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Landmark ruling strikes down CMA decision on excessive and unfair pricing

The UK's Competition Appeal Tribunal's Judgments in Pfizer v CMA and Flynn v CMA

On 7 June 2018, the UK's Competition Appeal Tribunal (*CAT*) partially set aside the Competition and Market Authority's (*CMA*'s) decision fining Pfizer and Flynn nearly £90 million for charging unfairly high, or excessive, prices for phenytoin sodium capsules (an anti-epilepsy drug) in breach of EU and UK competition law.

The CMA's 2016 decision was highly controversial. Indeed, even though the relevant law expressly provides that "*imposing unfair purchase or selling prices*" is prohibited, and a 1978 European Court of Justice (*ECJ*) judgment confirmed that it is illegal for a dominant firm to charge a price which is excessive because it has no reasonable relation to the economic value of the product supplied, there has been relatively little enforcement action in this area. Rather, EU competition agencies have to date been cautious about bringing such cases:

- **competition law should not deter innovation**: authorities are concerned that bringing unfair pricing cases may deter innovation, investment and competition in free markets. High prices provide a reward for investment and the lawful winning of the competitive battle, as well as a signal for new entry into the market. They thus attract "business acumen" and induce risk taking that produces innovation. Authorities have therefore preferred to focus resources on tackling exclusionary conduct which enables companies to maintain or reinforce their dominant position by preventing the development of competition (for example, through predatory pricing, exclusive arrangements, refusals to supply or tying and bundling products);

- **competition authorities are not price regulators**: there are also concerns that unfair prices are difficult to identify and remedy and that competition authorities and courts are ill-suited to act as price regulators. Not only is it extremely difficult to set out an administrable test to distinguish unfairly high prices from ones that would be reaped in normal and sufficiently effective competitive conditions, but excessive pricing is hard to remedy. Defining appropriate and fair terms of dealing is notoriously difficult.

In December 2016, the CMA imposed a record fine of nearly

£90m

on two pharmaceuticals companies for charging unfairly high prices.

In spite of these complexities, interest in excessively high prices has been mounting in recent years, especially in the healthcare and technology sectors (for further information see 10 Key Themes - pricing and sales practices). In the EU, a number of competition agencies have acted against, or are currently investigating, high pricing in the healthcare sphere. For this reason, the Pfizer and Flynn case has been closely watched as a potential precedent-setting case of relevance to the pharmaceutical sector and other industries.

In Pfizer and Flynn, the CMA commenced its investigation following huge overnight price increases in phenytoin sodium capsules. These occurred as a result of their debranding and the (generic) products falling outside the Pharmaceutical Price Regulation Scheme (*PPRS*) (the scheme controlling the overall profit that companies make on sales of branded medicines to the NHS).

The CMA's decision

The CMA found that:

- **Pfizer and Flynn held dominant positions in narrowly defined markets:** the manufacture and distribution of Pfizer-manufactured phenytoin sodium capsules; and
- **Pfizer and Flynn had abused their dominant positions by charging unfairly high prices:** applying the two-limb test set out by the ECJ, the CMA found that the prices were:
  - "excessive" based on a "Cost Plus" test and a benchmark based on the 6% return on sales target utilised in the PPRS; and
  - "unfair" in themselves, given the substantial disparity between the price and the economic value of the products.

The CMA also placed emphasis on a price comparison over time, the increase in prices which had occurred following debranding.

The CAT's judgment

Although the CAT upheld the CMA's finding on dominance, it set aside the finding on abuse. The key findings of the CAT were:

1 Narrow markets

Narrow markets in pharmaceutical markets: by upholding the CMA's finding on dominance, the CAT confirmed that narrow markets may be drawn in the pharmaceutical sector based on a lack of demand-side substitution between different forms of medicine and a lack of competitive constraint from alternatives. This confirms that competition authorities are likely to apply very narrow market definitions to the activities of pharmaceutical manufacturers and distributors. Pharma companies will take note that the CMA may seek to apply the "abuse of dominance" rules to a wide range of distribution and pricing activities on this basis.

2 Excessive and unfair pricing

The CAT confirmed that "excessive and unfair pricing" can be a breach of competition law but found the CMA did not apply the correct legal test: In particular:

- the CMA had been wrong in law to restrict its assessment of whether the prices were excessive to a "Cost Plus" approach. Further, it had applied an incorrect methodology and made an error in assessment by relying on it;
- the CMA had incorrectly assessed whether prices were unfair by relying on the fact that they were unfair in themselves without properly assessing the price of the products by comparison with the prices of other meaningfully comparable products;
- the CMA was mistaken in finding that there were no non-cost related factors which would increase the economic value of the products beyond Cost Plus;
- the sudden price increase (the price comparison over time) did not provide a stand-alone ground for finding unfair prices.

Rather, the CAT held that the correct application of the two-limb legal test involves:

- the establishment of a proper benchmark price or range for deducing a reasonable rate of return that reflects the price that would pertain under conditions of normal and sufficiently effective competition. In establishing the hypothetical counterfactual, it is necessary to consider all valid methods unless one method is the only, or overwhelmingly the best, one. For example, the CAT considered that in relation to Flynn, the CMA had placed too much emphasis on the PPRS benchmark and should have given greater weight to other comparisons put forward, such as rates of return on other products (both of Flynn and of other generic companies);
- a careful assessment of whether the prices charged were excessive in relation to that benchmark/range and considering whether the differential was sufficiently significant and persistent;
- an assessment of unfairness in itself or unfairness compared to competing products. Although factors such as, the increase in price, the selective nature of price changes, the impact on the buyer, the lack of any independent or objective justification, the commercial purpose of the agreement, could all be relevant to the application of the unfair in itself test, it is necessary to give due consideration to arguments that pricing is actually fair under either alternative;
- a finding overall that the price charged bears no reasonable relation to the economic value of product. Assessment of economic value is highly fact specific and essentially a matter of judgment but can include factors on both the supply and demand side, the costs of production and other elements of value to the purchaser (in this case, for example, deriving from the therapeutic benefit to patients); and
- a consideration of any objective justifications advanced.

3 The need for clarity

The CAT stressed the importance of the law being clear in this area and setting out a good and sound legal foundation for any similar actions in the future.

4 Next steps

The CAT held that it did not have enough information to apply the test correctly and therefore provisionally decided to remit the issues back to the CMA for further consideration.

Conclusions

The CAT set aside the CMA's finding of unfair prices, but emphasized on more than one occasion that it was not holding that there was no abuse in fact; only that it has not been established by the CMA. The judgment attempts to inject greater clarity into this difficult area and to provide clearer guidance on how the legal test governing unfair high pricing applies and can be made administrable. This direction is likely to be welcomed by companies and their advisers. Although the CAT's assessment focussed on the two limb test for identifying excessive pricing applied by the CMA, it stressed that there could be other alternative means for determining whether the price of a product is unfair.

The judgment is no doubt making sombre reading for the CMA. It confirms the danger of making price comparisons to pre-existing regulated pricing and the complexity involved in establishing the "economic value" of a product and that prices charged bear no reasonable relation to it, even where a sudden price hike, unrelated to an increase in cost, has occurred. The conduct in this case led to prices in the UK significantly exceeding those charged in other EU countries and to a dramatic increase in NHS expenditure on the products. Given the clear importance of the case for the public interest, the NHS, tax-payers and patients, the CMA is now likely to be considering very carefully whether to appeal and the wider implications of this ruling for other similar cases it has been investigating.