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Price discrimination

Virtuous price discrimination, pharmaceuticals, and parallel trade

By *Andrew Lilico and Dermot Glynn, Europe Economics**

Where products differ – for example, in size, chemistry, or distance required to transport – prices often differ naturally, even in the most competitive of markets. But “price discrimination” is the practice whereby different consumers are charged different prices for the same product.

Price discrimination has some potentially undesirable properties. At the extreme, if a monopolist could prevent arbitrage at zero cost, were able to charge a different price to each customer, and could identify the maximum amount each customer were willing to pay, all the gains from trade (including all the consumer surplus) would be captured by the monopolist.

Such perfect price discrimination is probably never feasible but, when markets can be segmented into a number of sub-groups, that typically enables a monopolist to capture a greater proportion of the gains from trade.

Price discrimination can also be anti-competitive, either because

- it enables a firm to abuse a dominant position in its own market, as in *Gas*, where British Gas’s discrimination in prices charged to industrial customers was condemned by the Monopolies and Mergers Commission, or
- it distorts downstream competition in the sense of article 82(2)(c), as in *Deutsche Bahn v Commission* where the European Court of First Instance said that maintaining “artificial price differences so as to place customers at a disadvantage and to distort competition” is an abuse.

Price discrimination could not exist in a fully competitive market because of arbitrage – those offered lower prices would re-sell to those offered higher prices and so the initial producer would not gain from discrimination.

Hence the existence of price discrimination tends to suggest imperfections of competition, which it is the usual business of competition law to address.

Virtuous price discrimination

It has traditionally been noted that, when price discrimination allows output to be increased, the sum of consumer and producer surplus may increase, creating a potential gain for producers, consumers or tax authorities, or all of these. Competition authorities typically bear this possibility in mind when assessing price discrimination.

However, beyond the argument in terms of output, some forms of price discrimination are often considered desirable for other reasons. Classic examples include special prices for children or the elderly on buses or at the cinema.

The issue in such cases is that, compared with a single price for all consumers, price discrimination creates winners as well as losers, and sometimes the interests of the winners from price discrimination are considered to be more important.

For example, in the case of charging special pensioner-only prices on buses, this allows the bus company to segment the market (because tickets may not be re-sold, arbitrage is forbidden) and hence to charge slightly higher prices to non-pensioners.

Thus, non-pensioner consumers lose from this price discrimination. However, the pensioners gain by having lower ticket prices, and in this case the interests of pensioners are regarded as more important.

Such cases involve some form of welfare policy, and these sorts of welfare considerations typically underlie those instances of price discrimination that are considered to be virtuous.

One clear candidate for virtuous price discrimination would appear to be the

provision of pharmaceuticals at lower prices in poor countries than in rich countries. Consider, for example, the regular calls for anti-HIV drugs to be made available in poor African countries at especially low prices.

Pharmaceuticals typically play an important role in public healthcare policies and are often purchased on tax-funded bases that naturally involve choosing between the interests of different groups in society. Hence pharmaceuticals markets are intimately involved with the sorts of welfare considerations that typically favour price discrimination.

The accession states and the EU15

During 2004, ten countries with a combined population of about 75 million people are due to join the EU – although negotiations are not yet complete. By way of comparison, the present EU (“EU15”) population is about 380 million.

These “accession states” have, on average, substantially lower income levels and spend substantially less per head of population on healthcare than the EU15.

For example, if we focus on the eight accession states from eastern Europe (ignoring for now Cyprus and Malta, which raise additional complex issues of their own), their average per capita GDP in 2001 was only 23 percent of the EU15 average at current exchange rates. Their average per capita expenditure on healthcare was, likewise, only about 25 per cent of the EU15 average.

Many pharmaceuticals prices are currently much lower in the accession states than in the EU15. An (unpublished) Europe Economics spot study in November 2002 suggested that some pharmaceuticals in eastern Europe retail mainly in the range 30–70 percent of the price in southern England.

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It should be clear that, if accession states are forced to pay prices comparable to those in present EU member states, they simply will not, in the short- to medium-term, be able to provide medicines for as many patients as they do at present.

The natural solution would appear to be for accession states to continue to be charged lower prices for their pharmaceuticals, to reflect their lower capacity to pay and the important role pharmaceuticals play in welfare policy.

However, as things stand at present, after accession the current price differentials will no longer be sustainable. The reason is that there are EU laws – in particular, article 81(1) and the relevant ECJ interpretations – promoting “parallel trade.”

Parallel trade

Parallel trade is the cross-border version of arbitrage. If a brand of soft drinks, for example, is sold sufficiently more cheaply in east Germany than in southern England, parallel traders can buy soft drinks in east Germany, transport them to southern England, and re-sell them, undercutting the higher English prices.

For most goods and services this process is considered to be a desirable promotion of competition and the single European market.

Article 81(1) of the Treaty prohibits anticompetitive agreements. As interpreted by the ECJ, if a manufacturer tries to prevent its distributors from taking part in parallel trade within the EU, it will in almost all cases fall within this prohibition. Important judgments include *AEG v Commission*, *Ford v Commission* and *Sandoz v Commission*.

Unsurprisingly, the ECJ's case law is particularly opposed to measures that might tend to segment EU markets along national boundaries, even for patented products.

For example, in *Merck v Primecrown*, the Court said that “if a patentee could prohibit the importation of protected products marketed in another member state by him or with his consent, he would be able to partition national markets and thereby restrict trade between member states.”

Article 81(3) provides a number of grounds for setting this presumption aside, but the applicability of these to the circumstances discussed here has not yet been tested in legal proceedings.

Parallel trade between the EU and accession states

Parallel trade in pharmaceuticals is already big business. By 2004, before any impact of accession, parallel imports will already account for 5 percent or more of total sales of pharmaceuticals in the EU, and for some products (e.g. Lipitor into the UK in 2002) parallel trade represents as much as half of sales.

The *Sunday Times Business Survey* of the 100 UK firms whose profits increased most rapidly in 2001 included no fewer than five parallel traders. This has had the expected consequence of narrowing price dispersion in the EU – despite the complexities arising from the nature of pharmaceuticals purchasing, with large state monopsonies exercising considerable market power.

A study based on Swedish data of average pharmaceuticals prices in ten EU countries between 1986 and 2001 suggests price dispersion decreased considerably across the period, from about a 30 percent standard deviation to about 10 percent.

Similarly, after accession we would expect the current price differentials between western and eastern Europe to be simply unsustainable. And, because western Europe is much more populous and much richer, in practice what that will mean is prices close to the EU15 price, and considerably above current accession state prices.

After accession, it is likely that there will be some convergence between EU15 per capita incomes and those in the accession states. But, even if growth rates were three times those in the EU15, it could still be some 20 years after accession before GDP at current exchange rates would be even half the average of that in the EU15.

The pace of convergence in pharmaceuticals prices, driven by parallel trade, would be much faster, and create significant issues for the health systems in accession states.

It should be noted that this is a problem specific to pharmaceuticals. For most products, parallel trade would be unambiguously desirable, promoting competition and efficiency, driving down prices in the EU15, and making more goods and opportunities available in accession states. As discussed above, for most products price discrimination is undesirable.

But other products are not like pharma-

ceuticals. They do not involve the same sunk costs, they are not so dependent on patents, they do not raise the same ethical considerations, and they are not central to government welfare policies.

If some price discrimination for pharmaceuticals is desirable, parallel trade in pharmaceuticals between accession states and the EU15 would be undesirable.

In practice, what parallel trade in pharmaceuticals would mean is marginally lower prices for the (rich) consumers of the current EU15, and higher prices for the (poor) consumers of accession states.

The same considerations that lead us to give structural funds to accession states to draw them up towards the EU average suggest that we should also restrict parallel trade in pharmaceuticals.

Why the IPR derogation is not the answer

It is sometimes, wrongly, suggested that this issue has already been addressed through a special intellectual property right (IPR) derogation largely agreed in earlier negotiations.

This IPR derogation aims to prevent parallel trade in cases where product patent systems were non-existent or inadequate in the accession states before 1991.

Because of the historical weakness of patent protection, an important problem can arise. Applying for a patent after accession for an established product will not be possible, because of the “novelty” requirement under patent law.

Without patent protection it would be possible, in accession states, to make copies of drugs patented in other EU countries, clearly undermining the price that could be obtained. Parallel trade would then permit sale into the EU15 at effectively out-of-patent prices, despite the EU15 patents.

This would undermine the economic value of EU intellectual property rights.

It might seem as if parallel imports of such drugs could simply be forbidden, but previous rulings of the ECJ mean that, if there is no corresponding patent right in the first member state of importation, the patent right in the second member state can be used to block the imports *only provided that the product was not marketed in the first member state by the patent owner or with his consent*.

So, if drugs were exported into the territory of a new accession state where

no patent rights existed, then the patent owner could block their import into another member state only provided the goods were not distributed originally in the new accession state by or with the owner's consent.

Under the proposed IPR derogation for accession states it is expected that, as with the derogation at the time of the accession of Spain, the holder of a patent or supplementary protection certificate (SPC) for a pharmaceutical product filed in a member state at a time when such protection could not be obtained in an accession state for that product will be able to rely on the rights granted by the patent or SPC in order to prevent the import and marketing of that product in member states where the drug enjoys patent or SPC protection, even if this product was put on the market in the accession state for the first time by him or with his consent – thereby amending the element of previous rulings of the ECJ italicised above.

The main difference from the generally similar mechanism employed at the time of the accessions of Spain and Portugal is that, in the case of Spain and Portugal, the protection applied only for a period of fixed, limited duration, while in the case of the accession states it is expected to apply for as long as there is a product falling within its scope of application.

This proposed IPR derogation will restrict parallel trade in a specific group of patented pharmaceuticals that obtained their patents perhaps ten or 15 years before accession. It would have no effect on parallel trade in drugs patented later – some of which will soon be approaching their peak commercial value and others of which have not yet even been launched – or in drugs for which previous patent provision was adequate, or in branded drugs that are out of patent.

The same November 2002 Europe Economics study investigated what proportion of pharmaceuticals would be affected by this proposed IPR derogation. Its conclusion was that such a derogation will create relevant restrictions of parallel trade for perhaps up to half the pharmaceuticals market for maybe the first two or three years.

After that, the IPR derogation will have little relevance to the parallel trade that will actually occur in the absence of measures to curtail it.

Measures to promote virtuous price discrimination

Given that the proposed IPR derogation will not significantly curtail parallel trade, and hence will not permit virtuous pharmaceuticals price discrimination after accession, what measures might work instead?

One possibility would be a derogation preventing all parallel trade in pharmaceuticals with accession states until a state had GDP per capita of at least (say) two thirds of the EU average. This would enable lower prices to be charged until a country was rich enough to be able to cope with higher EU prices.

An alternative might be the permitting of contracts restricting resale of pharmaceuticals. For example, such contracts could specify that pharmaceuticals were being sold on the understanding that they were to be used to treat patients within a given health system.

A third alternative would be to permit the use of rebates that depended on demonstrated use. That is to say, the pharmaceuticals company would charge the health system or insurer the single European price, but then grant rebates for product shown to be used within that particular health system.

Each of these proposals has its own strengths and weaknesses, and of course there are many variants that combine elements of the above. But the basic principle is the same, namely that they all facilitate the sale of pharmaceuticals at lower prices in relatively poor accession states.

Conclusion

Price discrimination can be desirable. The sale of pharmaceuticals at lower prices in accession states than in the current EU15 could well be an instance of such desirable price discrimination.

But competition law in the EU generally promotes parallel trade and hence undermines price discrimination. To permit virtuous pharmaceuticals price discrimination after accession there would need to be Community measures to restrict parallel trade, such as a limited derogation on parallel trade in pharmaceuticals, or the permitting in accession states either of contracts restricting resale of pharmaceuticals or of rebates for the approved use of pharmaceuticals.

Where it can be shown that price discrimination is virtuous, EC competition law

ought to provide a means of obtaining clearance for it. In some cases – perhaps pharmaceuticals – that may mean permitting restrictions on parallel trade.

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In Brief

\$7m for not obeying FTC order

A civil penalty of \$7.04 million was imposed on Boston Scientific Corporation on 31 March – the largest penalty ever for violating a consent order entered with the US Federal Trade Commission.

In 1995, when BSC gained clearance for its merger with CVIS, it undertook to share its intravascular ultrasound catheter technology and knowhow with the only other company active on the US market, Hewlett Packard.

HP left the market in 1998. The court said that BSC was a “substantial contributing cause” to this, and that it had not been entirely open with the FTC about its negotiating difficulties with HP.

Judge Saris said that BSC had taken an “obstreperous approach” to the negotiations. One result of HP’s exit was the loss of its Scout catheter. “Patients with heart disease were left with technology inferior to that available in 1995,” the judge said.

The penalty was half the maximum for the period before the FTC warned BSC about its violation. For the period after that and up to HP’s withdrawal from the market, the fine was set near the maximum.