included in the determination of the reasonable rate of return to be earned on capital employed*', but rather that hurdle rates should *"be used as part of the reasonableness assessment"*.[29]

62 We appreciate that the scope of the guidelines is limited to describing how the Commission intends to compute price-cost margins. However, we nonetheless believe that a better understanding of how the Commission is likely to interpret the results of such calculations, and how it might decide whether or not such results are reflective of a contravention of the excessive pricing provisions of the Act, would provide useful (additional) regulatory certainty for firms seeking to comply with the Act. In particular, we consider that it would be helpful for the Commission to issue further guidance in regard to (i) the magnitude of margins that are likely to raise serious concerns, (ii) how the Commission intends to account for and assess the relevant factors outlined in section 8(3) of the Act, and (iii) whether the Commission intends to consider those factors as part of the price-cost test, or as part of the reasonableness assessment.

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28 Guidelines, paragraph 3.1; and Amendment Act, Section 8(3).
29 Guidelines, paragraph 9.4.2.

4 Accounting records and economic reality

4.1 Overview

63 In our view, when it comes to the application of price-cost tests in excessive pricing investigations, it is important to properly distinguish between (i) costs that are reflected in accounting records (as often stated in the ordinary course of business) and (ii) costs that are reflective of substantive economic reality.

64 Absent this, there may be a risk of a prioritisation of form over substance, and hence a greater risk of unintended consequences from enforcement errors. There may also be a risk of even more perverse outcomes, as firms with high market shares might learn that preparing accounts on a "humble" basis (i.e., within commonly acceptable accounting standards, but showing measures of accounting profitability that are as low as possible) could be a way to avoid scrutiny in this area. This would not only stifle valid claims of excessive pricing, but would also be likely to disincentivise profitable efficiencies, and disincentivise further investment in apparently "unprofitable" businesses, thereby exacerbating any competition and underlying concentration concerns.

65 Below we provide a set of more detailed comments in respect of the parts of the guidelines that we believe are at risk of potentially blurring the line between accounting records and economic reality.

4.2 Cost allocation and measurement

66 The guidelines state that the Commission will prioritise cost allocations from normal accounting records over any contrived allocation:

> *"7.7 The Commission will have regard to how the respondent firm allocates costs in its ordinary course of business outside of a price-cost test, as the practice internally better reflects how costs are truly allocated rather than a contrived allocation in response to an allegation."*

67 We agree that no weight should be placed on any cost allocation that is purely contrived. However, we would at the same time caution that some allocations that are performed in the normal course of business, even if fully consistent with applicable accounting standards, may not accurately reflect the substantive economic reality of the activity in question. We therefore welcome the fact that the guidelines appear to hold open the possibility that alternative cost allocation methods may be more appropriate in some instances. In particular, the guidelines state the following:

> *"7.8. However, the Commission may determine alternative methods that differ from the methods used by respondent firm where appropriate. The Commission*

> *will consider the appropriateness of the allocation method used by the respondent by looking at amongst others; the cost drivers of the applicable cost items, the organisational structure, the nature of the cost, industry practices, accounting standards and company policies which prescribe how costs are allocated across the firm.*"

68 That being said, despite showing a willingness for flexibility in this area, the guidelines appear to more strongly dismiss revenue-based allocations as a potentially reasonable method for allocating shared costs. The guidelines state the following on this score:

> *"7.9.3. The Commission will not favour the use of revenue-based allocations because high-priced products will be allocated a high share of costs simply due to the nature of the method of allocation, thereby inflating costs to justify the high price. This method inherently assumes, without further evidence, that a large share of costs should be allocated to the cost of products that have the largest share of total sales revenue, rather than products that incur the largest indirect costs."*

69 While we recognise that a revenue-based allocation method may indeed imply that a larger share of common costs would be (potentially arbitrarily) allocated to higher priced products, we can also imagine situations in which this might be appropriate. For instance, the manufacture of higher priced, and potentially higher quality, products may require longer production times and/or higher quality (i.e., more expensive) inputs, such that an allocation of costs (roughly) in proportion to revenues would be justified. Accordingly, in our view the emphasis should rather remain on the underlying principles of cost allocation, which is that the exercise should aim to come as close as possible to an allocation of costs that would be implied in the notional competitive benchmark.

70 More generally, in our view it is important to appreciate that, in some contexts, it can be very difficult to arrive at a robust allocation of costs, and there may be substantial uncertainty in the proper allocation of some truly shared or common costs. If such uncertainty is inherent in a given context, such that any cost allocation method would be unreliable, we consider that it would not be appropriate to allocate costs merely for the sake of doing so, and then to place material evidential weight on the results. Instead, we consider that any inherent uncertainty surrounding cost allocation should lead to any resulting calculations being appropriately caveated, and/or should inform the Commission's confidence in relying on the results.

71 As a final observation on this topic, we note that the guidelines appear to reject an approach to measuring the value of tangible assets based on accounting costs / book values, and instead suggest that the Commission will prioritise an approach that is grounded in economic costs (see, for example, section 8 of the guidelines, and in particular paragraphs 8.3.2-8.3.5).

72 We endorse this approach as an overarching principle. This is because accounting records (as usually produced in the ordinary course of business) often do not fully reflect the substantive economic reality that is likely to be more relevant for the robust application of price-cost tests. In particular, it is well-recognised in economics (and in the relevant case law) that, when it comes to assessing whether a dominant firm's profits are excessive, it is appropriate to consider the depreciated replacement costs of a firm's assets (or a sufficiently similar measure of asset values).

4.3 Transfer pricing

73 Another area in which the guidelines appear to be at risk of ignoring economic reality in favour of accounting records relates to the intended approach to assessing transfer pricing.

74 In this regard, we acknowledge that the derivation of appropriate inter-company prices can be a challenging exercise, as can the estimation of relevant input costs for notional competitive firms focussed on a single activity. This is especially the case if the only available data concern large, vertically integrated producers. However, we would caution against too formalistic an approach to transfer pricing, especially in situations where there is clear evidence that the substantive economic costs are not properly recorded in company accounts.

75 By way of illustration, the guidelines state the following in respect of scenarios where transfer prices are set at IPP:

> *"7.12. Where there are indications that the input cost paid by the respondent firm has been artificially inflated due to the internal transfer pricing practices within a group of companies of which the respondent firm is a member, the Commission will use the actual cost of the entity producing the input as the input cost. For instance, where the respondent firm uses import parity price (IPP) as the transfer price instead of actual costs then preference will be for the actual cost of production for the input."*

76 However, in our view, it is not always the case that transfer prices that align with IPP will necessarily represent any kind of artificial inflation. To the contrary, there are likely to exist certain situations in which it would be appropriate for transfer prices to be set in line with IPP.

77 To see this, consider a situation in which a commodity is supplied upstream, and is then converted into one or more other products downstream. Assume further that the country is structurally short of the commodity, such that there are substantial net imports of that commodity to the country in question.

78 In this situation of a structural supply shortage, even a competitive set of local upstream suppliers would be likely to price the upstream commodity near the import parity price ("IPP"). In turn, the relevant cost faced by downstream firms (which purchase the commodity from the upstream firms) would be near IPP as well.

79 Notably, this would also apply to the downstream arm of a vertically integrated business, reflecting the opportunity cost of the local upstream arm choosing not to sell the commodity in question to other downstream firms at IPP. In other words, the relevant cost experienced even by downstream units of vertically integrated firms is near IPP, even though this may may not be reflected in accounting records as the actual transfer price paid. Ignoring this when evaluating whether the (dominant) downstream arm of a vertically integrated firm has engaged in excessive pricing would likely misdirect the focus of the competition inquiry, and would be likely to lead to erroneous conclusions.

80 We acknowledge that this issue may be covered under the notion of an *"arm's length transaction"*, as stated in paragraph 7.11 of the guidelines (which notes that the Commission will have regard to the "*actual cost paid for goods and services sold between related legal entities within a group of companies [, including] considering any transfer pricing reports for tax purposes to determine whether the transfer price is reflective of an arm's length transaction and cost related"*).

81 The guidelines' reference to prices being "cost related" in the final sentence of paragraph 7.11 might therefore relate to the relevance of considering opportunity costs, even though such costs may not appear in accounting records. However, in our view, the guidelines do not provide sufficient guidance concerning the types of opportunity costs that the Commission might consider, how the Commission intends to account for such opportunity costs, and how the Commission intends to distinguish between opportunity costs that may be artificially inflated versus those that are reflective of relevant economic reality. We consider that market participants would benefit from a better understanding of these nuances, and hence further guidance on this score would be welcomed.

82 Finally, the guidelines address the question of international transfer prices.

> *"7.14. For global companies, the Commission will consider the international transfer pricing practices to determine if these are truly reflective of costs or whether transfer prices have been adjusted to determine a specified return for SA domiciled firms. Where the transfer price is adjusted for a specified return, the Commission will have regard to the actual production costs of the input for the global company and not the transfer price.*"

83 In this regard, we acknowledge that the derivation of international transfer prices can be particularly complex. Analogous to the situation of cost allocation, it can be very difficult to derive transfer prices that properly reflect all of the different economic contributions that might have been made towards a given instance of production or service delivery. Some costs may have been incurred historically, and in different locations, concerning research, product development, product and process innovations, and the fluid, and often unrecorded, transfer of valuable knowledge and practices between different international subsidiaries. Nevertheless, despite these challenges, in our view the objective should remain to seek a fair

and accurate reflection of relevant economic costs incurred, whether or not these have been accurately recorded in internal accounts.

5 Risk and return

84 At the core of the guidelines' approach to the calculation of reasonable returns that shareholders might require for equity capital is the CAPM. This model was originally based on Markowitz's model of portfolio choice,[30] and was developed by Sharpe[31] and Lintner[32] in the 1960s. The central finding of the model is that the expected returns demanded by equity investors (shareholders) are only related to the sensitivity of that asset's return to variations in market returns, and that no other factors drive shareholder expectations.

85 In the first instance, we note that, at the most fundamental level, the CAPM was derived on the basis of *ex ante* shareholder expectations, or expected returns, and not *ex post* actual realised returns. Actual returns can vary substantially from year to year, and shareholders' expectations might well be exceeded or disappointed in any individual year. Accordingly, we consider that reference to this model even more strongly underlines the recommendation above, namely that a price-cost test can only be reasonably applied over a substantial time period.

86 Separately, we recognise that the CAPM has been widely adopted, and that it serves as a useful starting point for evaluating a firm's cost of capital. However, we also note that, in some contexts, it may be necessary to account for additional factors affecting a firm's risk profile that may not be properly captured in the CAPM (such as such as firm size, price-to-earnings ratios, and book-to-equity values).[33] For instance, one could imagine an industry in which, in part due to the nature and size of the South African economy, all firms are "small" within the context of the global market of all possible assets, and accordingly investors might expect higher returns from those firms than the returns that might be indicated by the CAPM alone.[34]

87 We acknowledge that the guidelines consider some of these putative risk factors, and the ways in which additional sources of risk may be accounted for in the application of the price-cost test. However, in our view the relevant parts of the guidelines are unlikely to foster a sufficient degree of certainty among firms seeking to conduct their businesses in a way that is compliant with the excessive pricing provisions of the Act, and aligned with the guidelines.

88 For example, when it comes to the consideration of the small stock premium, the guidelines state the following at paragraph 9.4.1.3:

> *"The small stock premium is an additional risk premium that investors expect to earn for the relative volatility of small companies versus their larger counterparts.*

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30 Harry Markowitz (1959), "Portfolio Selection: Efficient Diversification of Investments", Cowles Foundation Monograph No. 16., John Wiley & Sons, Inc.

31 William F. Sharpe (1964), "Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk", *Journal of Finance* 19(3), pages 425-442.

32 John Lintner (1965), "The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets", *Review of Economics and Statistics* 47(1), pages 13-37.

33 See, for example, Eugene F. Fama and Kenneth R. French (2004), "The Capital Asset Pricing Model: Theory and Evidence", *Journal of Economic Perspectives* 18(3), pages 25-46.

34 Separately, some contexts might require the consideration of whether the relevant benchmark of the "market" of all investable assets is in some ways constrained to local assets, for example due to exchange controls or other limits on cross-border investments. Of course, in these scenarios, this might affect the consideration of whether a firm constitutes a "small" asset.

> *Being a 'small stock' is unlikely to be an essential characteristic of a firm providing any good or service. The small stock premium is therefore a firm specific feature and may be considered in the determination of the competitive price."*

89 As written, it appears that the Commission accepts that a small stock premium may be considered in the determination of the competitive price. However, we would argue that this could be the case in particular if it is <u>not</u> a firm specific feature, based on the logic that some investors should be able to diversify their investments so as to protect themselves from non-systemic or idiosyncratic risks.

90 It is also unclear whether or not there is some internal tension in the guidelines when it comes to firm specific risk, which the guidelines (i) generally exclude from the determination of the reasonable rate of return to be earned on capital employed (see paragraphs 9.4.1, and 9.4.1.1 and 9.4.1.2) despite (ii) later appearing to accept the inclusion of project specific risk in the determination of the same reasonable return (at what is numbered paragraph 8.1.1, but which comes after paragraph 9.4.2):

> *"If there is an additional risk premium that investors expect to earn for bearing the unique risk factors associated with a specific project related to the provision the goods or services that is under investigation, the project specific risk premium may be considered in the determination of reasonable rate of return."*

91 The guidelines then state that hurdle rates should not be included in the determination of the reasonable rate of return to be earned on capital employed, because hurdle rates do not necessarily represent extra risks taken by the firm from which it deserves an additional return.[35]

92 In this regard, we recognise that hurdle rates are not included in the CAPM, and cannot easily be included in such a model in a theoretically rigorous manner. Moreover, there may be clear instances in which adding a hurdle rate to an objective cost of capital could undermine a simple comparison of actual historical returns against full economic costs.

93 However, in regard to some forward looking investments, hurdle rates might reflect some types of risks that firms face, but which are not adequately reflected in projected future cashflows.

94 By way of example, if a firm were to consider investing in a new production facility, and had prepared a budget that assumed 100% capacity utilisation, and operations on 365 days per year, this might not be an accurate reflection of the likely, or expected, returns, from that facility (e.g., due to risks such as load shedding, service delivery disruption, unrest, or insurrection). While these specific risks might be difficult to accurately capture within a production or cash flow forecast, they might be roughly accounted for by adding a hurdle rate to more heavily discount an overly optimistic forecast of cash flows.

[35] Guidelines, paragraph 9.4.2.

95 This suggests that it is necessary to examine how hurdle rates have been determined, and what types of risks they might be intended to account for, before altogether excluding them for the purposes of determining the appropriate return on capital.

96 With the above in mind, in our view future applications of price-cost tests would benefit from a consideration of the broader set of factors that are likely be relevant to the calculation of appropriate rates of return on capital in different contexts.

6 Concluding remarks

97 In conclusion, we support the Commission's decision to publish guidelines in respect of how it intends to apply price-cost tests in excessive pricing matters. We also agree with many of the principles outlined in the guidelines.

98 In particular, we support the general approach to the application of price-cost tests, and the recognition that prices should be compared against the full economic costs of supply (including a fair return on capital employed commensurate with risk). We also endorse the determination of alleged contraventions on a case-by-case basis, which we consider is likely to allow for a more robust assessment of factors relevant to each case.

99 However, as we highlight in this note, there are parts of the guidelines that, in our view, may not provide the clarity that would otherwise be sought by businesses, and which may also risk producing unintended adverse consequences for the South African economy. It appears that many of the issues that we have highlighted (despite being identified in our comments submitted in response to the draft guidelines), have not been addressed in the final guidelines. Nevertheless, for the reasons set out above, they remain important issues in our view, and hence will likely need to be addressed through future guidelines, and/or through the developing case law. In the meantime, applications of price-cost tests should bear the potential risks identified above in mind.