Fair Trading Commission

Case 5102

INVESTIGATION INTO ALLEGATION OF PREDATORY PRICING ON THE PART OF DRUG SERV PHARMACY LIMITED

The Staff's Conclusion

April 29, 2004

Public Version

Confidential information omitted. The omissions are indicated by the symbol ✄.

1. The Complaint

1.1 On June 19, 2003, the Fair Trading Commission (FTC) received a complaint from Jamaica Association of Pharmacy Owners (JAPO), against Drug Serv Pharmacy Limited (Drug Serv).

1.2 Specifically, in a letter dated June 17, 2003 and addressed to the FTC, JAPO complained about an advertisement which appeared on page C7 of the Daily Gleaner of Monday, June 16, 2003. The advertisement states that Drug Serv prices are "on the average 30% - 40% below the average market price." It goes on to urge consumers not to fill their prescriptions before first checking with Drug Serv. JAPO also expressed concern about similar radio advertisements aired on RJR Radio 2. The advertisement was replicated in the 2004 Cable and Wireless Telephone Directory.

1.3 JAPO's stated objections to the advertisements are as follows:

- Drug Serv, a 100% Government retail chain, is using its dominant position to compete unfairly with other pharmacies.
- The normal mark-up on drugs for most JAPO pharmacies is 40% add-on; and therefore attempting to compete with Drug Serv's prices (i.e. 30 – 40% discount) "would force JAPO to send our members into certain bankruptcy".

- Drug Serv, due to its Government connections and budget, is able to purchase drugs cheaper (by means of "tender") from the same overseas suppliers who sell to Jamaican agents and/or distributors eg. Hopwood, Carimed etc. Hopwood sells to Drug Serv at the exact same prices at which it sells to JAPO members.
- Due to Drug Serv's locations (Government clinics and/or health centers), it is not exposed to high commercial expenses such as rental, staff and storage costs. Drug Serv does not offer comparable standards of accessibility, comfort, convenience, and security as most normal JAPO members do.

1.4 JAPO believes that Drug Serv, as a state-owned pharmacy, should not be permitted to advertise to the general public (JAPO's potential customers) in such unfavourable terms. The Association contents that the advertisement gives the impression that its members are over-pricing their drugs.

2. Issues of complaint

2.1 The complaint raises two relevant issues: (1) Whether the advertisement is misleading; and (2) Whether Drug Serv has been engaging in predatory pricing.

- *Misleading advertising:* The FTC must determine whether the advertisement is factually correct and whether any material information has been omitted.
- *Predatory pricing:* Since only a dominant entity can be found guilty of predatory pricing, the FTC must first determine whether Drug Serv is dominant. It must then be determined whether Drug Serv is engaging in below cost pricing. Finally the FTC must determine whether that activity has the potential for lessening competition in the market.

2.2 The Fair Competition Act (FCA) prohibits both misleading advertising and predatory pricing. Section 37 addresses misleading advertising and Sections 19-21 address, among other things, the various ways in which a dominant entity may abuse its dominance, one of which is predatory pricing.

2.3 The misleading advertising aspect of the complaint was investigated and the Staff concluded that the advertisement is misleading and therefore constitutes a breach of Section 37 of the FCA. The Staff concluded that the advertisement is misleading for the following reasons:

- *The length of time between the last price survey and the date of the advertisement*—The last quarterly survey is for the period January – March 2003, and the relevant advertisement appeared in the newspaper on June 16, 2003, some two and a half months later. The FTC has obtained evidence to show that between March and June 16, there have been significant changes in the prices of some of the drugs used in the survey.
- *The number of drugs used in survey*—For the survey of January – March 2003, eighteen drugs were used. This represents less than 1% of the number of drugs on the market and the number of drugs carried by Drug Serv. Based

on the information provided by Drug Serv, its complement of drugs amounts to over [✂].

- *The number of pharmacies used in survey*—The prices charged for the 18 drugs used in the survey at each of the seven Drug Serv pharmacies were compared with the prices charged in at most 3 pharmacies. For example, the prices charged for the 18 drugs at the Glen Vincent branch of Drug Serv were compared with those charged at 3 pharmacies. In total, 27 pharmacies (7 Drug Serv) were used in the survey. There are over 229 pharmacies in Jamaica, with at least 96 located in Kingston and St. Andrew. This means that just about a mere 11.7% of all the pharmacies in Jamaica were used in the survey.

2.4 By way of letter dated September 3, 2003 the Staff informed Health Corporation Limited of its conclusion regarding the misleading advertising aspect of the complaint. Drug Serv is the retail arm of Health Corporation Limited. Health Corporation responded by letter dated September 22, 2003, admitting the aforesaid breach. The Staff recommended to the Commissioners that they settle the claim of misleading advertising by way of a Consent Agreement. The Commissioners accepted the Staff's recommendation.

2.5 A Consent Agreement between the Fair Trading Commission and Health Corporation Limited was signed, with an effective date of January 27, 2004. The main provision of the Agreement requires that the company issue four quarterly statements over a one-year period by way of the Gleaner. The statement should inform the public that the FTC has found the relevant advertisement misleading. The first statement was issued on February 7, 2004.

2.6 The real focus of this report is the question of whether Drug Serv is engaged in predatory pricing.

3. Application of the FCA

3.1 Sections 19-21 of the FCA prohibit the abuse of dominance, if such abuse had, is having or is likely to have the effect of lessening competition substantially. Under Section 20(1), an enterprise would be considered to have abused its dominant position if it impedes the maintenance or development of effective competition in a market. For the purposes of the FCA an enterprise holds a dominant position in a market if by itself or together with an interconnected company, it occupies such a position of economic strength as will enable it to operate in the market without effective constraints from its competitors or potential competitors.

3.2 Section 20(1)(d) states that an enterprise abuses its dominant position if it "directly or indirectly imposes unfair purchase or selling prices or other uncompetitive practices". The Staff of the FTC interprets section 20(1)(d) to include predatory pricing.

Predatory pricing

3.3 Predatory pricing, a subset of predatory behaviour, is an exclusionary conduct. It is manifested when a dominant firm reduces its prices to a loss-making level when faced with competition from an existing competitor or a new entrant to the market, with the aim of driving out the existing competitor or deterring entry of an entrant. The dominant firm having eliminated the competitor or fended off the entrant then increases its prices to recoup the losses incurred.

3.4 Distinguishing predatory pricing from legitimate competition is not simple. Low prices are normally seen as a benefit from; and the successful result of the process of competition. Since one of the main objectives of competition policy is to create conditions in which consumers benefit from effective competition, the distinction must be drawn between low prices that result from predatory pricing, and low prices that result from legitimate competitive behaviour.

3.5 There are three key elements to predatory behaviour:

Intent—Predation does not happen 'by coincidence'. There must be an intention to predate. Nevertheless, intent is a subjective concept and difficult to determine. Sometimes intent is inferred if an incumbent reduces price upon entry of a new competitor, therefore forcing the new competitor to exit; and subsequently raises its price back to its original level. Such behaviour, however, may also obtain under competitive circumstances since new entry raises overall market output and forces the incumbent to decrease its price or else concede market share. Such a price reduction is often not predatory but is instead a natural response to the increased competition.

Feasibility—certain structural conditions of the market must exist for predation to be feasible. Specifically, successful predation requires that the alleged predator have market power during the predation period. This is because the predator must expand output in order to depress the overall market price and put pressure on its rivals. To have a strong impact on market price, the predating firm would need a sufficiently high market share from the start. Otherwise the predating firm itself will not be able to survive through the predation period. Moreover, if market demand is price elastic[1], apart from the extra sales that the predator has to take over from its victims, it must also take on extra sales at a loss, to satisfy the new demand that is created at the lower price. This makes predatory pricing in fact more costly – at least in the short term – for the predator than for its victims. For this reason, predatory pricing always comes under the category of abuse of dominance.

Furthermore, predation is about the predator deliberately incurring losses in the short run, with the intention of making supernormal profits in the long run. In the short run, it incurs losses in order to eliminate competitors or deter entry. In the long run, it will expect to recoup the losses by charging higher prices. Predation works only if the firm will be able to recoup its short run

[1] Demand is said to be elastic if the proportional change in quantity demanded, as a result of the change in price, is greater than the proportional change in price. This means that a price change will cause an even greater change in quantity demanded.

losses by charging higher prices in the future – which will be possible only if the competition which the undertaking faces in the future is not able to constrain its behaviour.

While *future* market power is distinct from *current* market power, a currently dominant undertaking can be expected to retain future dominance and to recoup losses following predatory action. In other words, the market structure is likely to be retained.

Execution—finally for predatory pricing to take place the alleged predator must implement a pricing strategy that is in some way below cost and which is consistent with the intention to predate.

4. Predatory pricing: investigation guidelines

4.1 Many competition authorities apply a two-step method in investigating predatory pricing.[2] The first step is to determine the feasibility of market structure for predation. If the structural conditions are considered not to be feasible for successful predation, the conclusion drawn is that there is likely to be no predation and the investigation terminates.

4.2 If the structural conditions suggest that successful predation is feasible, however, then the second step is to carry out a price-cost comparison to determine if below cost pricing has been implemented in a manner that could be considered predatory. The second step also includes an analysis of legitimate factors which might be responsible for the loss incurred by the alleged predator.

Step 1: Analysis of market structure

4.3 As discussed above, a pre-condition for successful predation is a market structure in which the undertaking has a sufficiently large market share and therefore may be dominant. The first step in the investigation is therefore, to determine if the undertaking is dominant in the *relevant* market. Thus we would consider the following:-

- *Market shares*—a market share of between 40 – 50% is commonly used by competition authorities as a guideline threshold for dominance. The European Court, for example, has stated that dominance can be presumed in the absence of evidence to the contrary if an undertaking has a market share persistently above 50%.[3] The Staff of the FTC has adopted the same percentage in its cases under Sections 19-21 of the FCA.
- *Barriers to entry*—the ability of an undertaking to dominate a market is constrained to the extent that new entrants may easily enter the market. A firm

[2] For example, the United Kingdom and Canada.
[3] See Case C62/86, *AKZO Chemie BV v Commission* [1993] 5 CMLR 215

is said to dominate a market if it is able to act independently of competitive pressures, whether current or potential. If, however, barriers to entry are low, any action by the firm to increase prices and profits would attract new entrants who would put competitive pressure on the allegedly dominant firm, forcing it to reduce prices again. In this case, the firm cannot be considered to be dominant. On the other hand, if barriers to entry are high, entry is unlikely even if the market is highly profitable. In this case, the firm will be able to sustain high prices and profitability and can therefore be said to be dominant. High barriers to entry could exist for various reasons including licensing and regulatory requirements for entry and high sunk costs.[4]

- *Existing competitors*—the reaction of existing competitors has to be considered in evaluating dominance of a firm. If existing competitors can respond quickly, substantially and inexpensively to anti-competitive behaviour by a large firm, then that firm is unlikely to be dominant.

4.4 In sum, a firm may be considered to be dominant if it has a market share of approximately 50%; there are high barriers to entry and existing competitors are ineffective. A firm must be dominant for it to be able to predate successfully.

Step 2: Analysis of prices and costs

4.4 If a firm is found to be dominant, the next step is to analyse the price-cost relationship so as to ascertain if a pricing strategy which is consistent with predation has taken or is taking place. The following are the guidelines used in the determination of below cost pricing:

- A price at or above average *total* cost will not be regarded as unreasonably low;
- A price below average *variable* cost is likely to be considered predatory unless there is a clear justification such as the need to sell perishable inventory;
- Prices in the "gray range" between average total and variable costs require further investigation into the surrounding circumstances.

4.5 In addition, an analysis of pricing behaviour should also take into account the period and extent of predation. Specifically, below-cost pricing must be in effect for 'long enough' so as to be sufficient to inflict material harm upon competitors, otherwise it cannot be considered to be predation. What is considered to be 'long enough' a time period differs from market to market. Similarly, below cost pricing on only a small fraction of a product line cannot drive competitors out of a competitively meaningful market consisting of the entire product line. Such 'limited' action, therefore, would not constitute predation.

[4] Sunk costs refers to the investments that have to be made to enable production of a good or service. These costs are incurred even before a single unit of good or service is produced. An example of sunk costs can be found in telecommunications, in which the cable network has to be put in place – at a high cost – before any voice or data transmission can be made.

5. Allegation of predatory pricing against Drug Serv Pharmacy: An analysis

5.1 This section analyses the allegation of predatory pricing on the part of Drug Serv using the principles outlined in section 4. First, the relevant market is defined in section 6. The pricing strategy is then analysed in section 7; and section 8 concludes the report.

Defining the Relevant Market

5.2 As indicated above, before assessing whether a firm is dominant, the relevant market must be determined. This relevant market will have two dimensions - the relevant goods (i.e., the product market); and the geographic extent of the market (the geographic market).

- *The product market*—the boundaries of the market are determined by taking the products relevant to the investigation and looking at the closest substitute products, i.e. those products to which consumers would switch if prices of the relevant products rose. These substitute products are included in the market if substitution by consumers would prevent prices of the relevant products from rising above competitive levels. The alternative products do not need to be perfect substitutes, but alternatives that would fill a role similar to that of the goods in question, and to which consumers would switch in the event of a price increase. Essentially, any similar goods that would prevent prices being set above competitive levels should be included in the definition of the relevant product market.

  In addition to this substitution by customers ("demand substitution"), prices can also be constrained by the potential behaviour of suppliers of other products ("supply substitution"). Businesses that are not currently supplying a particular product might switch some of their existing facilities to supplying that product (or close substitutes) if the price of that product should increase significantly.

- *The geographic market*—the geographic market is defined as the area supplied by the enterprise which is being investigated. Consideration should also be given however to whether customers could easily obtain similar products from suppliers in other areas on reasonable terms. If this is the case then those other areas may form part of the relevant geographic market. The geographic market may be a part of Jamaica or the entire island.

6. The relevant market for pharmaceuticals

6.1 *Product market*—for this analysis there are two distinct groups of pharmaceuticals: prescribed drugs and over-the-counter drugs. Prescribed drugs are those drugs that can be obtained only by way of a prescription and must be dispensed by a registered pharmacist. Over-the-counter drugs may be obtained without a prescription and may be sold by persons other than registered pharmacists. The law requires however that certain over-the-counter drugs must be sold only in a pharmacy. There are therefore two relevant product markets: the market for prescribed and pharmacist-present drugs (PPPD) and the market for non-pharmacist-present drugs (NPPD).[5] The market for PPPD includes all pharmacies while the market for NPPD includes all pharmacies, supermarkets and shops.

6.2 In relation to the relevant product market, it may be concluded that there are two relevant product markets.

6.3 *Geographic market*—the extent of the relevant geographic market for PPPD and NPPD may be localised or may be the entire island. The extent of the market depends primarily on the chain of substitution, i.e. the proximity of retailers and the distance consumers are willing to travel to obtain the relevant product. Consumers in any one location might not be willing to travel more than, say one or two miles to purchase from a particular retailer. If, however, there are sufficient consumers - marginal consumers – who are willing to seek out other retailers in other locations then all those areas would be considered to be part of a single geographic market. A chain of substitution may therefore be created linking various locations across the island. Chains of substitution often break down in rural areas, for example between May Pen and Mandeville. If, however, there are sufficient consumers of either town, who shop in both towns then May Pen and Mandeville may be considered to belong to the same geographic market.

6.4 Drug Serv operates seven pharmacies in the seven southern parishes. It operates in the parishes of St. Thomas, Kingston and St. Andrew, St. Catherine, Clarendon, Manchester, St. Elizabeth and Westmoreland. In each of the parishes in which Drug Serv operates there are at least 4 other pharmacies. The percentage of the number of pharmacies operated by Drug Serv in each parish ranges between 1% and 20%. (See Table 1). For this analysis each parish, the southern parishes or the entire island may be a geographic market. Survey of consumers spending pattern would assist in delineating the relevant geographic market.

6.5 If the geographic market is considered to be each individual parish then Drug Serv would control at most 20% of the number of pharmacies, while if the market is considered to be the southern parishes taken together then Drug Serv's share of the number of pharmacies would be approximately 3.8%. Taking the entire island as the geographic market, the percentage of pharmacies operated by Drug Serv would be at least 3%.

6.6 With regard to the geographic market, it may be individual parishes, the southern parishes or it may be the entire island.

[5] Pharmacist-present drugs are over-the-counter drugs which are required to be sold in a pharmacy. Non-pharmacist-present drugs are over-the-counter drugs which may be sold in outlets other than a pharmacy.

Table 1: Number of Pharmacies in each parish

Parishes	Number of Pharmacies	Percentage of pharmacies operated by Drug Serv
Kingston and St. Andrew	96	1%
St. Thomas	5	20%
St. Catherine	27	3.7%
Clarendon	16	6.25%
Manchester	13	7.7%
St. Elizabeth	14	7.1%
Westmoreland	10	10%
Hanover	4	0%
St. James	19	0%
Trelawny	5	0%
St. Ann	9	0%
St. Mary	9	0%
Portland	2	0%
TOTAL	**229**	**3%**

Assessment of market power

6.7 As discussed in previous sections, predation is feasible only if the alleged predator is dominant. The question therefore is, whether Drug Serv is dominant in the relevant markets in which it operates. Dominance is assessed by comparing the market share of the alleged predator with the market share of each of its competitors[6]; evaluating entry barriers; and by analysing existing competitors.

6.8 As concluded above there are two relevant product markets. Assuming that the geographic extent of the market is the entire island, the market involving prescribed drugs includes all the pharmacies in Jamaica. Currently there are over 229 retail pharmacies operating in Jamaica of which Drug Serv operates 7. The market for over-the-counter drugs which can be sold in outlets other than pharmacies would include significantly more than 229 participants. Drug Serv therefore operates approximately 3% of the number of pharmacies in Jamaica. It

[6] Market share is calculated by totalling the revenue of all the players in the relevant markets and then finding each player's percentage share of the total.

is quite unlikely that 7 out of over 229 pharmacies could generate 50% of the pharmaceutical revenue in Jamaica.

6.9 If the geographic extent of the market is considered to be individual parishes then of the 13 markets St. Thomas represents the market with the highest market share for Drug Serv. That market share of 20% would need to generate at least 50% of the pharmaceutical revenue for Drug Serv to be considered dominant.

6.10 As regards entry barrier, in order to operate a pharmacy in Jamaica the operator must obtain a licence from the Pharmacy Council. The requirements to operate a pharmacy are not onerous. They include the applicant having the following:

a. Letter of commitment from a Registered Pharmacist signed in the presence of a J.P. indicating willingness to be Registered Pharmacist for not less than one (1) year.

b. Memorandum and Articles of Association if operated as a company;

c. Police report of all shareholders;

d. Floor plan and layout of proposed pharmacy. The plan should indicate: measurement of entire shop not less than 640 sq ft.; measurement of dispensary are not less than 130 sq. ft.; waiting area with chairs; two distinct entrances for the pharmacy area.

6.11 Applications are reviewed by the Pharmacy Council on the 4th Thursday of the months of January, April, July and October of each year. The length of time for entry into this market can therefore be estimated to be less than 6 months.

6.12 Since there are over 229 pharmacies operating in Jamaica, the number of competitors which Drug Serv faces is quite significant. While Drug Serv is a government-owned company and therefore has access to public funding, a number of pharmacies belong to large retail chains such as Megamart, Mainland International and Pricesmart, which appear to have significant resources and therefore the ability to effectively compete with Drug Serv. Private hospitals and medical complexes such as Andrews Memorial Hospital, St. Josephs Hospital and Apex Medical Complex all operate pharmacies, which can also be significant competitors of Drug Serv's.

6.13 Given the large number of pharmacies in Jamaica and the competitive landscape of the pharmaceutical industry it is unlikely that the seven Drug Serv pharmacies are able to generate over 50% of the revenue of the industry and therefore have the ability to negatively affect competition. With entry barriers being relatively low, it is further not likely that Drug Serv is dominant in any of the relevant markets.

7. Analysis of pricing practice

7.1 JAPO's complaint mentioned that the normal mark-up on drugs for most JAPO pharmacies is 40% add-on; and therefore attempting to compete with Drug Serv's prices of 30-40% discount would force JAPO pharmacies into bankruptcy. It therefore can be deduced that if a particular drug costs $100, then JAPO pharmacies would retail that drug for $140. Assume that Drug Serv purchases this particular drug from the same supplier and at the same cost ($100) as JAPO pharmacies do; and retails the drug at a price 30%-40% below JAPO pharmacies' retail price. This means that Drug Serv's price would range between $84 and $98[7], which is below the cost of the drug.

7.2 An examination of Drug Serv's sales reports of June 16, 2003 for each pharmacy reveals that some drugs were sold below cost, even though all 7 pharmacies recorded an overall profit margin. According to the sales reports and from which the following table is extracted, 13 drugs were sold below cost.

Table 2: Number of drugs sold below cost

Pharmacy	Drug	Cost Price	Selling Price
May Pen	✂	✂	✂
Princess Margaret			
Savanna-La-Mar			
Black River			
Mandeville			
Greater Portmore			

7.3 In a predatory pricing analysis involving retail outlets, which carries a wide variety of products, successful predation requires that a significant number of products be used in the below-cost pricing strategy. It is unlikely that an alleged predator, in a multi-product market would be able to substantially lessen competition in a situation in which only a few products are sold below cost.

7.4 Drug Serv pharmacies carry over [✂] different types of pharmaceuticals. On June 16, 2003 over [✂] different types of pharmaceuticals were sold but only 13 were found to have been sold below cost.

7.5 The figures for Drug Serv's total sales and purchases for the financial year ended March 31, 2003, translate to a ✂ profit margin, suggesting that its aggregate operation for that year was profitable. Its Profit and Loss Account for that year reveals a profit of [✂].

7.6 Given the number of participants in the two relevant markets and the limited number of drugs sold below cost, it is unlikely that Drug Serv has the potential to successfully predate in any of the markets.

8. Conclusion

8.1 There is evidence of below cost pricing involving a total of 13 drugs of the over [✂] drugs carried by Drug Serv. The two relevant markets, i.e. the market for

[7] A price of 30% below JAPO pharmacies' price would be 70% of $140, which is equal to $98. Likewise, a price of 40% below JAPO pharmacies' price would be 60% of $140, which is equal to $84.

drugs which must be sold by a registered pharmacist and the market for all other pharmaceuticals which can be sold in outlets other than pharmacies involve over 229 pharmacies of which 7 are operated by Drug Serv. Based on the large number of participants in the markets it is unlikely that Drug Serv's 7 pharmacies would generate 50% of the revenue of the industry; and therefore it is unlikely that Drug Serv is dominant. The sale of 13 products below cost, out of over [✂] products is insufficient and cannot have any effect on the markets. This pricing strategy cannot therefore result in a substantial lessening of competition.

8.2 Drug Serv, by way of letter dated September 22, 2003 explained that selling prices which showed below cost pricing are inaccurate and are as a result of a software bug, which is being addressed. The Staff of the FTC is inclined to accept this explanation, given that Drug Serv's sales records revealed also that in some cases the cost prices and selling prices for [✂] were the same, which is quite unusual.