IN THE COMPETITION APPEAL TRIBUNAL

Case No: 1524-1525/1/12/22

Salisbury Square House
8 Salisbury Square
London EC4Y 8AP

Monday 6th November – Wednesday 13th December 2023

Before:

The Honourable Mr Justice Marcus Smith
Eamonn Doran
Professor Michael Waterson

(Sitting as a Tribunal in England and Wales)

BETWEEN:

Appellants

Pfizer Inc. and Pfizer Limited & Flynn Pharma Limited and Flynn Pharma (Holdings) Limited

V

Respondent

Competition & Markets Authority

A P P E A R AN C E S

Mark Brealey KC, Robert O'Donoghue KC & Tim Johnston (Instructed by Clifford Chance LLP) on behalf of Pfizer

Jemima Stratford KC, Tom Pascoe & Alastair Richardson (Instructed by Macfarlanes LLP) on behalf of Flynn

Josh Holmes KC, David Bailey, Jennifer MacLeod, Julianne Kerr Morrison & Conor McCarthy
On Behalf of the Competition & Markets Authority

Tuesday, 12 December 2023

(10.00 am)

THE PRESIDENT: Ms Stratford, good morning.

Closing submissions by MS STRATFORD (continued)

MS STRATFORD: Good morning.

I finished yesterday on my submission that Mr Harman's ROCE WACC is a theoretical one, as the previous Tribunal found, and that as soon as one looks at the real world, it begins to crumble.

I am about to take the Tribunal to the real-world ROCE figures that I pulled up on the screen yesterday evening, but just before I do that can I briefly come back on Professor Waterson's question on the Pfizer/Flynn relationship.

The main issue as we see it is: is there something about this relationship which means that Flynn's costs should not be taken at face value? In a sense, this is a simple question because all of the parties are, as far as we are aware, agreed on the answer.

The CMA's case is not that Flynn's actual costs paid to Pfizer are to be disregarded. On the contrary, its positive case against Flynn is that its margins exceeded those costs plus a reasonable rate of return. The CMA's counsel has been very clear about this and advisedly so because that is what their decision says, and if we

could just, please, pull up the transcript {Day10LH1/89:1-4} and it is at the top of that page, lines 1 to 4. That is where Mr Bailey on behalf of the CMA put to Dr De Coninck who he was cross-examining:

"Question: Now it is right, is it not, that the decision in calculating cost plus was based on the costs that Flynn actually incurred in the real world, including Pfizer's supply prices?"

So the CMA has been at pains to make clear that they took Flynn's costs as they actually were.

THE PRESIDENT: Oh yes, indeed, and I think that is our understanding. I suspect Mr Bailey was making the point with Dr De Coninck because of the points that we raised in the course of the coffee shop example which attracted Mr Harman's response that some adjustment in some cases might be necessary for the, as it were, free premises in the mom-and-pop shop, and, there, there was an instance of an adjustment which is of interest, to be clear, in terms of how all this works, but does not affect the way in which we understand the CMA to approach matters in that it is the CMA's position that they have looked at the actual costs on an "erring on the side of generosity to Flynn" basis in order to -- I see nodding.

MS STRATFORD: I appreciate that is their case.

THE PRESIDENT: And that is absolutely our understanding as

well.

MS STRATFORD: I appreciate that is their case, but I do, I think, still need to address this if I may.

THE PRESIDENT: No, of course.

MS STRATFORD: Just to pick up on one point, we would not accept that it is a generous approach if it is the only legally permissible approach.

THE PRESIDENT: The CMA would say that is a generous approach.

MS STRATFORD: Well, I will come back to their --

THE PRESIDENT: You can certainly push back on that.

MS STRATFORD: -- the annex to their written closing where they claim generosity, but that is perhaps detail.

But what we do say is that had the CMA adopted a case that Flynn's costs should be ignored or adjusted downwards, they would have got themselves into the territory of finding Flynn guilty of an abuse for failure to sell below its costs, ie for failing to sell at a loss.

Now, one can imagine, it is possible to envisage some scenarios where that might be the right analysis such as in a case of illegal price collusion or collective dominance, but that would have required a completely different decision based on completely different analysis, and obviously we would have

responded in a completely different way, and the CMA, we say, quite rightly, after examining the evidence chose not to go down that route, and to be clear of course all of this is legal analysis, it is not an economic question of whether Flynn's supply prices should be disregarded or adjusted in some way because the task of the Tribunal is not to interrogate whether the market could have been more efficient from an economic point of view, it is to assess whether Pfizer and Flynn, as separate entities, are guilty of the abusive conduct of which they have been accused, and on that issue, and, sir, here I think we are all ad idem.

That said -- and this is part of the reason I do press my submission on this -- the CMA has been perhaps I can say a little sneaky in its written closing and has sometimes succumbed to the temptation of removing Pfizer's input costs altogether and maybe we can just look at an example of that.

If we could please pull up {XL/6/14}, this is in their written closing, and it is the second chart on that page which purports to show a very big gap between Flynn's costs, their incremental costs, and its revenue, but to be clear, that is because, in this chart, the CMA has silently but surely expunged Flynn's main cost, its price paid to Pfizer from the picture. It is hidden

there in a note, but, as I have said, their case is that those costs are not to be expunged, they are to be taken as read.

That is what I wanted to say about the Pfizer/Flynn relationship for now.

Yesterday afternoon, of course, I began making the submission that as soon as we look at some actual ROCE figures from the real world, Mr Harman's theory that a firm's ROCE should equal its WACC begins to crumble, and if we could please go back to Mr Williams' seventh report at {XE2/7/12}, and this is paragraph 42 that I want to focus on which are the ROCE rates that Mr Williams has calculated for his five comparator companies. Now, with the exception of Alliance PLC, which of course is a listed company with hundreds of millions of pounds of capital sitting on its balance sheet, these figures bear no resemblance to Mr Harman's 10% ROCE benchmark, and frankly, suggest that it is wrong.

I should say they are company-wide figures which is the best we as a private company can get, but that is not an issue, should not be an issue, because the purpose of the exercise at this stage is to test Mr Harman's hypothesis that there is a standard rate of return of 10% ROCE which is industry wide.

THE PRESIDENT: For your purposes, a purely negative approach that Mr Harman is wrong suffices?

MS STRATFORD: Yes.

The point we make is that his benchmark is not tied to any particular product or indeed, any particular company. What is important, we say, is not just the fact that these figures are way out of kilter with what Mr Harman would theorise should be the case, but also, frankly, that Mr Harman was so uninterested in this, and, sir, you asked Mr Harman whether he ever paused to consider that his ROCE WACC theory might not be right. Just for your note that is {Day12LH1/28:23} onwards.

With respect, that was a prescient question, and Mr Harman's response to these ROCE figures suggests the answer is "no", he did not pause.

His response was that if he had the necessary information at his fingertips, he could massage these figures of -- you see the range of 63%, 67%, 176% and 229% -- into something resembling 10%, and in our written closing we have referred to this, I think it is paragraph 101 of our written closing, as Mr Harman waving his magic wand.

With respect, from a methodological perspective, this is rather troubling. Firstly, Mr Harman or the CMA should have been doing this kind of empirical

sense-check themselves, not relying on us to do it for them, but secondly, when presented with comparator companies such as these, the correct response cannot be to assume in Mr Harman's own favour that with some accounting wizardry the figures could be moulded to fit his theory. We say that is just back to front, but, on any view, the suggestion that by making adjustments for inflation the figures would come down to 10% is implausible, completely implausible we would say, because it is a deliberate feature of Mr Williams' comparator companies that they are asset-light companies, and, therefore, would not be sitting with large, old capital investments on their balance sheet that need to be updated for inflation.

The reference for that is, just for your note, Williams 5, paragraph 18 at {XE2/5/6}.

The same picture arises when one looks at Flynn's products, and we can look, perhaps here, conveniently at the chart in our closing submissions, this is {XL/4/44}, and it is a chart which you may be painfully familiar with by now, but again, these return rates are all over the place and bear no resemblance to Mr Harman's one-size-fits-all ROCE rate.

Mr Harman, of course, produced a competing graph which still shows Flynn's products as being all over the

place but with a slightly less extreme range, but he has achieved that mainly by chopping off the products with very high ROCE rates on the basis that they are low volume products, and that is inappropriate.

One of the supposed virtues of Mr Harman's ROCE theory is that it is universal. The 10% ROCE rate remains the same whether you are selling high or low volume of products. So we see no basis for excluding any products from Flynn's portfolio for the purpose of this sense check.

Ultimately, however, much as Mr Harman tries to wave his magic wand, these figures -- the figures in Williams 5 -- are inconsistent with the idea that there is a normal industry-wide rate of 10% ROCE.

So far I have been on the theoretical versus market evidence point. The other point arising from the criticisms of Mr Harman's approach in the original Tribunal judgment that I need to deal with is idealised competition.

Now, in a sense, the point makes itself when one looks at what Mr Harman's benchmark means for Flynn in practice. If we could please look at, still in our written closing, at {XL/4/88}, and this is annex 1 to our written closing, and one can see that Mr Harman's cost plus is simply the sum of Flynn's total costs.

This is what the President described as the "inevitable and ineluctable elision between cost and cost plus". The logic of this is that the CMA's cost plus represents the lowest point at which Flynn could possibly price and therefore the outcome that would pertain under perfect or idealised competition.

Mr Harman's answer was that his benchmark is based on an average -- on average costs of capital rather than the minimum possible cost of capital that could be obtained on a market, but that is not an answer.

The criticism is not that Mr Harman is assuming perfect competition amongst the providers of capital such as the banks that offer through competition business loans to companies like Flynn. It is rather that Mr Harman is assuming perfect competition amongst sellers of the product because his benchmark represents the lowest possible level at which the seller could price before it begins to make a loss.

Now, as we have said in our written closing, the proof is ultimately in the pudding. The previous Tribunal criticised Mr Harman's way of thinking as being based on what it referred to as idealised rather than normal competition, that was when the CMA's benchmark was 6% ROS.

The CMA has now come back with an even lower

benchmark, we know we are now 2% ROS as a result of flipping the order of the primary benchmark and the cross-check. So how, we ask rhetorically, can an authority whose decision has been remitted on the basis that its benchmark has been wrongly based on perfect competition come back to the Tribunal with a straight face and present a benchmark that is even lower?

PROFESSOR WATERSON: Just on this annex, I am a bit puzzled about the weighted average figures. I have just been doing a quick sum, but we know that the 100mg tablet is by far the most common, and, therefore, that should get a greater weight, but this looks like a simple average of those figures.

MS STRATFORD: Well, I am instructed it is a weighted average. I am certainly not going to attempt to debate the maths, least of all with you, Professor, on my feet, but shall I discuss that with those behind me --

PROFESSOR WATERSON: Certainly, yes.

MS STRATFORD: -- when we have the short break?

PROFESSOR WATERSON: It is just a puzzle that I wanted cleared up.

THE PRESIDENT: Yes, I think there are two questions: one is what are these figures.

MS STRATFORD: Yes.

THE PRESIDENT: And, if they are weighted, then no problem;

if they are not weighted but in some other way allocated, then we need to debate whether that is right or not, because it would seem to be unlikely to be right, but let us proceed first by understanding what we have in front of us.

MS STRATFORD: I entirely see the point.

I think rather than take up time with it now.

THE PRESIDENT: Later on.

PROFESSOR WATERSON: I just raise it in passing.

MS STRATFORD: Yes, no, I am very grateful, because it is obviously important.

So in pound terms, the return which the CMA says would be reasonable based on Mr Harman's model is also very low. As we have seen based on Pfizer's actual supply prices, it amounts to £350,000 per year spread across the four strengths, so an average, and I accept it is just an average, of around £80,000 per year per strength, but that is not the whole picture because the CMA has also found that Pfizer exceeded its reasonable rate of return and has directed it to reduce its prices accordingly.

So if the Decision were upheld, Pfizer's input price will be lower and the value of Flynn's stock and net debtors will be lower, and the result, if we could just pull up for one, I think, final time {XO/2}, is our

chart, and if the Decision is upheld and both companies charge what the CMA considers to be their reasonable rates of return, I know you have the point that Flynn would earn just £66,000 per year, meaning roughly £10,000 to £20,000 per strength. To be clear, we do not understand the maths as such behind these figures to be in dispute, and Mr Harman acknowledged fairly in cross-examination that they looked very low.

What the CMA disputes is their relevance because they depend on a counterfactual where Pfizer charged its reasonable rate of return rather than its actual supply price, but what we say about that is we do not see why the CMA or the Tribunal should shut its eyes to what the Decision will actually look like if it is upheld in its entirety. That is an important part of stress-testing whether the CMA's rates of return are indeed reasonable ones.

So to sum up, the CMA has crafted the excessiveness limb into something that does no more than measure the company's costs. If that is the right approach, the CMA will be able to show up to the Tribunal in every future excessive pricing case and say: this seller is pricing above its costs, therefore it is excessive, therefore the seller must justify its prices under the unfairness limb, and what that really amounts to is abandoning the

excessive limb altogether because it seems vanishingly unlikely that the CMA would choose to take an excessive pricing case against a seller that was selling at or below cost.

Finally, and very briefly on this, on ROCE and the gap, the CMA's cross-checks go nowhere. We have addressed them at paragraph 111 of our written closings which I would ask the Tribunal, if it can ever find a spare moment, to read.

The short point is that all of the cross-checks assume what they are purporting to test by asking whether each cross-check enables Flynn to recover its capital, but the question of whether it is normal for a company such as Flynn to earn enough to recover its capital costs and no more is the very proposition we dispute, so the cross-checks, if you like, just go round in circles.

That is what I wanted to say on the ROCE benchmark. It is, with respect, important to bear in mind that at this point we are asking whether there is something materially wrong with the CMA's findings in the Decision. What the Tribunal can and cannot do to fill the void is a separate but logically different question which I will deal with shortly, and so I am going to move on, if I may, subject to coming back to that point,

I am going to move on to the market evidence.

We know that the CMA chose not to gather any market evidence on what is a normal rate of return. It chose to take what I have been calling the other turn at the cross-roads down the path of economic theory. That choice has coloured the evidence that is before the Tribunal because it is limited to what information Flynn as a private company has been able to obtain.

Obviously, if the CMA has made the wrong choice, if it has taken the wrong path at the cross-roads, that is not something that can be to the CMA's benefit. Any resulting gaps in the evidence must be resolved in Flynn's favour, and that can either be done by saying -- and this is our primary position -- that the result of the CMA's wrong turn is that it has not proved its case and the Decision must therefore be set aside, or it can be done by the Tribunal making its own decision but filling in the known unknowns, if I can use that expression, in ways that are favourable to Flynn, consistent with its right to the presumption of innocence, and with that in mind, I just want to look at what is the actual evidence before the Tribunal.

Could we please pull up again our written closing submissions {XL/4/49}. Looking at paragraph 117, which is most of this page, we have relatively full evidence

about Flynn's other products. We have relied on that as part of the picture on what is a reasonable rate of return, and Flynn's average return on sales over the relevant period was 24% to 25%.

We acknowledge that masks some variation between individual products, and I will return to that in a moment, but the important point to bear in mind about this evidence is that it is a small portfolio of other products. That is the only product-specific information we can obtain because we do not, unlike the CMA, have statutory information gathering powers. It is a limited sample and, as Mr Harman has been at pains to point out, the other products in the sample were, prior to the introduction of phenytoin, generating overall a loss.

The other type of evidence we have before the Tribunal is the returns earned by Mr Williams' comparator companies. Those are not broken down by product lines, of course, because that is not something that Flynn is able to do, and the CMA, having taken the path of theory rather than the real world, has chosen not to do. The average return on sales for those companies was 34%.

There are, then, three other sources that have been used, in Mr Williams' words, to triangulate these return figures. The first is Mr Williams' own industry

experience. He says that the average ROS rate seen on Flynn's and the other companies' portfolios are exactly what he would expect to see based on his more than 40 years of experience, and Mr Williams has said that in various places and on various occasions but, just to give you one of what we would say is one of the best references for the transcript, it is in his position paper which is at {XE6/5/18}, and it is paragraph 54 of his position paper, but no need to look at it now.

Importantly the CMA did not and could not challenge Mr Williams on this because of the turn that they had taken at the cross-roads. They did not adduce any industry evidence because they did not consider it to be relevant, so Mr Williams' evidence is unchallenged in this respect.

The second point of triangulation is the *Aspen* decision where the Commission found that an average ROS for a cohort of 23 companies which focused on generic medicines was 23%, and I am going to come back if I may to *Aspen*.

The third point of triangulation is Mr Williams' evidence on what is a normal rate of return under the PPRS for branded products which, as the Tribunal knows, I am sure, is 19% plus a margin of tolerance.

Putting those figures together and recognising that

this is not an exact science, we say that this evidence shows that a normal rate of return for a seller of a generic medicine is in the ballpark -- and I stress ballpark -- of 20-30% ROS.

That figure is significant for two reasons. The first is it shows the CMA's figure of 2% ROS to be wrong. It is just not a normal rate of return. We would go so far as to say it is an aberration.

The second reason why the 20-30% is significant is that it provides some positive evidence of what actually is a reasonable rate of return for phenytoin, and the question of whether the Tribunal can or should fill the void in this way, if the CMA's 2% ROS figure is wrong, is something that I will come back to.

I should just deal with one point now from the CMA's closing submissions which is their allegation that we have taken an absolutist approach by focusing exclusively on ROS. That is not correct. We have also relied on other measures of return such as gross margins, product contributions and differentials which all paint the same picture.

What the CMA is really saying is that we focused our market evidence on margins, ie measures of the relationship between cost and revenue. That is true, but other than ROCE, nobody has put forward any other

potential measure, and of course the CMA focused on a margin benchmark, its 6% ROS in the first appeal, as did the Commission in *Aspen*, as did the Tribunal in *Napp*. So there is really nothing absolutist in our position.

There is one key disagreement of principle between us and the CMA on the import of this evidence which I want to address now, and then, if I may, I will deal with some points of detail.

The core disagreement is whether it is appropriate, as the Commission did in *Aspen*, and this Tribunal did in *Napp*, to look at a ballpark range based on other companies' portfolios of products, or whether one should look for individual comparator products. To be clear, we say the former, and the CMA says the latter.

Our response to the CMA's position is twofold. First, it is unrealistic to insist on comparisons between individual product lines, and that has never been done in any of the previous excessive pricing cases. In that respect, the CMA would be making new law if a comparison with individual product lines were held to be a necessary requirement.

Second, if that was the right approach, the CMA cannot win by default by refusing to gather the evidence that it says would be necessary to assess the

product-by-product comparisons that it itself is insisting upon.

The weight of authority is on our side of the debate on this point, and could we, for one last time, I hope, turn up the *Aspen* decision again. It is at {XN6/7} and I want to go to page {XN6/7/25}, please.

Starting at the foot of that page -- in fact, what may be best, if the Tribunal would be so kind as to start at recital 129 and read over the page to 133.

THE PRESIDENT: 129 to 133?

MS STRATFORD: Oh yes, actually sorry, can we start at 128?

THE PRESIDENT: Of course.

MS STRATFORD: Mr Pascoe reminds me I wanted to make a point on that as well. (Pause)

What is striking about these passages, we say, is just how high level the Commission's comparison was. It did not even come close to a product-by-product analysis. There is no discussion of the features of the cancer drugs under investigation or how they match up to the individual products in the basket of comparators, it is just a broad industry average based on entire portfolios of products.

Just a point of detail while we are looking at *Aspen*, if I may. Mr Bailey for the CMA pointed out that the Commission excluded distributors from its cohort.

That is at footnote 89 of the decision.

That is not particularly surprising. If you are a mere wholesaler, there is no reason why you should be part of a cohort with actual medicine suppliers, but the reason I wanted to pick up that point is to be clear Flynn is not a distributor in that sense, it holds the marketing authorisation for the medicine with all of the responsibilities that that entails and supplies the medicine to the NHS, so we are not comparing apples with pears.

Mr Harman prevaricated when I asked him whether he thought the Commission had got it wrong in this case, but he did eventually admit that he would have advised the Commission to go about its task differently if it had been up to him, and the reference for the transcript is {Day13LH1/81:24} and going over to {Day13LH1/82:2}.

That is the clear logic of his position because he says that if you carry out a ROS comparison, you need to control for a whole host of product-specific factors and, unless you can do so, you should abandon the exercise.

One can see that from, for example, Mr Harman's table of variables which he says need to be controlled for under any ROS analysis. I am sure the Tribunal will recall that, it is at {XE1/15/84}. Maybe it is worth

just glancing at it.

These are all factors that Mr Harman says would need to be controlled for in any excessive pricing case, but the Commission did not look at any of them save for making sure that the comparator cohort was focused on generic rather than patented medicines.

The same approach was adopted in *Napp*. I am not going to go through it now, the references are at paragraph 62(a) of our skeleton argument.

So as a matter of precedent, history is on our side, and, aside from being the only realistic approach, we also say that looking in broad terms at what is a normal return for a generic medicine has the advantage of controlling for random variation within portfolios, including loss-making products. One of the problems with the CMA's benchmark is that it involves Flynn pricing at cost which, taken to its logical conclusion, for all of its products, would mean that it would cease trading because some of Flynn's products make a loss.

A portfolio-based approach to the evidence by its nature controls for that by looking at average returns across portfolios, and portfolios, by their nature, are likely to contain loss-making products, in other words, it all comes out in the wash.

We have seen that where it suits them the CMA has

been happy to adopt this approach itself, you might call it a "safety in numbers" approach: you take a portfolio of products and assume that in the round they capture a normal competitive rate of return across all of the natural lumps and bumps that one encounters in a basket of individual products, each with their own features and quirks, and you will recall yesterday Mr Brealey took you to a place in the Decision where the CMA was prepared to take a portfolio of Pfizer products and adopt that as a benchmark for its reasonable rate of return on the assumption that the products by and large operated in workable competition.

The CMA did not actually look at any of those individual products. Just for your note, it is at paragraph 5.145 of the Decision.

Mr Brealey also showed you that the CMA took a "safety in numbers" approach in *Liothyronine* where at one point it relied on an anonymous basket of 13 Scheme M drugs without examining them individually. That is again, just for the note, for convenience, it is *Liothyronine* paragraph 264.

So it seems that the CMA is happy to sign up to a broader-brush portfolio approach when it helps them.

A related point is the one that the President mentioned yesterday that, at its highest, the CMA's case

is that prices trend to cost over time, and one should therefore average prices over a wide period rather than taking a snapshot at the bottom of the market. Again, a portfolio approach controls for that because it captures different products at different stages of the life cycle.

I should mention here that this portfolio approach bears some resemblance to how Flynn actually prices its products. If we could maybe just go to {XC1/1/34}, this is in Mr Fakes' first witness statement, and if we could look at paragraph 80, Mr Fakes says that the "general principle" applied by Flynn when pricing its products is that its total portfolio revenue should exceed its total portfolio costs. So happily our approach to the market evidence is in line with how Flynn actually considers its prices.

The CMA's answer to all of this, as we understand it, is that phenytoin is such a peculiar product because of its high input prices and high volumes that the search for a margin comparator is hopeless.

Our initial response to that is, if that were the case, why did the Tribunal remit the investigation to the CMA to do more empirical research? On the CMA's case that was a futile exercise from the start, but more substantively, the CMA is wrong to say that phenytoin is

a totally exceptional product, and if we could please, on this, go back to our written closing at {XL/4/51} where at paragraph 122 we have set out some figures, and we can see that even amongst the small sample of Flynn's 12 other products, a quarter of them had higher input costs than phenytoin, and almost half of the portfolio -- so five out of 12 of the products -- had similar volumes to phenytoin.

Now, it is true to say that out of the 12 products in Flynn's portfolio none of them ticks both of the boxes of having similar volumes and similar input costs, but the suggestion that it would be impossible to find another product which did is rather fanciful given that neither of the two purportedly unusual features identified by the CMA are particularly uncommon even in Flynn's small catalogue of 12 products, and it would, we say, have been the easiest thing in the world for the CMA to ask one or more of Mr Williams' five comparator companies to provide details of their products with an input cost at or around the level of phenytoin, with volumes at or around the level of phenytoin, or both. It could then have looked at those products and seen if their returns were anywhere near a 2% ROS.

I want to deal with that latter point because the CMA has addressed it in its written closing in a way

which betrays a fundamental misunderstanding, we say, of its role and duties. So could we please go to the CMA's written closing at {XL/8/24}. This is in annex 2 to the CMA's written closing, and I want to look at paragraph 63 there.

The CMA refers to Flynn's claim that it ought to have asked some questions of Mr Williams' comparators if it thought there was missing information. It says:

"The CMA disagrees. The CMA reliably calculated a [reasonable rate of return] for Flynn's supply of Capsules based on a ROCE approach using a 10% WACC and tested the robustness of its conclusions using a 6% ROS."

Then this, which I stress:

"Given these calculations, it was neither necessary nor desirable for the CMA to gather detailed information about the price, cost, volumes, risks, activities and competitive conditions relating to the various products across the portfolios of other companies."

So what the CMA is saying boils down to this: because we are sufficiently confident in the calculations we have done to find you guilty, it is not worth our while doing any investigation into evidence that might exculpate you.

Now, one only needs to say that aloud to realise it

betrays a fundamental misunderstanding of the CMA's role and duties, as I have said. Those duties were laid out by the Court of Appeal in its judgment in this case. Perhaps we could please pull that up at {XN1/5/35}, and I want to start by looking at paragraph 113 where Lord Justice Green said:

"At base the CMA has a duty to conduct a fair evaluation of all the evidence before it."

So that is the basic duty. Then he says the content of that duty is context-specific:

"What this means in a given case is impossible to say in advance and will depend upon the facts of the case. A degree of proactivity might be needed, in some cases, but not in others."

He then goes on to say essentially the same thing halfway down the paragraph where he says:

"The notion of a duty to evaluate evidence fairly encapsulates the contextual nature of the duty. If the CMA fails in this duty the Tribunal exists to remedy any such failing."

So essentially the duty of fair evaluation may require proactive investigation in some cases but not in others, it depends on the context. We say that where the reason being put forward for rejecting a comparator is a lack of information, that by its nature the

undertaking could not obtain, that is a powerful factor in favour of a duty on the CMA to obtain that information itself through its statutory powers.

On no reading of the Court of Appeal judgment can the CMA refuse to carry out any investigation of exculpatory material because it has sufficient confidence in its own inculpatory material, and if we could just look, while we have it open, at paragraph 127 of the judgment which is on page {XN1/5/39}, Lord Justice Green was now dealing with comparators, and he said at 127 in the middle of that paragraph, towards the end:

"It was not therefore open to the CMA to ignore that evidence [so this is the evidence on comparators] because it had, in its judgment, conducted a sufficient analysis."

The point is also summarised -- I am sure you will have in mind -- in the passage which Mr Brealey took the Tribunal to yesterday at paragraph 97(viii) of the judgment. I do not know if you want to remind yourselves of it, but that is on page {XN1/5/29} of this tab where -- I will just read it out.

THE PRESIDENT: Yes.

MS STRATFORD: The Court of Appeal said:

"If an undertaking relies, in its defence, upon

other methods or types of evidence to that relied upon by the competition authority then the authority must fairly evaluate it."

You will remember that, thank you.

So to complete the point, the same error is made, could we please go back to the CMA's closing submissions at now page {XL/8/25} and paragraph 65, which says:

"Given that the CMA adopted a reliable ROCE method and that the CMA explained why it did not accept Mr Williams' comparators as a meaningful benchmark for the [reasonable rate of return] for Capsules, the CMA was not obliged to investigate his set of companies."

We do say that this reflects a hard-edged error of law. It is also of a piece with the CMA's general approach to its investigation which is to pin its colours to the mast of Mr Harman's finance theory and refuse to look at any real world evidence which might call it into question. So it has once again, we say, taken the wrong turn at the cross-roads between theory and the real world.

Now, I have been addressing the high level point of principle between us which is whether one is entitled to look at portfolio-based rates of return or one has to zoom in on individual products. If the CMA were right that the latter is the only proper approach, it would

mean one of two things: either that excessive pricing investigations will become much more burdensome for the CMA because they will have to go out to the market and gather product-specific information of the kind we have been discussing, or that the CMA is setting up companies to fail because they will never be able to get hold of the kind of comparator information which the CMA is insisting on, and the CMA is not willing to gather that information itself, and neither of those positions can be right, we say.

I said there are some points of detail that I just want to mop up, if I can, about Mr Williams' comparator companies.

As a starting point, please could I just ask the Tribunal if we could go to, again, in our closing submissions, at {XL/4/53}, and if I could ask the Tribunal to read the excerpt from Mr Williams' oral evidence where he rather helpfully summarised how he selected his cohort of five companies at paragraph -- it is at the top half of that page. Thank you. (Pause)

THE PRESIDENT: Yes, thank you.

MS STRATFORD: The Tribunal asked me yesterday for some factors that could be used as guidance for companies wishing to set a non-excessive price and I said I would come back to that, and that is what I would like to do

now. The first overarching piece of guidance, we would suggest, is that the company should look to real-world evidence on what is a normal rate of return.

The second is that, when looking at that evidence, whether it be the returns on individual products or, more realistically, other companies' portfolios, it should take into account broadly the same factors as Mr Williams has controlled for, and I am going to suggest that there are six key factors.

First, and most basically, to control for the nature of the product. Mr Williams ensured that all but one of his comparator companies sold other AEDs, and, as you are aware, the only one that did not is Alliance, and all of them focus on off-patent medicines.

Second, to control for whether the company or product involves significant innovation or not. Mr Williams did this and focused on companies, in his words, that tend to be selling old molecules that likely will have been acquired from someone else, and at this point, I should just correct something that I said yesterday.

While it is of course true that Flynn did not innovate in relation to phenytoin, which is why Mr Williams has chosen the comparators that he has, Flynn does invest in innovation and R&D. Dr Fakes

describes the innovative arm of Flynn's business at paragraph 19 of his first statement which is at {XC1/1/8}.

The third factor is to control for the broad activities involved in the supply of the product. That is why all of Mr Williams' companies are marketing authorisation holders rather than what he described, rather colourfully, as mere "box-shifters", ie wholesalers.

Fourth, to control for the correct level of the supply chain, and Mr Williams did that by excluding companies that manufacture their own drugs. So his companies are all sales, marketing and distribution companies.

Fifth, to control for the time period. Mr Williams expanded his time period in response to the CMA's criticisms. Essentially one should not be looking at a short snapshot of time, one should look at long-term trends to make sure that one avoids anomalies.

Sixth, to control for volumes, and Mr Williams did this by looking at companies that operate on a similar scale to Flynn, and by excluding companies that focus on selling very high volume generics such as statins. If you want a reference for that, it is in his position paper at paragraph 35.

So we say these are all relevant factors to take into account, and the stage at which they should be taken into account is when selecting the pieces of market evidence to go into the mix.

You have already heard what I said about not applying a counsel of perfection and being realistic about what information a private company can access about other companies' individual products, and that is one reason why we advocate a portfolio-based approach to this market evidence in line with the Commission in *Aspen* and the Tribunal in *Napp*, but of course if a company does have individual comparator products at its fingertips which tick at least some of the boxes, then, hooray, those should certainly go into the mix.

Another important point of approach is that the company or authority should be taking a weighted approach to comparators, not a binary one. So a comparator should not be thrown in the bin simply because it cannot be matched on every relevant factor. That is what the original Tribunal held, and it is unclear to us whether the CMA is seeking to resile from that finding. On any view, in practice, the CMA has taken a binary approach by rejecting every comparator in sight out of hand.

The CMA tried to poke some fairly limited holes in

Mr Williams' comparators, so can I just deal with those points now. I appreciate I am rattling through this, and of course if you want me to slow down or pause at any point, I would be happy to do that.

THE PRESIDENT: We will certainly intervene either with questions or with a request for further detail. You do not need to worry about that.

MS STRATFORD: I am grateful.

The first point is a straightforward factual error by Mr Harman. We need to remember he has no industry expertise, so he cannot give direct evidence about these companies.

At a point in his evidence he suggested that two of Mr Williams' five companies, Chemidex and Alliance, do not belong there because they focus on manufacturing. Unfortunately, that is just a straight misreading of the evidence. The reason those companies are included in Mr Williams' cohort, as can be seen from the excerpt from his evidence that you just read, is that these companies do not manufacture their products.

It was not put to Mr Williams that he was wrong about that, and we have explained at paragraph 128 of our written closing he was in fact right. We have set out the supporting documents in a footnote there, but I do not think we need to go into the detail, but that

is of course the danger of having an economist rather than an industry expert comment on comparators.

The only point actually put to Mr Williams about his comparators is that some of them held products which have been subject to CMA investigations, and, again, we have set out the true position at paragraph 127 of our closing submissions. If we could go, please, to {XL/4/53}. I am focusing now on paragraph 127 at the bottom of the page. Maybe we can zoom into that, thank you.

In short, there is only one product owned by one company, Alliance, that could even conceivably have contaminated the data. The investigation against the second product was discontinued, and the third product was only acquired by one of Mr Williams' companies at the very tail end of the period he was examining.

Of course, if the CMA were concerned that Mr Williams' comparisons were being skewed by that lone product it could have asked for some information from Alliance about how that product affected its overall revenues or profitability, but again, it has adopted a policy of wilful ignorance.

Subject to this jury point about the CMA investigations, it was not actually put to Mr Williams that his comparators were bad or unrepresentative ones,

and without any industry evidence of its own, that was not a point that the CMA was even in a position to put.

The final matter I want to deal with on the market evidence, before I move on to deal with what the Tribunal should do with that evidence, is absolute profits.

It might be helpful if we could please go to {XO/1} which was our very first hand-up, it must seem like a long time ago. Just to remind the Tribunal what Flynn's absolute profits actually were, they were between £1 and £3 million per year on each strength.

I do not think even the CMA is saying that one can simply look at these figures and say in the abstract that they are evidence of excess; that really would be a finger in the air job.

Neither the CMA nor Mr Harman has identified any objective test for assessing what is and is not an excessive level of profits in pound terms, and Mr Harman frankly accepted that neither he nor the CMA know what a normal level of return in pound terms is for a generic medicine. The reference for the transcript is {Day13LH1/37:} to {Day13LH1/38:}.

That is no doubt why, when he was pushed, Mr Harman said that absolute profits were only being used in a negative sense to check for type 1 errors which does

make more sense to us from an economic perspective. In other words, Mr Harman said that absolute profits were being used as a shield rather than a sword.

Could I just perhaps show you that on the transcript. That is {Day13LH1/45:11}, and could I perhaps ask you to read from there over to page {Day13LH1/46:11}.

THE PRESIDENT: Yes, of course.

MS STRATFORD: Thank you. (Pause)

THE PRESIDENT: Yes, thank you.

MS STRATFORD: Thank you.

I asked Mr Harman to confirm that the only way in which the CMA was using absolute profits was to check for type 1 errors, ie that the CMA's reasonable return was not yielding returns that were too low in pound terms. He agreed. He said:

"... in essence that is what [the CMA] are seeking to do ..."

You already have my submission that the CMA's reasonable return for Flynn does produce returns that are too low, that is our £66,000 point, and I do not need to make that point again.

One claim that is made in the CMA's written closing, just for your note, it is at annex 2, paragraph 21, but I do not think we need to turn it up, the CMA says that

one should look at Flynn's absolute profits on a per-pack basis. That is something we have done, and it shows the profits on phenytoin to be unexceptional, and if we could -- this is the very end of this section, and it might be convenient to take the shorthand break after this, but if I could just show you one last chart.

THE PRESIDENT: No, please do.

MS STRATFORD: It is at {XL/4/57}. Again, we have included it in our written closing, and we say that that makes the point in visual form that the profits on phenytoin on a per pack basis were unexceptional.

As I say, that is all I wanted to say on absolute profits. I am coming on to, if it helps just to know where I am going, I was going to come on to deal with remedy, then tablets and economic value, albeit more shortly, and finally, penalty, but I am making pretty good progress.

THE PRESIDENT: Well, you are certainly moving appropriately swiftly, so thank you very much.

So now is a convenient moment?

MS STRATFORD: Unless it is inconvenient to the shorthand writer, I think it would be a natural moment to pause.

THE PRESIDENT: No, that makes very good sense. Well, in that case, we will rise for 10 minutes and resume at 20-past.

(11.13 am)

(A short break)

(11.32 am)

THE PRESIDENT: Ms Stratford.

MS STRATFORD: Before I come on to remedy, just to answer the question that was raised earlier this morning, and I can reassure you it is a weighted average by volume of packs, I do not think I need to say any more than that.

PROFESSOR WATERSON: Thank you. No, I was just puzzled because it is actually very similar to the simple average that I had calculated, that was what puzzled me.

THE PRESIDENT: If that is what it is, then we will accept those figures, because --

MS STRATFORD: I am grateful.

So the final point I want to cover on excess is, as I say, the question of remedy. The starting point, very simply, is that we say the CMA's findings of excessiveness against Flynn, based as they are on Mr Harman's ROCE theory, are flawed for the same reasons as identified in the original judgment and should be set aside for those reasons.

The next question that arises is whether the Tribunal can plug the gap with its own finding.

THE PRESIDENT: Yes.

MS STRATFORD: As I am quite sure the Tribunal knows, there

is of course jurisdiction to do that, but it is not unlimited, and we have, in our written closing at paragraph 138, set out a passage from the *Imperial Tobacco* case, there is no need to turn it up unless the Tribunal wants to, but there, as you will recollect, the Tribunal made clear that out of respect for the accused's rights of defence, the Tribunal can only reach a decision based on the actual evidence before it and the actual allegations in the Decision.

If the Tribunal did want to attempt this exercise, it would have to be on the very clear basis that the evidence is incomplete because of the CMA's decision not to obtain any market evidence of its own. So it has adopted what we would describe as a policy of wilful blindness. The consequence is that any gaps or ambiguities in the evidence would have to be resolved in Flynn's favour. Flynn cannot be punished for the CMA having taken my wrong turn at the cross-roads.

An example is that the Tribunal could not properly assume in the CMA's favour that Mr Williams' comparator companies are uninformative because they do not contain products reflecting the properties of phenytoin. That is something the CMA could have investigated but chose not to, so the adverse assumption cannot be drawn.

In terms of how the market evidence shapes up, could

we perhaps for this again pull up annex 1 of our written closing that we were just discussing, {XL/4/88}.

Now, as I have already mentioned, this is a response to the Tribunal's request to identify the floor price for phenytoin and the relevant mezzanines in terms of a reasonable rate of return. So just to be clear, we are working on the assumption at this stage that the CMA's ROCE benchmark is wrong and, therefore, goes out of the window.

What one is then left with -- and this is our middle cost plus box where we have a range of reasonable rates of return drawn from the market evidence, and Mr Williams has drawn his range between 19% which is at the lower bound of the range he has identified, and reflects what he says are normal rates of return under the PPRS once transfer pricing is taken into account, and at the top he has 31.25%, which is at the upper end of our 20-30% range and pretty much eliminates the excess.

One can see on the chart the prices that would obtain under each of those benchmarks. We say that whichever of them is adopted, the gap between cost plus and price is not sufficiently significant or in the Tribunal's words, "immodest", to give rise to an abuse, but the correct approach, we would say, is to recognise

all three rates as within a reasonable range rather than take them individually, in which case, the same outcome follows.

If the Tribunal does want to see the gaps expressed as a percentage, that is Mr Williams' table in his position paper which is at {XE6/5/16}. It is at paragraph 49 of his position paper.

Here Mr Williams not only takes his three benchmark rates, so 19% ROS, 30% ROS, 31.25% ROS, but also applies some sensitivities to the method of cost allocation in order to show just how the figures change, and the excess percentages vary between 0% and 22% depending on the assumptions that one applies, but, again, on no view can they be said to be demonstrably immodest or immoderate.

One point I should make about these figures is that they cannot be knocked out on the basis that these are ROS margins because, although Mr Harman tried to disown his previous evidence, he and the CMA both found ROS margins to be a reasonable, indeed, the most appropriate metric for Flynn in the first appeal. So, in that sense, the CMA has hoisted itself by its own petard, we say, and cannot now say that Flynn's ROS benchmarks are so unreasonable that they are beyond the scope of reasonable expert disagreement and must therefore be

removed from the evidential picture on what is a reasonable rate of return.

So we say, if the Tribunal is minded to go down the route of reaching its own decision, it ought to find that Flynn's margins were, to use the President's words, in the ballpark of a normal rate of return and, therefore, were not excessive.

I was going to move on now more shortly to the tablet comparator and economic value unless there are any questions.

THE PRESIDENT: No, thank you very much.

MS STRATFORD: Thank you.

We have, of course, deferred to Mr Brealey and Pfizer on the tablet comparator mainly for reasons of economy, as I mentioned in opening, but I do not want to understate its importance to our case.

In a sense, it is what makes this case stand out from many of the other excessive pricing appeals. This is not a case where Flynn attempted to get the price of its medicine as high as it could possibly go. There was a logic behind its price which was that the Department of Health had agreed to pay £30 per pack for the identical tablet product, and Flynn benchmarked its price at a discount to that level.

There was some debate in opening about whether the

£30 price which the Department of Health agreed to pay to pharmacies for tablets was a true price comparator or was it what the President referred to as a price control or a price constraint.

In our submission, there is no need, with respect, to overcomplicate this. £30 is the actual price of the tablets, or was at the relevant time the actual price of the tablets, that was paid by the actual complainant in this case, the Department, so in that sense it is properly described as a price comparator, but even if it were a price control, that would not make it irrelevant, and I would like to test the point briefly, if I may, by using an example.

Could we for this look at {XG/24/3}, this is the email from Mat Otton-Goulder to John Beighton at Teva which Mr Brealey showed you, and, as you know, it was the day after an agreement on the price of tablets had been reached.

The scenario I would like to imagine is if the contents of this email were not contained in private correspondence between the negotiating parties but rather in a press release put out by Mr Otton-Goulder on behalf of the Department saying the DH was pleased to announce that, following a negotiation, it had reached a deal with Teva to buy tablets for £30 per pack and

that it considered this to be of value for the NHS. Now, if that had been done and a second seller had approached Mr Otton-Goulder at the Department a week later saying that it had seen his press release and was going to start selling phenytoin capsules at the same price, would it have been reasonable for him to turn round and accuse Flynn of quasi-criminal conduct through abusive pricing?

We say of course not, and the only difference between that scenario and our case is that the parties were left to infer that the £30 price had been the subject of a negotiation. As it happens, the disclosure, belatedly given by the Department, shows that the inference was correct, and what this example shows, we say, is that it cannot be right that even if the £30 is classed as a price control, it is legally irrelevant and can therefore be ignored when asking whether the second seller's price is a reasonable one: it plainly falls within the ambit of what the Tribunal is entitled to consider under the fairness limb.

We have explained in our written closing that another way to look at the relevance of the agreed £30 price is that it reflected the economic value of tablets. One of the difficulties with the concept of economic value is that it is easy to discuss in the

abstract but sometimes hard to translate into concrete figures and prices.

In this case, the Tribunal has a ready-made measure of economic value which is the £30 price that the monopsony buyer of medicines in this country, the Department of Health, agreed to pay for it following a negotiation.

The Tribunal has heard a lot of evidence about the benefits that both capsules and tablets bring to patients and the NHS and that provides a ready explanation for why the Department was prepared to pay what it did. The agreed price was not irrational or some kind of aberration, and we have cited in our closing submission at paragraph 155 -- and no need to turn it up unless you want to, but the *Attheraces* case which Mr Brealey showed the Tribunal yesterday where the Court of Appeal made clear that the concept of economic value includes not only the cost of supplying the product but also demand side value. In this case, we say that the agreed £30 tablet is a good measure of economic value.

I am not planning to say very much about tablet ASPs which was the domain of Ms Webster and has been covered by Pfizer in closing. The one point we would like to make is that if Ms Webster were right that the test for

a comparator is whether it is priced at or near cost, it is not clear to us what work the comparator would actually be doing in the analysis. So if the only valid type of comparator is one priced at or near cost, why not just ask whether the product under investigation is priced at or near cost? Why does it help to look at a comparator at all? The fact that you may be able to find other products that are or are not priced near cost does not seem to us to add anything if that were the right test, and of course, we say that is because it is the wrong test.

THE PRESIDENT: Does it go to really questions of weight? I mean, we have had a discussion already about the extent to which comparators ought to be excluded as a matter of, effectively, law and just not looked at, but assuming we are going to go down that route and we just look at comparators as helpful indicators to these questions, one then needs to look at what the comparator actually tells us, and it may be that in a completely free competitive market that has very little regulation you are right that price is the key factor that one should take from it, and cost fades into a back issue, but if one has, say, a market which is more controlled where there is an attempt to push price closer to cost -- and I am not saying this is such a case, but

were one to say that that was the instance, then one might be more interested in that context in the relationship between price and cost, but what I am saying is does it perhaps depend on the market in which the good is sold and all the circumstances of the case in question?

MS STRATFORD: Well, it may, yes. I heard what Mr Brealey said in answer to I think a closely related question from you, sir, yesterday.

THE PRESIDENT: Yes, I mean, what Mr Brealey says is you get an idea of the value that was attached by the relevant purchaser by virtue of the fact that they agreed to pay that price in the tablet context.

MS STRATFORD: Yes, yes, and we agree with that.

THE PRESIDENT: Yes.

MS STRATFORD: So on the facts of this case, which is what matters, understandably, for my clients here --

THE PRESIDENT: Indeed.

MS STRATFORD: -- we do say that the £30 is perhaps peculiarly relevant and should be given considerable weight.

THE PRESIDENT: What, in the nicest possible way, you are saying is: look to the headline price and the fact that it does not trend towards cost is neither here nor there on the facts of this particular comparable.

MS STRATFORD: Yes, we are at a different stage of the analysis, we are at *United Brands* limb 2 and Ms Webster's approach risks collapsing comparators into excessiveness --

THE PRESIDENT: Yes, I see.

MS STRATFORD: -- if it means nothing more than you have got to price at or near cost. That is really the point I was trying to make.

THE PRESIDENT: I am grateful.

MS STRATFORD: Because we say workable competition does not mean just pricing at cost. It is a much more open textured concept than that, and the whole point of looking at comparators is to see if there is some precedent in the market for pricing above that level, and on that, as I have said, we do adopt all of the submissions of Mr Brealey as to why Ms Webster was wrong to find that the tablet market was not sufficiently competitive and ought, therefore, to use her words, to be thrown "in the bin".

She did actually say that. It is at {Day11LH1/145:10-16}.

How is that relevant to Flynn? The point we take from tablet ASPs is that if the tablet market were even remotely competitive, the ASPs that obtained in that market show that the CMA is way off base in calculating

the reasonable rates of return for Pfizer and Flynn, and could we on this please turn up {XJ/57}. What this is is Pfizer's graph showing the various tablet and capsule prices, and again, it will be familiar to the Tribunal.

The important line for our purposes, for Flynn's purposes, on this point is the salmon pink line at the bottom. That is the CMA's reasonable rate of return price which, as you'll recall, is 8p per capsule, so that is the price that would earn Flynn £66,000 per year. The point we make is that if the tablet market is even remotely competitive, it seems that the CMA has got its reasonable rate of return, which of course is supposed to be a proxy for a normal competitive return, it has that rate wrong by several orders of magnitude.

The final point to flag is tablet margins, and I have made much already of the fact that the CMA has not obtained any market evidence on a reasonable rate of return, but it is fair to say that as part of its investigation into the tablets market for the unfairness limb, it has uncovered evidence of margins.

Now, this is, in truth, more a case of stumbling across that evidence rather than actually looking for it, but on any view, it is on the record, and we acknowledge that. So could we on this, please, go to {XE1/10/28}. This is in, as you can see, CRA's,

Dr De Coninck's fifth report, and I wanted to focus in on table 4 which sets out the margin information that we have.

One initial observation is that very tellingly, we say, the CMA has not attempted to calculate the ROCE rates for tablets, and that is a missed opportunity given that the CMA has been in touch with tablet suppliers about their data. Given the ROS margins earned on tablets, we expect their ROCE rates will be well in excess of Mr Harman's 10% threshold, but we do not know because the CMA has adopted its usual policy and has not asked.

What we can see from the table is that, whether expressed as a percentage margin or an absolute margin in pound terms, Flynn's figures are the lowest.

Now, Ms Webster and Mr Harman tried to contort the data in a way that suited the CMA but ultimately we say the figures speak for themselves. Flynn's margins were well below those of the other tablet suppliers both in percentage and absolute pound terms so, again, the real world data speaks with a very different voice to Mr Harman's finance theory.

That was all I proposed to say on tablets and economic value, so if I can then move on to say something fairly brief on penalties.

Let me begin with whether there should be a penalty at all. We say not, perhaps unsurprisingly, but as the Tribunal knows and as has already been discussed with Mr O'Donoghue yesterday, a penalty can only be imposed where the undertaking has acted intentionally or negligently, and as to what this test requires, just for your note -- actually, it may be worth going to it, there is a helpful synthesis of the relevant case law in the Tribunal's judgment in *Generics UK*, a paroxetine judgment. That is at {XN2/22} and the paragraphs I wanted to look at start, I think, on page {XN2/22/39}.

I just wanted to focus in on paragraph 114, in particular because the Tribunal queried yesterday what "intention" means in the context of this test. We can see here the Tribunal quotes from its own judgment in *Napp* stating:

"... an infringement is committed intentionally for the purpose of section 36(3) of the Act if the undertaking [and then I stress these words] must have been aware, or could not have been unaware, that its conduct had the object or would have the effect of restricting competition ..."

So it follows that the CMA must show that Flynn could not reasonably have concluded that its prices were not excessive.

THE PRESIDENT: Yes, I mean, restricting competition is an umbrella term and we need to locate the intention by reference to the infringement in question. I think you are taking that for granted.

MS STRATFORD: Yes.

THE PRESIDENT: So the question has to be: are you aware or could you have been not unaware of the proper price for the capsules you were selling?

MS STRATFORD: Yes, I think, yes.

THE PRESIDENT: Otherwise you will not know whether you are restricting competition by pricing in excess.

MS STRATFORD: Certainly if you could not have been aware of that or could not reasonably have concluded.

THE PRESIDENT: I mean, "must have been aware" is higher than "could not have been unaware".

MS STRATFORD: Yes.

THE PRESIDENT: But they are both strong tests.

MS STRATFORD: Yes. Mr Pascoe rightly reminds me "price or margin", we would say here.

THE PRESIDENT: Yes, well, it will be coloured by --

MS STRATFORD: What is relevant in a particular case.

THE PRESIDENT: Indeed, yes.

MS STRATFORD: So we rely on --

THE PRESIDENT: What are the factors that would go to negligence?

MS STRATFORD: Well, can I maybe answer that by telling you what we rely on to say that Flynn's conduct, we say, was plainly not negligent, neither intentional nor negligent, in the sense that the paroxetine judgment is addressing.

THE PRESIDENT: Yes, of course.

MS STRATFORD: So first, Flynn set the price of capsules at a discount to the £30 drug tariff price for tablets, and we say that is the closest conceivable comparator to capsules. Flynn was transparent with the Department about its intention to set its price at this level, and just for your note, I do not think there is any need to go back to it, but the reference for that is, the meeting note, {XG/155/1} at paragraph 8.

On any view, this was an entirely reasonable approach to setting the price for capsules, particularly in circumstances where the tablet price had been the subject of a bespoke negotiation by the Department. The Tribunal has heard the evidence of Dr Fakes and Mr Williams that this is what all drug companies do all the time.

Indeed, if Flynn had not taken the tablets as a benchmark, it is not clear where else it ought to have priced other than at cost, which is a point I was making yesterday in a different context. So that is my first

point.

Second, as I said, again, at the beginning of my submissions yesterday, the Tribunal was right to emphasise that competition law really ought to be quite predictable and that it would be unreasonable to expect a firm to engage in an exercise of uncertainty as to what is an excessive price, and it is precisely such an exercise of uncertainty which the CMA would require Flynn to carry out.

The CMA's experts could not provide a sensible answer to the question of how they would have advised Flynn to price phenytoin when it launched the drug in 2012. Ms Webster's advice during this hearing was that the further they are from a cost reflection -- these are her words. The transcript reference is {Day11LH1/153:9-15}. Maybe just bring that up. Thank you.

Lines 9 to 15 there, her advice was:

"... the further they are from a cost-reflective price, knowing that they are in a position of dominance, the more risk they would be encountering that their price would be viewed as abusive ..."

So, we say that would have left Flynn in no clearer a position than it would be in had it received no advice at all.

The CMA's cost plus benchmark does not, on the CMA's own case, enable it to establish whether Flynn's prices were excessive. To do that, the CMA must also apply ex post policy considerations in forming its judgment of whether Flynn's returns are too high above its cost plus benchmark.

Sorry, Mr Pascoe -- I am just going to correct what I said because it may cause confusion. I think I said the CMA's cost plus benchmark does not enable it to establish whether Flynn's prices were "excessive", but I should have said "abusive" at that point, so we are into the discretionary territory.

THE PRESIDENT: I understand.

MS STRATFORD: Thank you. As I mentioned earlier, Flynn asked the CMA at the beginning of the investigation, so almost ten years ago, what it considered to be a fair margin for phenytoin, and the fact that it has taken many years to come up with an answer and that the answer is essentially from Ms Webster "you are at risk with any margin above cost", shows that Flynn did not act negligently in failing to predict the CMA's position back in 2011. So those are the four particular -- three or four, three maybe -- oh, no, I have got one more, sorry, I will keep going.

My third point is that the CMA has chopped and

changed its case throughout the decade-long proceeding against Flynn, and indeed Pfizer, and this is something that again Mr O'Donoghue addressed you on yesterday. Now I have dealt with some of the more spectacular volte-faces in my earlier submissions.

One point that might not be on the Tribunal's radar but Mr Brealey has now flagged is that Lord Justice Green in the Court of Appeal said that the CMA's changes of position could be taken into account when deciding whether Pfizer and Flynn acted negligently, and for your note that is in the judgment at {XN1/4/10} at paragraph 42.

We say the changes of position have only become more severe since that judgment was handed down.

Fourth -- and this is my fourth point -- the CMA in its original Decision was unable to come up with a robust method for establishing that Flynn's prices were excessive. In fact, its analysis was so wide of the mark that a remittal hearing was required since the Tribunal considered it lacked the information necessary to make a proper determination on abuse.

As I have said, the CMA has still not come up with any useful guidance. Its position is simply that companies should not price above cost and that, if they do, they must justify their prices. Flynn, we submit,

plainly did not act negligently in failing to foresee such an uncompromising test.

Moving on -- and this really will be new territory, at least orally, for this hearing -- there is also a hard-edged jurisdictional point which has been covered in written submissions but not orally, and it is whether Flynn's infringement, if it were proven, would fall within the conduct of minor significance regime.

The background to the point is that Flynn's turnover was under £50 million for all but one year in the relevant period. Conduct of minor significance is defined in the regulations. I do not know if you would like to have them up on screen, but they are at {XN8/3/1}, and conduct of minor significance is defined there as:

"... conduct by an undertaking the applicable turnover of which for the business year ending in the calendar year preceding one during which the infringement occurred does not exceed £50 million."

As the Tribunal will know, under section 40(3) of the 1998 Act, conduct of minor significance is then exempted from penalties.

In my submission, this definition is clear. Taken at face value, it means that the immunity applies where the undertaking's turnover falls below the £50 million

threshold in any one of the years, any one of the relevant years. Flynn's turnover was below £50 million in each relevant year, as I have said, apart from 2014 when its turnover was £54.1 million, and it follows, straightforwardly, we say, that the immunity applies to Flynn.

The CMA contends that the immunity only applies where turnover falls below the threshold in every relevant year, however, that interpretation is not consistent either with the plain meaning of the language used or with the purpose underlying the regime, and just as to the words used, we submit that if Parliament intended to limit the immunity to situations in which the turnover fell below £50 million in every relevant year, it would have included the word "every". It chose not to, the implication is clear: the immunity applies wherever a firm's turnover falls below the threshold in one relevant year.

On the CMA's construction, the immunity would not apply to an undertaking whose revenue was just shy of £50 million per year for each relevant year bar one, but which persistently earned revenues consistent with those of a small and medium enterprise, an SME.

An example would be a firm with revenues of £45-49 million per year in each relevant year

but £50-55 million per year in one relevant year, and we say that result would undermine the aim of the regime which is to exempt SMEs from penalties.

Finally, it is a longstanding principle of statutory construction that "penal statutes must be construed strictly in favour of those penalised", and we have cited authority in support of that proposition at paragraph 219 of our closing submissions. I do not propose to go to any of that, but that is another reason why Flynn's penalty should be annulled, we say.

Finally, even on the assumption that the CMA was entitled to impose a penalty on Flynn, the CMA has in any event erred in its calculation of the appropriate penalty to impose on Flynn. Again, we rely on all of the points set out in our skeleton, but I want to emphasise one short point now, if I may: the CMA has imposed a higher fine on Flynn than it imposed in the original decision by taking advantage of the fact that Flynn's turnover has increased since that time. So the fine in the original decision, just to give you the figures, was £5,164,425. The CMA now imposes a fine of £6,704,422, so we have gone from rounding it up £5.2 million, rounding it up, to £6.7.

The CMA maintains that this is justified on the basis of section 36(8) of the Act which is the provision

which applies the 10% turnover cap in relation to the business year preceding the date of the decision of course. For your reference, the CMA dealt with this in their opening skeleton at paragraph 165.

These provisions, we say, do no more than establish a cap on the level of penalty which the CMA may impose. The penalty cannot exceed the amount of the undertaking's turnover at the time of the CMA's decision. It does not follow that the CMA must calculate its penalty by reference to Flynn's turnover at that time.

So whilst the CMA may calculate a penalty by reference to the financial position of the undertaking at the time of its decision, the CMA may adopt a different approach in an appropriate case, and again, if authority were needed for that, it is to be found in *McCann v The CMA* which is in the authorities bundle at {XN2/19/115}, but I will not go to it unless you want me to, and we submit -- it will not surprise you to hear -- that the present case plainly justifies a different approach since the CMA's fine in effect penalises Flynn for the delay caused by the CMA's unlawful original decision and the CMA's approach in that respect smacks of opportunism.

So, sir, I am happy to say I have beaten my time

estimate. I am of course very happy to answer questions.

PROFESSOR WATERSON: One question. The case you are answering, as I understand it, concerns four different strengths. You have, in a sense, bundled them together in your analysis. Do you want to say anything about the separate strengths?

MS STRATFORD: You have not just got in mind annex 1 that we were looking at where I recognise that there is a weighted average per pack column at the end, and I recognise that in a sense that may not be the most helpful way to look at it, and we do -- I mean, as I have said on a number of occasions through the course of the hearing, we do rely on the fact that the CMA has reached four separate -- in relation to Flynn, four separate infringement decisions and four more in relation to Pfizer.

So we do absolutely rely on that, but I think I am right in saying that all of the points that I have been making yesterday afternoon and today apply, we would say, with equal force to all of the strengths. So that is why I have not, at that point, needed to break it down and go to the individual strengths, but that may not meet the point you had in mind.

PROFESSOR WATERSON: Well, the point I had in mind is that

within that table there is the 100mg and 300mg which essentially fit within your framework, but then the 25 and the 50mg are quite far away.

MS STRATFORD: I am sorry, sir, but you mean the percentages?

PROFESSOR WATERSON: In that annex that you took us to earlier.

MS STRATFORD: There was evidence, you will recall Mr Williams dealt with this in his evidence about the standard industry practice, I do not know if I am putting it slightly too high, but that it was very normal in the industry that in relation to lower milligram, lower API products, there would be relatively higher prices; is that the point?

PROFESSOR WATERSON: Yes, that is the point.

MS STRATFORD: Yes. Mr Pascoe makes the helpful point that if one is thinking about where to fit that into the analysis, perhaps at least one convenient place it comes in is when you are thinking about fairness and if one takes account of that evidence, I think I am right in saying uncontested evidence, then it can explain why there is a slight disparity if you are looking at it on a strictly quantitative basis in relation to the lower strength capsule products.

PROFESSOR WATERSON: Thank you.

MS STRATFORD: I hope that has dealt with it sufficiently. Of course I did in cross-examination put the individual strength points to Mr Harman and explored that with him, but I think that is all I need to say on it for now.

THE PRESIDENT: Well, thank you very much, Ms Stratford. We are very much obliged to you. We have no further questions.

MS STRATFORD: Thank you.

THE PRESIDENT: Mr Holmes.

Closing submissions by MR HOLMES

MR HOLMES: Good afternoon, sir, members of the Tribunal.

You have already heard and read a great deal. You now have lengthy written closings and I am not going to try, you will be very pleased to hear, to cover every point.

I am happy to address anything that you would find helpful, so if there are points that I do not cover that you would want to hear me on, I am sure that you will raise them in questions.

My proposal is to proceed in the following way. I would like to start with the framework, the two-limb test for unfair pricing and the *Hydrocortisone* schema; second, to consider the application of the framework to this case. Is this case 3 or case 2? If so, how does that affect the analysis, and how, we say, the two-limb

test is clearly met in this case, and then finally, I will deal with the appellants' comparators and value benchmarks, the tablet DT and ASPs, Flynn's margin comparators, and the various arguments on patient benefit, avoided cost to the NHS and QALY.

My submissions will deal with the topic of liability and on penalty I shall hand over to Mr Bailey who has particular expertise to address those questions as the Tribunal is aware from previous cases.

Now, on the framework, you have seen our answers to the questions in the Tribunal's guide for closings. In overview, our position is, as we see it, very simple, and it can be quickly summarised in four broad propositions.

First, the overall test is whether the price is unfair, and an unfair price is one which allows the dominant firm to earn profits that would not have been achieved under conditions of normal and sufficiently effective competition.

Normal and sufficiently effective competition means, in particular, the absence of dominance. You could therefore restate the overall question as being whether the firm is using its dominance to impose prices and extract profits which would not be possible in a competitive market.

Second, the two-limb *United Brands* test is an appropriate way to structure the assessment of whether a price is unfair. It is not the only way of proceeding, but it is a well-established and legitimate approach, particularly for tangible products. Intangibles, data, audio-visual content and the like, are trickier, but fortunately we do not need to worry about those in this case.

At the first limb, the focus is on the relationship between cost and price, and the limb is met if prices are clearly and persistently excessive. Your suggested formulation of demonstrably immoderate we think captures the point well, and we are very happy with it, provided, of course -- and I do not think you were suggesting otherwise -- the temporal dimension is attended to, the need for clear and persistent excesses, and at the second limb, if the price is shown to be excessive, one then turns to consider if the price may nonetheless be viewed as fair, and fairness is a contextual matter: you can look at the circumstances of the pricing. What is the economic and commercial context of the pricing? Why were the prices fixed at the level they were? How did customers react? What were the effects? And that is as we see it the unfair in itself limb of the equation.

At the fairness stage, it is also appropriate to

consider any suitable comparators, but given the overall focus of the test, which is to see whether the returns are those that would not have been available under normal and sufficiently effective competition, one obviously needs to be careful to attend to whether the comparators reflect competition otherwise, there is an obvious risk of boot-strapping: a dominant firm justifying exploitative pricing in one market by reference to the exploitative pricing of another dominant firm in a different market.

Third, as part of the assessment, it is necessary to take account of the economic value of the product to see whether that could justify the price, and this is not a separate third limb of the assessment, it is something that needs to be factored in somewhere when applying the two-limb test.

Care is needed, however, with the meaning of economic value. It cannot mean, sir, as you canvassed in questioning yesterday, any price that a customer is actually willing to pay, otherwise there could never be unfair pricing. Where a product is essential for some of its users, the price could in that case be very high indeed, and that is so in this context whether one considers matters from the point of view of the user, the person taking the tablet, or whether one considers

the financial aspect and the analysis of the NHS as the payor.

Instead, an appropriate proxy is the price that customers would be prepared to pay for the product under conditions of normal and sufficiently effective competition.

Fourth, as we see it, the *Hydrocortisone* schema is a helpful gloss on the two-stage limb test, but in particular on the fairness limb. It identifies features of the economic context that may suggest that the price is fair or, indeed, that it is unfair. In case 1, it identifies a scenario of pricing involving superior efficiency that should properly be viewed as fair, notwithstanding the differential between price and cost. In case 2, it identifies some relatively diverse scenarios in which prices may be viewed as fair even when prices are materially above cost.

In particular, and as we see it, the core paradigm examples: generation of value through product differentiation in circumstances where consumers or customers are able to exercise a choice; situations of patent protection and temporary imbalances of supply and demand which can be expected to self-correct within a reasonable timeframe, and that is the face mask scenario.

Now, whether prices in those scenarios in fact are fair requires a deeper dive. One needs to examine closely the economic context. Situations in reality fall on a spectrum: they defy ready classification into three neat boxes, and this was a point that the Tribunal in *Hydrocortisone* was alive to.

In the distinctive value scenario, one needs to look, for example, at whether there is really any value-generative activity or, instead, whether the differentiating factor relied on is some purely external circumstance which in fact protects the dominant firm from competition, or, in the face mask example, one needs to see whether the distortion is indeed temporary or whether barriers to entry preclude a competitive response within a reasonable timeframe.

It would therefore be wrong, as we understand the schema, to think that one can first pigeon-hole a case and then apply a significantly different test depending on which basket it falls in. One needs to consider what the evidence shows about the context and the conduct and any competitive comparators and to consider all of that together. The evidence may show that the gap is too large to be justified by any economic value that can realistically be identified.

To put the point another way, the *Hydro* schema is

a directional factor and an important one at that, which can lend clarity and certainty to this framework, but it is a directional factor in relation to the application of what is by nature a multi-factorial test, and this a point which I shall develop in order to see whether we are ad idem about that.

THE PRESIDENT: Yes, I mean, on that point, what you say about a multi-factorial test is, looking at what is said about case 2 in *Hydrocortisone*, right. I think, but this is where the dialogue matters, case 3 is a simpler instance in that what you have in case 3 is a situation of no legitimate basis for pricing it above cost plus a reasonable rate of return.

Now, one has an extremely difficult question about what a reasonable rate of return is which is nothing to do with the differentiation between case 2 or case 3, but on case 3, that is all you get, because you have no justification to price higher than that because there is no product differentiation. Case 2 is harder because certainly *Hydrocortisone* says in terms that even if you sit in case 2, that does not justify any price. What it justifies is a price above that in case 3, but what level it sits at is, as you say, multi-factorial.

MR HOLMES: Yes, that is extremely helpful. So if I apprehend rightly the point you are making is that

really case 3 is conclusory: it is the result you arrive at once you have tested to see whether this is an example which falls under case 1 where really it is very hard to see why the price would ever be unfair, or whether it falls into case 2, and that is very helpful and it matches, I think, our perception and understanding of *Hydrocortisone*.

The critical force of *Hydrocortisone*, its usefulness as a mode of analysis therefore lies in particular in the instances or examples under case 2 which help in identifying what are likely to be problematic cases on that approach.

THE PRESIDENT: Yes, I mean, one needs to be careful about any schema and certainly we would not want *Hydrocortisone* to be read as if it were a statute. I mean, case 1, for example, might conceivably subsist alongside case 2 or case 3 but has not arisen here, and is difficult to imagine arising in a situation where one is talking about a dominant undertaking --

MR HOLMES: Yes.

THE PRESIDENT: -- because almost by definition you have got an absence of a range of competitors, where you have got that range of inefficiency which enables the efficient competitor to generate a consumer surplus. So what cases 1, 2 and 3 are, I think trying to do, is explain

the point at which the perfect competition analysis ceases to be of assistance. Perfect competition assists in the sense that one can understand using those assumptions why it is that in perfect competition, all prices trend to cost plus a proper rate of return and there is no exception to that because you either match the most efficient firm or you leave the market, and that is that, but the problem with perfect competition is you do not get the differentiated products and the differentiated nature of the suppliers of those products which one gets in the real world, and so one gets an additional rate of return not explained by perfect competition which is the three cases arising out of the analysis in *Hydrocortisone*.

MR HOLMES: Yes. Well, sir, that has been, from my perspective anyway an extremely helpful exchange, and I will return to this question of the extent to which markets might depart from a perfectly competitive model, and just to anticipate my submission, there are, in my submission, some markets, commodity product markets that more closely resemble a framework related to perfect competition in which one would expect a closer relationship between price and cost and where one would expect competition to focus very much upon price, and there are other markets of a kind identified under

case 2, differentiated product markets, where there are other dimensions of competition in play that take one far away from that, and again, to anticipate my submission, generic pharmaceutical product markets are, we say, much more likely under conditions of effective competition to resemble a commodity market than they are to resemble a differentiated product market, and I will return to that and address you on continuity of supply if I may in due course.

THE PRESIDENT: No, that will be helpful. Continuity of supply is clearly something we would be greatly assisted on both in terms of its location between case 2 and case 3 and, assuming it is in case 2, what value actually needs to be attributed to it in the sense of how great a bump up or how less of a bump down, depending on which end you start from, it entails.

MR HOLMES: Yes.

THE PRESIDENT: But we, I think, do accept that the nature of the market is obviously intrinsic in terms of how close price is to a perfectly competitive world. If you are talking about, say, an exchange where you have a purely fungible product and clear information as to price, then you are going to have a very competitive market. I do not know if you can say that the price tracks cost, I think that would be very hard to say in

a market for shares, for instance, but nevertheless, you have a listed product which is exactly the same as what everyone else is selling, and it clears at that price, whereas at the other extreme, the housing market is something where you have a whole series of difficulties in terms of equating the price of one product to another because the properties are all unique, they come on to the market at different times, you cannot choose in that sort of way as you can between different sellers of the same share.

MR HOLMES: Yes, yes. I will, if I may, return to that.

First, there is a submission that I would like to make in justification of the framework in terms of its economic logic and in terms of legal certainty given some of the submissions that are made and have been made and the interest that the Tribunal expressed in the extent to which, in relation to unfair pricing, the framework provided sufficient clarity prospectively for firms ordering their conduct in the market. We say that the framework does make sense in economic terms and that it also achieves legal certainty. It lends itself to prospective application. So starting with the first limb of the two-limb test, in economic terms, the relationship between price and cost is on any view a relevant reference point to consider. I do not think

anyone has suggested otherwise.

There are of course a variety of pricing models in competitive markets and the prices which result may vary widely in the degree to which they reflect cost, but it is equally clear that where a firm's prices are consistently and persistently detached from cost, that may suggest a lack of competition.

On inspection, one may find that competition is lively across other dimensions, that is the differentiated consumer product situation, but in relation to a commodity product with low levels of innovation, very significant profits are, we say, a mark of competitive dysfunction, so it makes good sense to begin by minding the gap.

As regards considerations of legal certainty, price and cost are an eminently suitable benchmark. A firm will have information available to it about its prices and its costs. Direct costs should be relatively straightforward, common costs require allocation, but we say that that is not beyond the wit of a dominant undertaking.

The CMA for its part adopted a conservative approach and ran a number of sensitivities using different methods of allocation. The case law is clear on the need to avoid methods which introduce circularity by

concentrating a firm's common costs overwhelmingly on one very profitable product. That is by using a revenue driver to allocate the costs.

Looking at direct and indirect costs will already give a good sense of the scale of the return. In many firms also information will be available for assessing their rate of return. One of Flynn's themes is to suggest that WACC is not used in the pharmaceutical industry based on the particular experience of Mr Williams and his clients.

Be that as it may, it is certainly not the case that businesses generally, or in the pharmaceutical sector, do not use WACC in the ordinary course of their business. That much is clear from the information provided by Pfizer to the CMA during the investigation.

If we could go, please, to {XG/350/1}, you see from the heading that this is Pfizer's response to a request for information on reasonable return. The date of the document is 28 October 2014, and question 1 asks Pfizer to set out what it considers to be an appropriate pre-tax nominal weighted average cost of capital for the UK subsidiary or the group if different, and you see from the response in the non-bold text in the middle of the page that:

"The WACC for Pfizer Limited ... is calculated in

the ordinary course of business, and is as follows ..."

8.7% for the year to 2012 and 9.3% for the year to 2013.

THE PRESIDENT: Right, so we have now moved on from cost in the hard edged sense to the return on what is sold.

MR HOLMES: That's right, sir, and my submission is that in many cases, firms will have available to them business metrics to situate their expected returns for a given product at a given price. They will have a comparison based on their own experience.

Mr Brealey seemed to suggest that this metric is a product of regulation during his submissions yesterday. We do not ourselves understand that submission. It is clearly stated as an ordinary course of business measure across the Pfizer business.

As regards the second limb, the unfair in itself exercise is likewise, we say, an economically grounded exercise. It seeks to identify the factors which underlie the price increase. Is the increase simply an exploitation of market power, or are there other pro-competitive explanations? We say that approach is also consistent with legal certainty. A dominant firm will know how it is setting its own prices. It will know why they are being set at the level they are. It will know the circumstances which led it to apply

a particular pricing strategy. It will know how its customers respond to the price increases and how it chooses to deal with any objections. It will know the economic context in which it operates. Is it a differentiated product market where firms compete to differentiate across dimensions of quality, innovation or brand, or is it more of a commodity product in which such competition as there is or could be will take place in relation to price? It will know what competitive response to expect in relation to a price increase. Will it lose more in volumes than it gains in margins when it increases prices, or are there barriers to entry which make it confident that the price increase will prove profitable?

It may very well also know how its prices compare with those in other geographical markets, particularly if it supplies those markets as well.

So a focus on the circumstances surrounding the pricing factors in considerations that will be in the dominant firm's own knowledge and understanding.

THE PRESIDENT: So if I could repackage what you are saying: price is not a mechanistic thing; it is a key entrepreneurial decision which will involve the entrepreneur in working out precisely what is the profit-maximising rate given the market in which the

entrepreneur sits, and so you have as a key element in price not just cost but also demand, and where the demand exceeds the supply of the product then, as in the face mask example, you would expect prices to rise in order to attract more people into the market, so the prices can then fall.

MR HOLMES: Yes.

THE PRESIDENT: That may be over the long term or it may be over the short term, and in the very short term no doubt Uber surge-pricing is an excellent example where drivers are tempted into a half-hour slot to deliver a service because lots of people want to have transport because it happens to be raining or whatever, and there you have no change in the cost base but a significant change in demand justifying the higher price, but it is all context-sensitive.

MR HOLMES: Yes, I agree entirely with all of that, sir, and it neatly encapsulates my submission.

The further dimension that I might emphasise is that as well as demand, a firm will know about the competitive response which it is likely to face. It will know whether there are other competitors in the market and it will know whether it needs to take them into account in deciding whether a price increase will stick.

So in concrete terms, when assessing a particular price increase, whether that is lawful or unlawful, a dominant firm will know, will have a good idea whether it anticipates a competitive response or whether it is calculating that there will be no competitive response because of barriers to entry in the market, and where that is the case, where it is relying upon factors which confer market power, a dominant firm needs to be on its guard.

Of course, in this case, we have a rich, contemporaneous documentary record which one could easily lose sight of amid all of the detail in this case, the wall-to-wall experts, the hard-fought process of contestation on appeal. It shows that the firms at issue here, whose pricing is being investigated, precisely analysed the extent to which, before implementing the price increase, they could make it stick having regard to the likely responses that they would face, and they identified a range of barriers to entry which gave them confidence that the price increase would not be eroded through competition.

They did anticipate one competitive response, you will recall, and that was parallel imports, but you will recall the kind of crude critical loss analysis which they undertook on that point. What they said was: even

if we lost 50% of the market we are still going to make a killing. We are still going to make a very large amount of money, and, as matters turned out, they lost much less than that to parallel trade. They correctly anticipated that there would be limited competitive response from other products in the same treatment space. That is all in the contemporaneous documents. We can give you the references, they will anyway be apparent from my submissions, I hope, in opening the case.

THE PRESIDENT: I think we have the documents well in mind. It is more whether they direct uniformly against Flynn and Pfizer or whether there is a difference to be drawn between Pfizer and Flynn in this regard, and it really does go to the question of input costs into Pfizer and the significance of the fact that, so far as those costs were concerned, can it be said, as I am quite sure Ms Stratford would say, that Flynn is a price-taker for what it pays to Pfizer for the capsules, and, to that extent, it has to price according to what is its costs base.

MR HOLMES: Yes.

THE PRESIDENT: In other words, looking at the point in time which you are focusing on when the deal is done between Pfizer and Flynn that Flynn will enter the supply chain

as the exclusive distributor and receive the marketing authorisation, at that point in time you can say, I suspect, that Pfizer is changing the way in which it is selling the product and thereby increasing its margins, but can the same actually be said of Flynn because they are not in the market, they come into the market, but at a certain price.

MR HOLMES: Well, sir, that is a very helpful observation. It may very well be that Ms Stratford would seek to make the submission that you describe that you characterised Flynn as a price-taker, but in my submission, that is an unreal position to take if you look at the actual circumstances in which this arrangement came to fruition, came into existence.

I showed you the presentation by Flynn to Pfizer. I showed you the document in which they said: we will leave the breakdown between us in terms of profits for later negotiation, but this is how our arrangement will work. Flynn is coming in to protect Pfizer against pharmacopolitical damage, it is all about reputation. You recall those really pungent documents. That was why Flynn was coming in.

They negotiated an arrangement between them. They discussed different splits of profit as the Tribunal found the first time around. Now, to the extent that

Pfizer had the whip hand in that negotiation between a monopolist and a potential monopsonist, that is only because of the limited and artificial role which Flynn played in this arrangement. Flynn was being introduced as a stooge, it was a shield against pharmacopolitical damage.

THE PRESIDENT: Well, you may well be right about that, but is that not nonetheless something which was of value to Pfizer that Flynn was delivering? It may not have been of value to the end users, we are not interested in that at the moment, but in terms of the benefit that Pfizer gets, they get the insulation, such as it is, of Flynn doing the selling, but you are coming very close to suggesting that the manner in which one analyses the Pfizer/Flynn relationship is of one of collusion rather than arm's length.

MR HOLMES: No, I do not accept that, sir.

THE PRESIDENT: No.

MR HOLMES: We say that every act needs to be analysed under the competition rules, having regard to the relevant circumstances.

THE PRESIDENT: Yes.

MR HOLMES: We have analysed this by reference to the individual liability of Pfizer and of Flynn.

THE PRESIDENT: Yes.

MR HOLMES: But in assessing arguments that are made by the parties, we do say that it is essential to keep in mind the artificial nature of the arrangement, the intransparent arrangement, to use Flynn's description of it, and I do not think any of the parties have ever prayed in aid the value that Pfizer got from Flynn insulating Pfizer against criticism and complaint by the health service or by the Department of Health. That would be an extraordinary submission, sir.

THE PRESIDENT: Well, it would be extraordinary if it was used to justify the price paid by the Department of Health, that is obviously right, but what we are talking about here is not the end price paid at the end of the supply chain. What we are talking about is the negotiation between the two elements, formerly one, in that supply chain, and what I am putting to you, and I am putting it to you so that you can push back as you are, is that when one looks at the bargain between Pfizer and Flynn and therefore Flynn's input costs, does one not need to say: well, absent a case that this was a non-arm's length transaction, absent a form of collective dominance or collusion which is not articulated in the Decision, you have to ask yourself, well, what is it that each side is bringing to the party.

Now, part of that is a benefit in terms of distribution, that Pfizer was quite easily distributing on its own, so why is it that Pfizer is allowing Flynn to be making the margins it is making on the product? Well, is not the answer what you have just expressed, the reputational question?

MR HOLMES: Yes, it is sir, it is absolutely the answer, and we say it is one that should not be afforded value, but in any event --

THE PRESIDENT: No, not in the question of what price is being paid.

MR HOLMES: Yes.

THE PRESIDENT: I mean, when you are saying: I am getting good value for the phenytoin capsules, looking at it from the aspect of the NHS paying, the idea that Flynn is acting as a kind of, to use your word, stooge for Pfizer, well, that is nothing that they should be paying for, obviously, but that is not the point I am putting to you now. The point I am putting to you now is how one is allocating costs and differentials as between Pfizer and Flynn in circumstances where we have not got a single infringement, nor have we got four infringements, we have eight infringements.

MR HOLMES: I understand the question now, sir, and I can be very clear. We do not suggest that the high input cost

is not to be taken into account. We do say that when evaluating a simple ROS measure, one needs to be extraordinarily careful because of the high input cost which has an obvious and dramatic depressive effect upon the returns that were earned by Flynn, and so one needs to look beyond the ROS percentages and one needs to look at absolute returns bearing in mind the obvious point, which Mr Williams accepted when it was put by the Tribunal, that business people look not only at margins but also at volumes, and margins taken together with volumes gives you absolute returns.

THE PRESIDENT: Yes, you certainly do not need to persuade us about the relevance of those factors.

MR HOLMES: Yes.

THE PRESIDENT: What I think we are or I am pushing back on is the extent to which one can minimise the significance of the price that Flynn is paying to Pfizer for the product it receives, and whilst we understand why you are saying there is a dramatic shift up compared to what Pfizer was charging prior to this arrangement and what it was able to charge post the arrangement, that is something I am suggesting is slightly asymmetric in terms of its evaluation because Flynn is coming in, they are providing something that Pfizer values, it may well be not something that the ultimate consumer values, but

that is not the focus of our enquiry.

MR HOLMES: Yes, so what we do know, of course -- and to be clear, just to situate where I am in my submissions, the submission that I am currently making to you is one which is somewhat detached from the facts of this case.

THE PRESIDENT: No, indeed.

MR HOLMES: It is an argument about legal certainty. It is pointing to the fact that price and cost are matters that are well within a dominant firm's knowledge and that equally the circumstances surrounding a dominant firm's pricing and the extent to which prices result from pro-competitive elements or they result from market power are also things that a dominant firm can and should attend to, and I am also making the point that in the contemporaneous documents we see the parties, Flynn and Pfizer together, discussing the threats of a competitive nature that might arise and ruling them out of account, concluding that they will not in fact in this case result in a loss of the large monopoly rates that they planned to share between them.

We will come on to whether Flynn's returns are demonstrably immoderate, and I will make my submissions about this and you will not be surprised to hear that we say that they very clearly are by a number of metrics. We have been offered a very reductionist account of what

the CMA actually did in the Decision in an attempt to corral the Tribunal down a particular route and I will show you in the Decision just how far we have strayed from the reality of the Decision in some of the submissions that Flynn has been making before you, but what is certainly clear is that they took a generous piece of the pie.

If this is a monopoly/monopsony negotiation, and it is, because the arrangement created market power at the downstream level through the exclusivity of the supply arrangement, it is clear that Pfizer took a big chunk but Flynn also took a big chunk, and that submission does not rest on any allegation of collusion, it rests on the practical reality of how these parties planned and considered the competitive situation that they faced.

So a focus on the circumstances of the pricing factors in, we say, considerations that will be in the dominant firm's own knowledge and understanding, and the Tribunal has seen the internal documents, they show that the appellants were indeed alive to all of the various matters that I have identified.

I will return to that submission, if I may, after the short adjournment.

THE PRESIDENT: Thank you very much, Mr Holmes.

1 We will resume at 2.00. Thank you.
2 (1.02 pm)
3 (The short adjournment)
4 (2.02 pm)
5 THE PRESIDENT: Mr Holmes, good afternoon. Just so that we
6 have the timing clear: we are going to have to rise at
7 4.15 today, but there is no reason we cannot start at
8 10.00 tomorrow if that would assist.
9 MR HOLMES: Let us see how we are going, sir, if we may. At
10 the moment I think I am making reasonable progress.
11 THE PRESIDENT: Oh, I will do my best to disrupt that, then.
12 MR HOLMES: I hope so, sir, I very much encourage the
13 Tribunal to ask questions. In many ways, whether
14 I reach the end of my script or not does not matter so
15 much as whether the Tribunal has had an opportunity to
16 raise its concerns and to canvass them. You have
17 lengthy written submissions and those are really our
18 compendious statement of case. This is just to test and
19 explore those, so I am at your disposal for that.
20 I want to return, if I may, in a moment to legal
21 certainty and the framework, but before I do so, could
22 I briefly return to the questions you raised before the
23 short adjournment.
24 You asked whether Flynn, unlike Pfizer, was
25 a price-taker who came to this arrangement and received

an input price from Pfizer, and whether it could be said to confer value on Pfizer as a result of the contribution it provided insulating Pfizer from pharmacopolitical damage, as the contemporary documents put it the avoidance of Daily Mail journalists camping on Pfizer executives' lawns, by analogy to the *Hydrocortisone* case.

There are three points I would make in this connection if I may. First, we say that Flynn was not in the position of an existing purchaser suffering a price increase. That would be to get it wrong. Pfizer and Flynn planned the price rise together, and they considered where they should pitch the end price.

You can see that from the Flynn slide deck I took you to in opening from July 2010. The version that I showed you is at {XG/70/3}.

So this is Flynn's proposals to Pfizer after their initial discussions, and you can see that Flynn's proposal canvasses possible price points by reference to tablet prices, or possible profits that could be achieved or, sorry, sales values that could be achieved by reference to particular price points, and they recommend that price is pitched at half of the price for phenytoin tabs initially, that is to say £15, so half of the £30 drug tariff. That is the downstream supplier

recommending the overall price that will be got out of this arrangement. In fact, as we know, Flynn ultimately opted for a higher price point at around two-thirds of the tablet's drug tariff price.

Secondly, it is certainly the case that Flynn was included for reputational reasons, and that was something that Pfizer was prepared to give substantial credit for. So, if we turn on within this slide deck to page {XG/70/5}, you see there the "Strategic options":

"Pfizer uses Flynn Pharma as the MA holder to avoid pharmacopolitical damage."

And you see then the second bullet Pfizer enters into exclusive supply, that is how the market power was passed down the chain, and the structure of the deal is then flexible, including the supply price, so they are still going to carve the cake at this point, but it is a matter that they are discussing between them.

Pfizer itself acknowledged that it could have debranded and increased the price itself, and Flynn was aware of this as well. One sees that from the document {XG/97/1}. If we could just enlarge it, you can see that this is a Pfizer executive reporting back on a conversation with Dave Waters at Flynn:

"Regarding the question of why not do it ourselves:

"1. We could, he does not think there are any PPRS

issues."

So in other words, they did not need Flynn to play any role in the supply chain. It is all about reputation, and then the reference to the "Daily Mail hydrocortisone" and:

"... would Pfizer execs want the Daily Mail camped on their doorstep."

So what Flynn was being paid for was to protect against the risk of a Daily Mail campaign of the kind that had occurred in relation to hydrocortisone.

Now, third, we say that this is not demand-side value that should be given weight in a competition law --

MR BREALEY: Sorry, could you just read number 4?

MR HOLMES: Of course:

"He made the point that Pfizer red tape and corporate glue would probably stop us from doing it ourselves in anything like the timescales needed."

So Pfizer got some speed as well in implementing these price increases by bringing in a third party. So we say that this is not demand-side value that should be given weight in a competition law analysis. It is not value that would even exist under conditions of normal and sufficiently effective competition. It only arises from Pfizer's monopoly and its creation of a separate

downstream monopoly for Flynn through an exclusive supply arrangement and how they then divided the cake in relation to a planned price increase. It is value that can only subsist in a case of competitive dysfunction, and we say that that is the opposite of value under conditions of competition.

It was a cost of Pfizer's unfair pricing which it was happy to pay in order to reap the benefits, and for that protection Flynn was handsomely rewarded, and those facts explain the findings of the Tribunal in the first appeal at paragraph 457, which is at {XN1/2/143} which very neatly encapsulates the factual background of the case and its relevance when considering Chapter II:

"Finally, and critically, the evidence consistently showed that the strategy, which was jointly evolved between Pfizer and Flynn, to remove ... capsules from the PPRS and to price them at a much higher level (close to the [DT] of tablets), was based on a clear-sighted view, by both, of the increased profit that would flow to each from that arrangement: indeed that was the admitted purpose. Pfizer and Flynn expressly discussed a percentage split of that benefit, ultimately reaching a commercial solution based on a supply price which provided each with a satisfactory share of the increased profit."

So the cut the cake negotiation.

"They did so, irrespective of the fact that Flynn was left free as a matter of contract law to determine precisely what price ... it actually set. Pricing was an integral part of the strategy radically to improve the profitability of the capsules."

That was considered relevant by the Tribunal last time around.

MR DORAN: Sorry, forgive me, Mr Holmes, could I just ask a question about that last sentence, because the profitability of the capsules, as I had understood it from Mr Poulton's witness statement, reading it the other day from the first trial, was that it had been an issue for a considerable period of time?

MR HOLMES: Yes.

MR DORAN: So presumably you either discontinue, which is what he suggested was being mooted with, no doubt other pharmacopolitical damage, or you do something else, and this was the something else; is that so bad?

MR HOLMES: That is not quite how we see matters, and I am grateful for the question so that I can give you our position.

MR DORAN: That was one of the reasons I want to ask the question.

MR HOLMES: Of course. So the binary choice which

confronted Pfizer was not -- it is true that they were marginally profitable and at times loss-making for certain periods on the prices pre-debranding, taking the phenytoin capsule product on its own. Now, you have my point that of course under the PPRS, because it is a profit cap, the fact that one product is unprofitable or only marginally profitable may not mean that across the portfolio they are reaping profits within the regulatory setting: they launch new products, they can set that price, and they can give themselves credit when doing so for the overall balance under the profit cap. So there is a slight danger in taking a single product in isolation when assessing profitability under the PPRS.

MR DORAN: Is there something else that we should be reading in the first case, or it is just a warning that one should not read too much into what Mr Poulton said?

MR HOLMES: No, this is not a warning that one should not read too much into what Mr Poulton said. I am not --

MR DORAN: No, no, sorry, it was the other point. The other point, that there is more we should read or we should not read too much into what Mr Poulton said.

MR HOLMES: Oh, I see, so one should not -- the point is that Mr Poulton and Pfizer had a choice: they had the option of debranding themselves, they could have done

that and they had the option to choose a price bearing in mind their responsibilities, their special responsibility as a dominant firm in setting their price, and they could have fixed a price that was profitable.

The question for the Tribunal is whether the level of price increases that were achieved in this case, the 24 times multiple at the downstream level, and I think the 16 times multiple at the upstream level, could remotely be justified by reference to any prior marginal profitability of the product, and in my submission, it really and clearly could not, because there is a vast gulf, a chasm between price and cost after these price increases, and indeed, the CMA calculated that within two months of the price increases, any historical losses over the preceding five years would be recouped in their entirety, and you see that from paragraph 6.15.1 of the Decision:

"... owing to the sheer scale of Pfizer's price increases, any potential historical losses on sales of its Capsules were more than recovered within two months of increasing its prices."

That is not contested in these proceedings, that is accepted, it is an undisputed fact.

So the position is a little like the one that the

Tribunal was confronted with in *Liothyronine* where Professor Waterson may recall that one of the arguments that was made was, you know, this product was at risk, it might have left the market, we might have gone away, stopped producing.

The answer, which I remember was canvassed in questioning I believe by Professor Waterson, was: well, did you need to impose this price increase, this level of price increase, in order to put the product on an assured footing, and it is very, very clear in this case that that cannot be a justification for what was done here.

Applying the two-stage test, looking at the excessive limb, and I will explain the metrics on the basis of which I say this, there was a demonstrably immoderate gap between Pfizer's prices and its costs. Looking at the unfairness limb, the factors point to this price being unfair in itself, considered in the economic context of this product, looking at the market power and the consideration of market power in the contemporaneous documents, and we say that that is the basis -- a sound basis on which to find that this pricing was excessive and unfair, notwithstanding the marginal profitability of the product prior to the increases.

I hope that addresses your question.

MR DORAN: You have been very helpful with both the pharmacopolitical damage and the profitability question.

MR HOLMES: I am grateful.

So returning to my structure, I have discussed the first limb and why that is predictable and makes economic sense. I have discussed the second limb in relation to unfair in itself, which is where the economic context comes in, including the factors relevant to the *Hydrocortisone* schema, and we say that the internal documents show the ability of the firms in this case to assess whether their conduct was unfair in itself.

They show that the appellants were very alive to the economic context. They scrutinised carefully the likely outcome of their price rise in mapping out their strategy. They anticipated the hostile reaction of the Department of Health, and they planned a way of dealing with that by interposing Flynn. They carefully examined the circumstances of the market to work out if they could make the price increase stick. In other words, they assessed whether they had market power to sustain their plan. They concluded that substitution to other AEDs was unlikely. They considered that generic entry was unlikely. They were aware of continuity of supply

and the limits that faced on substitution. They knew that Pfizer's products were cheaper elsewhere and assessed the resulting risk from parallel trade. They identified strategies to limit such trade and calculated that they would make more than enough from the price rises to offset any losses of volumes as a result of imports, and these factors are of course all indicators of dominance, of market power, and Pfizer and Flynn's special responsibility was or ought to have been very clear.

So we say the relevant context was well known, the record shows that they analysed all the matters relied on by the CMA in concluding that their conduct was exploitation of market power. Now, that leaves the other part of the second limb, unfair when compared, and I want to assess that both in terms of its economic role and its legal certainty dimension.

We say that it provide a further means of checking whether the price of the product is fair. By this stage of the analysis, one will already have looked at prices and costs and considered the specific economic context of the product. One can then also look to see whether there is any suitably similar product which generates similar results under competitive conditions. If so, that would cast doubt on the conclusion that the high

price for the focal product could simply be attributed to market power, but -- and it is an important but -- one would need to be assured that the comparison was at least sufficiently similar to be useful to decide what weight to afford to it, and also one would need to consider whether the comparator product was not itself insulated from competition, not as a legal rule, sir, to exclude any comparator from the table, but just in order to see -- I think you put it very well, if I may say so -- to see what weight can be reposed upon particular comparators. A comparator considered acontextually is not helpful: one needs to look at it in its context.

Again, we say that this comparison process is consistent with legal certainty. It offers a further opportunity to dominant undertakings to justify their conduct. They can rely on such comparators whether or not they had them in mind at the time of their conduct. In some cases, they will have the information to undertake a comparison themselves.

So, for example, where they supply on another product market that has similar characteristics, or on a neighbouring geographic market with different competitive conditions. They will also be aware of their own competitors on the downstream -- sorry, on the market itself. So, you know, that in itself is a good

indicator that comparators cannot be totally excluded even in situations where there are limits on effective competition.

If you look at *United Brands* where this limb -- this test originated, it was by reference to other competing products of the dominant undertaking's product, but that comparison needs to be treated with caution because of the risk of umbrella pricing which I think was identified by a number of the experts in the hot-tub.

In other cases, comparators may not be transparently visible, and a party may invoke a comparator product, and the competition authority can then fairly evaluate it in accordance with its public law duties, but the bottom line is that this aspect of the test provides another opportunity to justify the price as fair or of good value and for prospective compliance purposes the key ingredients which are in the hands of the dominant undertaking I have already canvassed, the price cost data and the economic circumstances applicable to their own home market, and we say that the framework makes sense, and it can be applied in a way consistent with legal certainty.

Now, it is not of course in the nature of an economic -- sorry, of a formula which gives a precise figure. Law is rarely like a sausage machine that spits

out an answer. Legal principles more generally require a multi-factorial assessment. Take dominance, for example, the assessment of which can be quite involved but is an essential element of compliance analysis for firms in the market, but while this is a multi-factorial analysis, it is nonetheless one in my submission which is structured and predictable.

In the circumstances of this case, we say that there are further factors which are relevant when assessing whether there is a legal certainty concern here. I have discussed the internal documents.

There is also, of course, the customer response, including, within a few weeks, a couple of weeks of the start of the infringement, the letter from a group of CCGs, medics, pharmacists and health service managers, identifying, and I quote "the abuse of virtual monopoly position for purely commercial gains", and referring to "unethical anti-competitive behaviour at the expense of patient care".

Now, we say that this was clearly identifying an exploitative abuse at the very outset of the relevant period. If it was relevant to the buying side of this market, the CCGs, it should also have been to the parties. If nothing else, the correspondence put them clearly on notice, but of course they were already on

notice because they anticipated the pharmacopolitical damage, they knew what reaction these price increases would prompt.

Third, the appellants were under formal investigation by the CMA from May 2013, only eight months into the infringement period, which continued for over three years thereafter, and, fourth, we say the parties were both aware that the Department of Health was unhappy with the prices charged.

I showed you, sir, the minutes of Flynn's board meetings which record that the Department of Health were "unhappy about the pricing of the capsule product". For your note that is at {XG/212/2}. Pfizer knew about Flynn's meeting with the Department of Health on 12 November 2012 and about the fact that the Department was pressing for cost information which Pfizer declined to provide. Flynn, for its part, assured the Department of Health by letter of 16 November 2012 that:

"Flynn (and Pfizer) are fully aware of the Department and Stakeholder concerns in regard to the supply and pricing of this product [in] the UK."

That is {XG/237/6}. And Pfizer and Flynn of course both received the GMMMG letter and many other vociferous complaints from across the NHS. They can have been in no doubt that the Department and the NHS were not happy.

As they had anticipated, the expected pharmacopolitical damage had come to pass and Flynn played its role as a buffer.

So this is not a case where the appellants were in any doubt of the need to scrutinise their conduct anxiously for breach of the competition rules, including the Chapter II prohibition and the rule against unfair pricing. In the face of the investigation, they dug in as they had done when asked for cost information by the Department of Health, and those in overview are, we say, the relevant principles and why they are both economically rational and consistent with legal certainty.

Can I now develop those submissions by reference to three cases and show where you my basic propositions are to be found in the case law. The first is Phenytoin in the Court of Appeal, and the other two are *Hydrocortisone* and *Liothyronine*.

The Tribunal has the point that the present case is one of three unfair pricing cases all involving old off-patent products which were then debranded and subject to substantial price increases, and the CMA found unfair pricing in all three. The Tribunal has considered two of the three, *Hydro* and *Lio*, and has agreed in finding an exploitative abuse.

I make this point not because of nostalgia for earlier victories, as Ms Stratford suggested. It is simply a practical reality that where you have three cases of this kind proceeding in rapid succession before this Tribunal, the Tribunal will of course be alive to the need that the application of the rules is done in a consistent fashion across the three. Each case must of course be decided on its facts, but they do need to be considered in conjunction, and a key question for the Tribunal is whether there is anything qualitatively different about this case which would justify a difference in treatment from the other two.

Starting with Phenytoin in the Court of Appeal, you have seen this now so many times, sir, in this case and in many others, you probably know it by heart, but I still, if I may, will take it to you one further time because it is a helpful vehicle for me to make submissions by, if nothing else.

If we could pick it up, please, in the key passage in Lord Justice Green's judgment at {XN1/5/29}. If we could enlarge the top of the page you see at 97(i) he identifies the basic test, whether the price is unfair, and then the elaboration of that test by reference to whether the dominant undertaking is able to reap trading benefits which it could no have obtained in conditions

of normal and sufficiently effective competition, that is to say workable competition. So that is the authority for my first proposition.

In the context of this appeal, sir, you invited the experts to elaborate on the meaning of normal and sufficiently effective competition and there was actually quite a consensus, I think, which emerged from that process.

If I could add my gloss to that. First of all, for the purposes of the focal product, you rightly, sir, raised the question of whether the normal and sufficiently effective competition could arise in a situation of dominance, and my submission is that for the purposes of the focal product, that is the product in relation to which unfair pricing is alleged, conditions of normal and sufficiently effective competition are clearly intended in contradistinction to the dominance which characterises the focal product market.

That is clear from paragraph 249 of *United Brands* from which this first proposition ultimately derives. If we could go back in this document, please, to page {XN1/5/17}, Lord Justice Green sets out that paragraph. You see there at the top of the page, second paragraph:

"It is advisable ... to ascertain whether the

dominant undertaking has made use of the opportunities arising out of its dominant position in such a way as to reap trading benefits which it would not have reaped if there had been normal and sufficiently effective competition."

So the question is whether the high prices and profits are attributable to exploitation of dominance and, therefore, would not have been obtained in a competitive market where dominance was not in play. That is the basic and the fundamental touchstone.

The point is reflected in the Tribunal's judgment in *Liothyronine*, as Professor Waterson may recall, which is at {XN2/28/47} at paragraph 127, and if we could enlarge the top of the page:

"The *United Brands* test ... does not define what was meant by 'normal and sufficiently effective competition'. It was not suggested by any of the parties of this appeal that [those] words or the words 'workable competition' are terms of art in economics. Read in context, the words 'normal and sufficiently effective competition' denote a counterfactual to conditions of insufficiently effective competition in which an undertaking is able to exploit opportunities arising from its dominant position."

So for the focal product, the enquiry is whether the

high pricing is attributable to the dominant undertaking's market power, and the question is whether such pricing would be possible absent such market power. Now, when considering the position of comparator products to the focal product, there may of course be other sources of competitive dysfunction besides dominance which one also needs to be alive to. The experts agreed, sir, that collective market power achieved through multilateral conduct might be one such example, the collusion example. In our submission, there is also a temporal dimension here: one needs to consider the lingering effects of previous market power, and the distortive effects may, as was found in the *Liothyronine* case, take some time to unwind.

In the period when prices remain contaminated, they do not provide a reliable comparator for the purposes of assessing the prices to be expected under conditions of normal and sufficiently effective competition, and we say that is particularly pertinent when considering the tablet prices during period 3, when we saw that really one is shooting at a moving target as the prices fall, as you leave that stable duopoly and they trend down. By the end of period 3, they are at a much lower level than the benchmarks from which Dr Majumdar was working, and we say that it is precisely here that one needs to

bear in mind the risk of lingering effects as the Tribunal did in *Liothyronine*.

For my second proposition, the appropriateness of the two-limb test, could we go back, please, to paragraph 97 of Lord Justice Green's judgment at {XN1/5/29}. At (iii) you see Lord Justice Green emphasises that:

"There is no single method or 'way' ..."

And that:

"... competition authorities have a margin of manoeuvre ... in deciding [what method] to use and which evidence to rely on."

At (iv), the authority may use:

"... one or more of the alternative economic tests ... available... no rule of law requiring [them] to use more than one test or method in all cases."

And then at (v) one comes to an articulation of the two-limb test as one legitimate approach that is available to a competition authority. So:

"If a Cost-Plus test is applied the competition authority may compare the cost of production with the selling price in order to disclose the profit margin. Then the authority should determine whether the margin is 'excessive'. This can be done by comparing the price charged against a benchmark higher than cost such as

a reasonable rate of return on sales (ROS) or ... some other appropriate benchmark such as return on capital employed (ROCE). When that is performed, and if the price exceeds the selected benchmark, the authority should then compare the price charged against any other factors which might otherwise serve to justify the price charged as fair and not abusive."

So several points to note here. First, Lord Justice Green begins with the excessive limb, and he breaks it down into stages, a comparison of price and cost followed by a consideration of whether the resulting margin is excessive by comparison with an appropriate benchmark for a reasonable rate of return.

Second, ROCE and ROS are both identified as potential benchmarks for the purposes of such comparison that are available to a competition authority, and that is consistent with the earlier reference to margin of manoeuvre identified by his Lordship at point (iii). It is also compatible, we say, with the approach taken to cost plus by the CMA in this case.

Third, his Lordship explains the sequential nature of the excessive and unfair limbs. If the price is excessive, one then turns to consider possible justifications which may nonetheless show the price to be fair, and that is what of course the second limb, the

fairness state, is all about.

He elaborates at (vi), if we could go down, please, on the approach of the unfairness limb:

"In analysing whether the end price is unfair a competition authority may look at a range of relevant factors including, but not limited to, evidence and data relating to the defendant undertaking itself ..."

I think in my submission that should be construed broadly as covering whether the price is fair or unfair in itself having regard to the economic context. It is a very fertile part of the test for applying your *Hydrocortisone* schema.

"... and/or evidence of comparables drawn from competing products and/or any other relevant comparable, or all of these. There is no fixed list of categories of evidence relevant to unfairness."

So the two-limb test, therefore, lays down a clear structure of analysis. First, the relationship between price and costs and where price is excessive, that calls for an explanation. The explanatory enquiry may involve investigating the situation of the dominant firm itself, and it may encompass relevant comparables, and that structured process of reasoning is also helpfully elucidated by the decision of the European Commission in the *Aspen* case. If we could go briefly there, please.

It is at {XN6/7}, and if we could go to page {XN6/7/33}, please.

Now, I should say just initially that this case has to be approached with something of a health warning as I am sure the Tribunal has appreciated. It is only a commitments decision, so it is a short-form decision in circumstances where the dominant firm has accepted its liability, so for that reason, the analysis is limited and high level, but it does provide a guide to the applicable legal principles, and it also sheds light on the linkage between the two-limb test and the *Hydrocortisone* schema as we see it working.

So if we could look, please, at paragraph 163 at the top of the page. So that explains that:

"The Limb 2 unfairness analysis has the purpose of examining whether there may be legitimate reasons underlying the excessive profits identified under Limb 1, in particular reasons not yet reflected in the cost analysis in Limb 1. For instance, the dominant undertaking's excessive profits could reflect, partially or entirely, superior efficiencies regarding the production or the selling of the products. Similarly, a dominant undertaking may have taken risks, made investments, improved a product or innovated in a way that would render high profits, partially or entirely,

a legitimate reward for pro-competitive efforts. It is important to note, however, that even these reasons do not legitimise the charging of a price at any high level. They have, however, to be given due consideration in the assessment of a potential unfairness."

Now, sir, to our eyes anyway this bears a striking concordance or similarity with some of the points that are made in *Hydrocortisone* about the schema, so if you look at the explanations referred to as possible justifications by the European Commission, the first is none other than our case 1 in the *Hydrocortisone* schema, and the second is at all events, or is, or is closely related to case 2. So that is how we say that the two-limb test should operate as illuminated by both of those authorities.

Now, before I move on to my third proposition, I should show you one important aspect of the Court of Appeal's judgment which departed from the reasoning of the Competition Appeal Tribunal in its judgment following the first appeal which is relevant to the issue of cost plus.

So if we could go first to the Tribunal's judgment at {XN1/2/102} and you see that the Tribunal introduces an error -- you see at paragraph 310 the Tribunal

introduces an error which it considered to infect the CMA's analysis at the excessive limb. It says that:

"... the CMA was (a) wrong in law to restrict its Excessive Limb assessment to a Cost Plus approach, and to exclude other methodologies, rather than seeing to establish a benchmark price (or range) that would have pertained in circumstances of normal and sufficiently effective competition using the evidence more widely available ..."

And that it was also:

"... wrong in law to adopt a Cost Plus methodology that produced a result that would have pertained in [conditions] of perfect or ... idealised competition rather than the 'real-world evidence'; and (c) made an error of assessment by relying only on the Cost Plus approach that it selected. In saying that, we are not concluding that the benchmark price, on the right methodology, would not have given rise to a finding of excessiveness; rather we do not consider that the approach actually adopted is a sufficient basis for that finding."

So errors alleged at the excessive limb.

Turning on a page, you see at paragraph 312 what the appellants were contending in the appeal. So the authority should have determined what the actual price

would have been under conditions of -- you see this at the end of the paragraph -- sorry, in the fourth line down:

"... what the actual price would have been under normal competition conditions in the real world."

The Tribunal agrees at paragraph 313 in the third line from the end, if we go down, please. It says:

"There must be a benchmark for the normal competitive price to estimate the excess [upon] the Excessive Limb."

And you see that Advocate General Wahl's opinion is prayed in aid in the *Latvian Copyright* case.

At paragraph 314:

"... *United Brands* does not establish that Cost Plus is, in isolation, a sufficient method for establishing the excess if other methods are available ..."

Then over the page at paragraph 316, the Tribunal indicates that:

"... 'cost-plus' ... will often form part of the methodology ... But it is not sufficient to select it as the sole method when there are other valid methods ... to assist the authority in establishing ... the hypothetical counterfactual of the price [under workable competition]."

Then paragraph 317 at the end of the paragraph:

" ... in our view it is enough for the authority to establish a benchmark price (or range)."

There is then a discussion of Mr Harman's evidence on which Ms Stratford focused her cross-examination of Mr Harman in this appeal, and at page {XN1/2/106} at the top of the page one sees the root of the problem the Tribunal identified with Mr Harman's evidence. Picking it up in the second line, you see that:

"... Mr Harman's ... reasonable rate of return ... was consistent with his instructions ... [which were] within the framework of a Cost Plus approach ... "

The Tribunal did not, however think that was what *United Brands* required. In the final sentence, they identify the problem they see with this analysis:

"... [the] approach does not enable a determination of the appropriate benchmark price against which to assess whether the actual prices at issue are excessive, as the law stands."

Now, we have seen already Lord Justice Green's endorsement of a cost plus approach at the excessive limb at 97(v).

There was a specific ground of appeal concerning the need to identify a benchmark price, and that is addressed, sir, by Lord Justice Green at {XN1/5/37}. If you look at the heading, please, in the lower half of

the page:

"... the existence of a duty on competition authorities to use a hypothetical benchmark price?"

The ground of appeal is then described:

"The second Ground ... concerns the interpretation of paragraph 249 of *United Brands* ... The CMA argues that the Tribunal erred in that it mandated that a competition authority 'should', as part of its analysis, construct a hypothetical benchmark price or range of prices against which to measure the actual prices charged. The Tribunal held [at] 443(1) ... that the CMA should: ... 'consider a range of possible analyses, reflecting market conditions and the extent and quality of the data that can be obtained, to establish a benchmark price, or range, that reflects the price that would pertain under conditions of normal and sufficiently effective competitions'."

So again, the benchmark price.

Elsewhere the Tribunal referred to a hypothetical price and the Tribunal cites the opinion of the Advocate General in *Latvian Copyright*.

At paragraph 119 you see that both the CMA and the European Commission which intervened in support of the CMA argued that there was no basis in law for this requirement which was not to be found in *United Brands*

or later case law, and turning over page you see their argument that, to the extent that Advocate General Wahl suggested otherwise, that was not endorsed by the court.

At paragraph 120, the Court of Appeal agreed with those submissions. It says that the answer lies in paragraph 97, that is the key passage I have already shown you:

"The authority has a margin of manoeuvre or discretion as to how it goes about proving its case, subject always to the appellant jurisdiction of the Tribunal. To the extent therefore that the Tribunal compelled the use of a particular test then in my view it has misconstrued the case law. It is not entirely clear what the Tribunal was referring to when it used the expression 'hypothetical' price. If this was intended to refer to an artificially constructed price, then I agree with the CMA and the Commission. But it might well be that the Tribunal was referring simply to the exercise of calculating a benchmark ROS or ROCE and/or the exercise of looking to external comparators. Nonetheless, given the uncertainty which has arisen in respect of the phrase I consider it necessary to consider what sorts of evidence should be used in the analysis.

"First as to the expression 'hypothetical' nothing

suggests that every case there is a need for the creation of a hypothetical benchmark, in the sense of an artificial construct. Indeed, the thrust of the OECD Paper and the literature it cites suggests that the counterfactuals of greatest practical value are often those drawn from real life, as opposed to some hypothetical model."

His Lordship notes that:

"The case law supports [that] conclusion."

In the final sentence of the paragraph, he notes that:

"Any suggestion by the Advocate General in Latvian Copyright that the use of hypothetical price benchmarking was mandatory is not a proposition that was endorsed by Court [of Justice] which, as already observed, emphasised the flexibility of the margin of manoeuvre of competition authorities."

In paragraph 122 he similarly rejects the proposition that benchmarking must be by reference to price as opposed to costs plus a reasonable rate of return:

"Second, as to whether that benchmark must relate to price, I agree with the CMA and the Commission. I also agree with the submissions of Ms Bacon ... for Flynn (who ultimately did not support the reasoning of the

Tribunal, if the Judgment was to be construed as requiring a hypothetical benchmark price in every case) that in both law and in economics all that is required is that there must be 'a" benchmark or standard against which to measure excess or fairness. The need for a comparator is economically logical since the concepts of fairness, excessiveness and reasonableness are all relative concepts. They must be compared with their counterfactual, eg unfairness, normality or unreasonableness. But case law and literature make clear that there are numerous counterfactuals which might be used, and importantly this includes the costs of the dominant undertaking as well as benchmarks set by reference to ROS or ROCE or some other similar measure. As was pointed out in argument, the overarching description of an abuse in *United Brands* ... is by reference to a comparison with 'trading benefits' realised in conditions of normal and sufficiently effective (ie workable) competition. This necessarily comparative exercise does not exclude a benchmark premised upon the undertaking's own cost base or an assessment of what an appropriate ROS or ROCE would be for that undertaking."

At paragraph 125 the conclusion:

"... by the nature of the abuse ... there needs to

be 'a' benchmark. But, in the first instance at least, the choice of benchmark is for the competition authority to choose and [it] can be based upon the costs of the undertaking being investigated or ... upon comparables ... or indeed any other benchmark ... capable of providing a 'sufficient' indication that the price charged are excessive and unfair..."

To the extent:

"... the Tribunal was mandating the use in all cases of a hypothetical benchmark price which did not include the costs of the undertaking or some other benchmark related to the undertaking, then I respectfully disagree ... I would allow this Ground of Appeal."

For completeness, Chancellor Vos took the same view. If we could turn on, please, to page {XN1/5/69} you see at the foot the page "The Benchmark Issue", in the heading:

"Was the CAT wrong to suggest that a benchmark beyond the cost plus basis adopted by the CMA was necessary ... to determine whether the prices were excessive?"

Then turning over the page at paragraph 248, the Chancellor's conclusion:

" ... as a matter of law, the CAT was wrong to suggest ... that the CMA was required in considering the

excessive limb as a matter of law to seek 'to establish a benchmark price (or range) that would have pertained in [conditions] of normal and sufficiently effective competition using the evidence more widely available'. Such an approach might be appropriate in some cases, but has not been specifically endorsed ... in either *United Brands* or *Latvian Copyright*, and certainly did not automatically vitiate the CMA's methodology ..."

Turning on to page {XN1/5/71} at paragraph 252, a clear conclusion as to the appropriate direction of travel:

"In my judgment, the first step in the analysis for the excessive limb is likely in most cases to be for the competition authority to consider whether the costs of production or the costs actually incurred in relation to the product in question, including of course a reasonable rate of return, can be ascertained. In some cases, that simply cannot be done, and in others, it may provide an inappropriate counterfactual. But, where it can be done, there is no reason, based on the applicable authorities, why the authority should not use that methodology to ascertain an appropriate counterfactual for the excessive limb of the analysis. In other cases, it may be necessary to determine the excessive limb by other methods."

So at the first limb, the standard approach endorsed in strong terms by the Court of Appeal is to undertake a cost plus assessment. The authority has a margin of manoeuvre and may use either a ROS or a ROCE benchmark or another appropriate benchmark. It has been a repeated refrain of Flynn in this appeal that the CMA has stubbornly erred by sticking to a cost plus analysis despite the tribunal's criticisms in the first CAT judgment. They have gone so far as to describe this as borderline abusive. They have criticised Mr Harman's expert analysis in strong terms by reference to the tribunal's first judgment, but, in my submission, Flynn's criticisms ignore the inconvenient truth that on this point the Tribunal was reversed. The Court of Appeal endorsed the use of cost plus at the excessive limb as the first step in most cases. They rejected any suggestion of the need to formulate a hypothetical competitive price at either limb. They identified ROS and ROCE as appropriate comparators to be adopted according to the circumstances, and bearing in mind the obvious margin of manoeuvre for an authority in determining a reasonable rate of return, and we say against that backdrop Flynn's critique of the CMA's cost plus assessment is, with respect, not well founded. The CMA approached matters in accordance with authority and

there has been no error of law in adopting it.

THE PRESIDENT: Well, is the problem perhaps a little more in the detail in which one articulates a ROCE test? One of the things which struck us with Mr Harman was how one has a costs stack which is granular in the sense that it relates to the specific infringing products, and one has the problem, a recognised one, of how one attributes common costs to particular products, and you have addressed that this morning and we understand the problem is, with respect, a common one.

MR HOLMES: Yes.

THE PRESIDENT: What we then got with Mr Harman was a return which was based not on that costs stack but one which then moved away from it to the generalities of the firm in question. In other words, one was looking at the return for the entirety of the undertaking which was then itself allocated as a return to the product, which seemed a rather convoluted way of going about the process. Why does one not just ask: we worked out what this particular allegedly infringing product costs, what is the appropriate return for that particular product? Why does one need to divorce oneself from the examination of the costs stack that has been so laboriously evolved?

MR HOLMES: Yes.

THE PRESIDENT: It is not unconnected with the point which arose in opening where we are saying, well, where is the line in your schedule for return, and you said we can easily insert it, and I am not sure that is right. I think we have a costs stack which is agreed and subject to questions about allocation according to revenue rather than other factors we have essentially got the figures, but the one thing we do not have agreed, and is not in the schedule, is the return on capital because it has been assessed in radically different ways by all of the experts.

MR HOLMES: Yes, so one is moving beyond the uncontentious to the contentious, I fully appreciate that. I am not suggesting for one moment that there are not points about the application of the test which are controversial and those controversies are ones that of course remain open and up for grabs before this Tribunal.

But at times Flynn appears to go further and to suggest that the whole cost plus method, and Pfizer as well, that the whole cost plus methodology is by its very nature a flawed or inappropriate exercise, and that really cannot be sustained in face of the authorities.

THE PRESIDENT: I think, though, there is a danger in being confused by which stage of the analysis that is being

addressed. I mean, if we take Mr Brealey and his submissions, he went to town with what was said in *Attheraces*, for example.

MR HOLMES: Yes.

THE PRESIDENT: But he was addressing the unfair limb, whereas you are addressing the excessive limb.

MR HOLMES: Sir, he also of course made submissions -- he took to you a particular ground of his notice of appeal --

THE PRESIDENT: I am not saying it is hermetically sealed, but what I am saying is that there is obviously a difference between the question of what is excessive and what is unfair, they are different questions for parsing the same phenomenon, namely the gap between the cost and the price. So all that I understand. The point I am asking about is when we see in the Court of Appeal, for instance, in *Pfizer*, reference to ROCE, do they have in mind precisely the exercise carried out by Mr Harman or do they have in mind a return on costs incurred however they may have been calculated? I mean, to what extent is there a precision to the meaning of ROCE that is effectively being laid down as a rule of law as to how one should do these things?

MR HOLMES: Sir, I certainly do not suggest that there is

a precision to be found in the Court of Appeal on the application of the ROCE test. That would be a surprising thing to find there.

THE PRESIDENT: I agree.

MR HOLMES: What Lord Justice Green certainly did do was, as you will recall, because I think the Tribunal had the benefit of the same literature, he read very widely in preparing this judgment. He obtained a great deal of economic literature, and we will see that in the context of ROCE and ROS he specifically refers to that wider reading, and I think ROCE is a more specific exercise than simply determining, if you like, a reasonable rate of return by any method. It is cited in contradistinction to ROS, and in my submission, his Lordship did have in mind a specific methodology in broad terms described in the literature.

THE PRESIDENT: I absolutely can see a difference between a measure that is focused on sales and a measure that is focused on costs, they are opposite ends of the telescope, I quite get that.

I think where I am more in need of assistance is in the confusion that seems to emerge quite quickly when one starts talking about capital, and I think we got that in Mr Harman's evidence in that we start by capital in the sense of facts of production and we move

ineluctably and without the join being very clearly identified into capital as in what is lent to make the business work, and that move from one form of capital to another is, I think, something which is not very clearly articulated in the factual material, by which I include the expert material, that we have had to date. It does seem to me that we have a need to break down the stages of the analysis when one is talking about ROCE because one suddenly moves from, as I say, the capital in the sense of that which is used to turn factors of production into products sold versus capital in the sense of that which is injected to enable the business to run.

MR HOLMES: Sir, let me take that in two stages.

The first stage concerns your specific earlier enquiry about whether there was a shift, if you like, from considering the costs stack which was specific to a particular product to then applying a return on capital rate, a weighted average cost of capital that was not specific to a particular product line.

In my submission, that is an essential aspect of the exercise. One cannot look at return in a way that is focused exclusively on the product line. One is looking here for an external measure against which to compare the returns that were achieved in relation to the

product line, and an obvious place to look, where such a figure can be obtained, is the levels of return expected by investors in a particular business or across a particular sector.

In my submission, there is no confusion or difficulty with that move from the costs and capital resources used in relation to an individual product line and the testing, the returns, by reference to an average cost of capital across a business, or indeed across a particular type of business. So that is the first submission, if I may. It is a point I will return to later, but I am just unpacking it now.

The second point, sir, was your subsequent question which I will just need to remind myself of.

THE PRESIDENT: Which is the ambiguity in capital.

MR HOLMES: Yes, sir. I would hazard a suggestion here, sir, and it is again one perhaps we can return to later when I come to this aspect of the grounds of appeal, but capital are a set of resources that are used in the production of a given product, and they can be funded either by equity or by debt. So the resources themselves are indeed assets that are used, involved, in a particular line of production, a particular process of production, an economic activity, and those are funded in part by debt and they are funded in part by assets

that are in the ownership of the business, equity.

One needs to factor in the costs attaching to each of those methods of funding to ensure that those different investors in the capital assets used to produce a given product are remunerated at a level which covers their expected returns. If that were not done, if that were not taken into account by a competition authority, there is a risk, particularly in relation to very risky lines of activity, that one would ignore the levels of return that are expected by investors to go into business at all.

THE PRESIDENT: Well, I entirely get the importance of assessing risk, that is obviously right, but does it have to be as complicated as all that? I mean, let us say we have isolated the costs of the sale, let us talk about a single unit, though I appreciate volume is important and we have that well in mind, but let us take a single unit which costs £100 to make. You have isolated the direct costs, you have isolated the common costs, and that is the cost that it takes, and it is being sold for £200, so quite a chunky margin, one would think, and we want to get a sense of what is the -- is it excessive? That is what we want to test. We want to have something which is predictable.

So are there not two factors in working out whether

the gap is excessive or not? One is the time value for money and the other is risk. So why do you not just say -- we did put this to Mr Harman -- okay, £100 is what is required to produce the widget. If I have to borrow £100, what is the time value for money, ignoring risk, that is involved, and let us say it is 5%, maybe it is more, maybe it is less, but 5% is what economists would agree is in a risk-free environment simply the value of lending money. And then you say, well, what is the risk of getting the £200 price that you hoped to charge, and maybe it is a hugely speculative venture such that the chances of failure, of getting nothing, are extraordinarily high, in which case the loading becomes greater because you might actually lose the £100.

If, on the other hand, the £200 is a sure thing, then you might say, well, it is 5% for the time value of money, and maybe another 10% for the riskiness, and so a return of £15 in this instance is something which takes into account both time value of money and risk, and you can say then: well, do you know, the gap between 115 and 200 seems to me to be excessive.

MR HOLMES: Yes.

THE PRESIDENT: So that is something which, when one is explaining it to the lay man or lay person is nicely

comprehensible, whereas the moment one gets into debt equity ratios and that sort of thing, one loses the person on the Clapham omnibus' interest.

MR HOLMES: I entirely see and understand the Tribunal's desire to break this down into concepts that are readily comprehensible and that make sense outside the rarefied world of expert analysis. That is clearly a sensible way through. The analysis that you are describing, if I have correctly understood the £100, there is a difficulty that I always have, sir, when I hear these examples is trying to tease out -- and I am sure it is my own error -- whether we are talking here about operating costs involved in producing a unit or whether we are talking about capital that needs to be put into producing a unit. The operating costs will of course ordinarily, in most lines of business, be covered from revenues. You very rarely borrow, save in the early stages of a business, to cover your operating costs.

THE PRESIDENT: Of course, this is exactly the confusion that we had with Mr Harman.

MR HOLMES: Yes.

THE PRESIDENT: And what we are computing is the costs, ignoring the revenue that comes in, we are computing the costs of producing that particular item, including, though, the capital items which are involved which then

need to be apportioned and we go back to the machines used to make the coffee in our coffee shop example. So we had that discussion again with Mr Harman where we say: well, if you are buying a coffee machine which has an expected life of many years then you are going to have to somehow allocate that cost to the particular coffee cup that you are making, and we tried to make that all very simple to --

MR HOLMES: Yes.

THE PRESIDENT: But all we are talking about, though, is the costs stack that we have got in this case for the production of the four types of capsule present. So we have worked out what it costs to make it. We are now asking ourselves what return will induce the entrepreneur to actually go about producing the capsule, the cup of coffee, and something needs to be given back in order to make it worthwhile.

MR HOLMES: This is hugely helpful, if I may say so, sir. I think you are quite right to tease this out, so I understand entirely the direction of travel in the question. In my submission, an important element in the businesses' calculations will be how much not only their costs as they go along, but also how much they have had to stake in buying what you described as the factors of production, the coffee machine, for example, and they

will factor that in, together with the riskiness of the venture in deciding a return, and that is true whether they borrow the money on the debt market for the machine or whether this is an implicit cost, because they inherited the machine from grandma or they bought it with their own money. Either way, there is a cost there, an implicit cost, or an explicit cost, which should be factored into the equation, and that is what the ROCE assessment aims to crystallise.

Now, there are a number of ways of stabilising this relationship between price and cost, and it is certainly not my submission -- I will develop this subsequently -- that the only way of skinning a cat is ROCE, and it is certainly not the only way in which the CMA sought to understand the relationship between price and cost for either of these undertakings, so I do want to make that clear, I am not wedded to ROCE as the only show in town by any stretch, but on the example that you give, sir, we think that a relevant dimension for assessing return is not only the operating costs but a different kind of cost which is the cost that you have to invest in advance in the machinery or equipment.

THE PRESIDENT: Well, I do see that. Sorry for interrupting --

MR HOLMES: Not at all.

THE PRESIDENT: -- but there is a point of considerable importance here, because what one must not do in this assessment is load into the return the amount that would encourage someone to enter the market in the first place. In other words, the test needs to be what would induce an entrepreneur already in the market to sell the capsule or the cup of coffee, because if one focuses on what would induce someone to come in, one is immediately in the face mask example of very high prices encouraging new entrants, and one does not want to confuse the situation of scarcity. What you want to articulate is, given that they are already in the market, what will induce the entrepreneur to sell the product and incur, in doing so, the costs.

Now, of course you are right, the way those costs are incurred are in a whole variety of ways, but at the end of the day, the costs are what it takes to make the product in question, which we have in this case rather happily and uncontroversially isolated, so let us bank what we have got.

MR HOLMES: Yes.

THE PRESIDENT: We have a costs stack. All we are talking about is the return, and if one says that the return that will induce the entrepreneur to sell, to spend the £100 in producing the widget, if there are only two

elements in assessing that, time value of money and risk, then why do we not just say so and work out by reference to the totality of the evidence what those elements are worth in either percentage or in absolute terms, and of course there are other factors, volume being one, which will be hugely important, I mean, one might say, if one is producing a single widget, then a margin of £100 over cost is likely to be more defensible, I am not saying it is defensible, but more defensible than in a situation where one has a million widgets with that margin because we look at absolutes as well as percentages, but what I am trying to do is boil down the question to a way that gets us away from finance theory, at least in the first instance so that we can actually articulate what it is that we are talking about when we are talking about the return on what it is one is doing, which is selling a thing that has a certain cost that we know and a certain price that we know and what we are trying to do is work out how much of the gap between the two is defensible.

MR HOLMES: Yes, well, sir, I should say to begin with, building out from the common ground, I fully agree with the need to strip this back to essentials and to consider the underlying data and information before this Tribunal, so I have no difficulty with that and I will

show you some of those data that we say are laying ROCE and the application of ROCE to one side.

Equally, we would strongly endorse the need to take account of all of the relevant evidence, all of the materials that are before the Tribunal, the authority, when assessing. Indeed, for example, in the context of ROS, we think it is really important to have regard to absolute returns here for Flynn in order to get a sense of how much money they are getting in their pocket. So there is a lot of common ground, I think, with what you say.

If I could push back on one point, and it is something I will continue to reflect on subsequently with those behind me and may give you a fuller and more coherent answer subsequently. That is simply the suggestion that one need not worry about the amount needed to bring people into the market. Now, as we had seen matters, it is important to consider ex ante incentives to come into a market and to take account of those incentives when deciding what reasonable rate of return might be, because you want to ensure that you are not identifying a case of excessive and unfair pricing in a way that would chill others from coming into the market ex ante. So it is something that I think one needs to be careful about in factoring in

cost of capital.

THE PRESIDENT: I completely agree. The difference is what would induce the entrepreneur to enter the market not being in it, and what would induce the entrepreneur being in the market to sell -- to incur the costs and to sell. You are absolutely right, those are two rather different measures.

MR HOLMES: Yes.

THE PRESIDENT: But the danger with assessing the return at a level that encouraged someone to come into the market is liable to be significantly higher than the return to someone who is already in the market and who is simply incurring the costs, including of course the capital costs that we have allocated to the product.

MR HOLMES: Yes, that is a very good point.

THE PRESIDENT: We have done that.

MR HOLMES: I understand your point, sir, and I should say that here I am looking at the ex ante incentives of the dominant firm and not of other entrants where you could have, I agree, very high prices justified.

THE PRESIDENT: But what we are trying to compute here is not what the dominant undertaking can charge, we know that, and we are arguing about, you know, how high it is, whether it is too high or not. What we are saying is what can a non-dominant undertaking -- because we are

extracting dominance from the question -- what return will produce enough incentive for a non-dominant entrepreneur to spend the £100 to produce the widget to sell it, and if taking into account -- well, I mean, while you are thinking about this it would be very helpful to know if there are other factors beyond time value of money and risk that we ought to be taking into account, but if you look at -- you know, if I put the money into the bank rather than spend it on the widget, I will get 4%, well, that is obviously something which is the opportunity cost, you are going to have to earn more than that because of the risk. The question is how much more, and, if it is, you know, a sure fine winner, you know, someone could buy my cup of coffee tomorrow and I will make my money, well, the loading for risk ought to be quite small, but if it is a question of no one may want my widget, I may make it and no one shows and I just cannot sell it, well, then not only am I not getting the 4% if I put it in the bank, but I am losing the £100 that I have spent on the widget that nobody wants. I mean, that is the extra loading. If there is more to it than that, then it would be very helpful to know.

MR HOLMES: Well, thank you, sir. This is a conversation that we will no doubt return to during the course of

closing submissions, but I am very glad to have crystallised the point at this stage.

One final point, if I may, in relation to cost plus. I have so far been discussing cost plus at the excessive stage. By "cost plus" I mean the relationship between price and cost judged by a suitable metric, whatever it might be at this point. We say that it is a measure of potential relevance not only at the excessive stage but, depending on the circumstances of the case, it may be highly significant at the fairness stage as well, and that can be seen from the Tribunal's judgment in the *Liothyronine* case. I noted already the similarity of the facts to this case, very old product, debranded and then dramatically increased in price.

There is just one passage that Professor Waterson may recall which is at {XN2/28/123}. At paragraph 348 one sees that one of the grounds of appeal being pursued was that the CMA's cost plus model ignores fundamental policy considerations applicable to, and the nature of, the generics industry, and similar complaints are raised by Pfizer in this case, you remember in the ground that Mr Brealey showed you yesterday.

Now, the Tribunal in *Liothyronine* had no difficulty in rejecting this argument having regard to the nature of generic product markets. In the third line they say:

"We consider that Cost Plus is an appropriate benchmark for determining a competitive price in generic markets, characterised as they are by low levels of innovation."

So in the particular context of generic product markets which are effectively commodity markets, not differentiated product markets, as that concept is typically understood, and have no intellectual property in play, cost plus is a sensible reference point for value. It sheds light on what value would attach even to an essential and life-saving medicine under conditions of normal and sufficiently effective competition, and we say that is the two-stage test and the legitimate place for cost plus within it.

I think similar considerations, sir, informed the tribunal's assessment in the *Hydrocortisone* case.

THE PRESIDENT: Again, that is very helpful, and just to locate you in what I was putting to you, I was only talking about excessive in the conversation we just had.

MR HOLMES: That is extremely helpful.

THE PRESIDENT: But just to assist you further, and please do push back if and when you disagree, when one is talking about case 3, the story begins and ends with cost and cost plus, in other words, you look at the cost, you look at the appropriate return and, if there

is a gap -- giving a margin of appreciation for error -- but if there is a gap between cost plus rate of return and price, then in a case 3 case, that is the end of the story, because there is no legitimate reason to charge more than that because there is no product differentiation and there we are.

One then transfers that over into case 2 and it seems important just for analytical purposes so that you are talking the same language, that one uses the same measure of rate of return in case 2 as in case 3, otherwise you just get hopelessly confused, no other reason than that, but one then has to identify the other factors that justify the filling of the gap to the extent there is one between cost, rate of return on cost and price.

So assuming there is a gap, there are all sorts of factors, the product differentiation factors, which go to the fairness question which one needs to consider further, and of course you are right: if one is selling a generic product as opposed to a bespoke product, if one does not have the trials and errors of the patenting process to use an example that we have used many times already, well, those are all factors that go into those questions of how far the gap between the price and the cost plus the rate of return is eroded or justified, and

I have said nothing about that because unfairness is something we have yet to come to, but that is, I think, as far as I am saying there needs to be a degree of parity between case 2 and case 3 not because they are the same, they are very different, but because we at least need to have a common lingua franca between the two so that we know what we are talking about in each case.

MR HOLMES: So, sir, I broadly agree with that, but I think I would frame it somewhat differently because from our perspective, the test is *United Brands* test of fairness. It is clear from Lord Justice Green's judgment in Phenytoin Court of Appeal that the two-limb approach is a legitimate way of approaching that question. Both of those limbs need to be considered in every case. There is not a case in which one finishes at the excessive limb and you can pack up and go home.

The conclusion that you reach at the fairness limb will be shaped by considerations which are reflected in the *Hydrocortisone* schema, and if considering that schema in all of the circumstances of the case one concludes that there is no justification for the increase, then it is clear that the fairness test will not be met and the excessiveness found at limb 1 will be the conclusive outcome of the case. Does that make --

THE PRESIDENT: Yes, I mean, all you are doing is repackaging case 3. Case 3 is by definition the instance where there is no justification for the higher price.

MR HOLMES: Yes, sir, and in case -- I only do it, sir, to avoid any suggestion that the Tribunal is ignoring a limb of the test or skipping over an aspect of the analysis. On the contrary, it is that the *Hydro* schema fits in at the second limb and informs the consideration of that second limb.

THE PRESIDENT: Well, we are talking about the borderline between case 2 and case 3, and as I think the *Hydrocortisone* judgment says, but I do not have it immediately to hand, but it says the function of competition law is to articulate the distinction between case 2 and case 3. Case 2 is where product differentiation, broadly defined, justifies a price because consumers want to pay it. Case 3 is the instance where, for other reasons, there is an ability to leverage price over a reasonable rate of return for reasons that are not defensible.

Now, of course, when all is said and done we are just trying to work out the order in which we pack things, so I do not disagree with that, but the point about case 3 is that once one has identified that there

is no justification for anything above the reasonable rate of return, which is the definition of case 3, then you do not need to worry about filling the gap between cost, reasonable rate of return and price by anything else because there is by definition nothing else.

MR HOLMES: Yes, sir, I think we are violently agreeing with one another --

THE PRESIDENT: I think we are agreeing.

MR HOLMES: -- that where there is no justification and that is the basis on which a case falls within case 3, then the case will not escape liability through an application of the unfairness test.

THE PRESIDENT: Indeed, no one is saying that the borderline is an easy one, I mean, that obviously is wrong, it is a hard line.

MR HOLMES: Yes.

THE PRESIDENT: But it makes the categorisation case 2, case 3, a very important and nuanced one, and once one has done that categorisation and said: look, there is a basis for charging more because you are legitimately differentiating your product, the really hard question which *Hydrocortisone* does not answer is how do you value that, and it is that which is the very difficult question which this case may raise but which was not raised in *Hydrocortisone*.

MR HOLMES: Yes, no, I have that point well in mind, sir, and to anticipate my submissions, first point: you need to look when you are applying this schema at whether there is really meaningful value on the table. You need to look and see whether the source of the supposed value is actually something which renders the market incontestable and where you are not involved in any generative -- value-generative activity by the dominant firm itself through a process of competition on some other dimension, that is really important, because otherwise you will start conferring value for something which is a happenstance in the market, and thirdly, when assessing what value to afford the touchstone is what value would be achieved under conditions of normal and sufficiently effective competition.

There are two ways of approaching that which are relevant to this case: the first is by considering if one had a situation in which a choice was being made prior to any patient lock-in, if the distinct differentiating value arises through continuity of supply what price would a firm be able to extract. So you have got two competing firms before any lock-in, before a patient is rendered incontestable by being started on a particular product, and there we say the price would very much be reflective of cost.

THE PRESIDENT: Well, I do not say this in any way disrespectfully -- you are mixing a lot of things together in that. I mean, for instance, just to start with what I have highlighted there, you said what is really important is to avoid conferring value for something which is a happenstance in the market. Now, I am not sure that can be right because that would shunt the face mask example from case 2 into case 3.

Now, the face mask example I fully accept is a difficult instance, but it is one where through happenstance, demand for the product -- the face mask in this case -- shoots through the roof. For a period of time those in the market make monopoly rates because they happen to be producing face masks that previously nobody wanted, now they have a massive demand. So, for a certain period of time they make super-normal profits, but provided the market is workably competitive, people come in to fill the supply.

So that is an instance of happenstance, but it is located within case 2, but two further points on that: case 2 does not say anything, or at least not on the basis of *Hydrocortisone*, as to how high the price of the face mask can be legitimately.

MR HOLMES: Yes.

THE PRESIDENT: *Hydrocortisone* says literally nothing about

the level. It says you can go above cost plus, but it does not say anything more than that.

MR HOLMES: Yes.

THE PRESIDENT: What it does say is that if for non-competitive reasons the cost plus line carries on beyond what is defensible by normal competitive means, then that in and of itself will shunt it from case 2 into case 3, but again saying nothing about price level.

So first question we have to ask ourselves -- and I know the CMA's primary position is that continuity of supply does not shunt this case into case 2, it keeps it in case 3, well, fine, that is your primary submission. It is actually the easy case. The case we are interested in is, first of all, why does it not belong in case 2, but much more importantly, if it belongs in case 2, what factors ought we to be looking at to delimit the extent to which continuity of supply is a factor that can legitimately push the price up from cost plus to something else because no one is saying that the price can be an infinite one, I mean, that is obviously wrong.

MR HOLMES: Sir, if I may, firstly, a submission in relation to the face mask example.

As I think the Tribunal recognised in *Hydrocortisone*, this is a difficult case to classify

because it does not have the hallmarks of product differentiation. It identifies distinctive value that arises from shortage or scarcity, and it is undoubtedly a case of market power. It is a situation where somebody acquires market power for a transient period.

Now, from our perspective, the key feature which means that the face mask example might not be a case where a price is deemed unfair is because the price is considered unlikely to be persistently and consistently above the competitive level because the face mask scenario, the high prices, act as a signal to entry and the market is in principle contestable, there is scope for entry within a reasonable timeframe, which brings the prices down, and you specifically identified the possibility that the market may be uncontestable as a reason that would shunt the case out of case 2 and into case 3.

So my first submission here is that continuity of supply is precisely a circumstance of something that renders a market uncontestable and means that you are never going to get that competitive response that would reduce the value, and so for that reason this should be viewed as a case 3 scenario, not as a face mask scenario.

THE PRESIDENT: Well, it is clearly not a face mask example.

MR HOLMES: Yes.

THE PRESIDENT: That is agreed, but --

MR HOLMES: So that is the first point.

THE PRESIDENT: The question is, the fact that it is not a face mask example does not mean it is not a case 2 case.

I mean, the question is given that it is a consequence of medical guidance that continuity of supply matters, we have heard the evidence on that, there may be questions as to how valuable continuity of supply is, but it unquestionably is something of value. What differentiates Pfizer and Flynn is that they are providing to the market a product that is emanating from a particular factory which they are operating, and the question is, first of all, is that continuity of supply which is not something they have created, it is something which they are, yes, taking advantage of, but it is not something they have created, it is something which arises out of the medical position as to how patients should be treated, does that factor cause them to be differentiated from other products in a manner that is legitimate, case 2/case 3? Secondly, if it is case 2, to what extent does that differentiation erode the gap between cost and price? No one is saying that it is a factor that is capable of being stretched to

infinity and beyond, that is not what anyone is saying.

MR HOLMES: Yes, so perhaps I could approach things in this way: in a classic case of product differentiation, products will differ because of innovation, investment, in quality, or branding or idiosyncratic creativity, if you like, your example of the branded T-shirt which captures the mood. These are all ways in which consumers, customers, gain a benefit as a result of the efforts of the dominant firm, and you want to ensure incentives for the dominant firm to engage in those other dimensions of competition, and they will achieve value in markets -- absent these types of consideration will achieve value, and differentials between price and cost in markets which are on any view competitive, not only in markets where there is market power, as a result of a choice being exercised, and it is precisely because you have got other dimensions of competition in play that you need to be very cautious.

Here, with continuity of supply, you have medical guidance which doctors seem to ignore completely, by the by, leaving that to one side, but which influences some pharmacies in the choices that they make --

THE PRESIDENT: Just pausing there because there has been a lot of sniping on the importance of continuity of supply from both sides of the courtroom, and I am not

sure how far we can properly, given the findings that have been made in the previous decision, take those points into account because the markets definition which we are bound by has wrapped up in it the continuity of supply.

MR HOLMES: Sir, I am not suggesting continuity of supply was not influential on competitive conditions in the capsule and the tablet market.

THE PRESIDENT: It has to be, yes.

MR HOLMES: I take that absolutely as read. My point was simply that it operated at the level of pharmacy choices.

THE PRESIDENT: It may very well be an attenuating factor in the sense that it is not as valuable as one might think, that is absolutely fine, we can talk about that, but --

MR HOLMES: We are on the same page there.

THE PRESIDENT: So the problem that we have and that we are debating is to what extent is the happenstance which this case shares with the face mask example eroded or differentiated by the fact that continuity of supply is a permanent attribute, a permanent advantage, in circumstances where the face mask example was impermanent. So one has in this case the happenstance of the face mask example but the inability by virtue of the nature of the continuity of supply factor, the

inability to attract further new entrants into the market, because by definition you cannot have new entrants because we want the supply from this particular factory.

So that is the reason we have been so interested in the patent example because there one has something which is not happenstance, it is an invention that has been patented, so different from face mask, but there is no correlation between the 20-year period you get by way of a monopoly and the amount of money you have to spend to get the patent.

What you get is a mismatch, sometimes maybe there is a correlation, but there is no necessary reason why there should be, you might strike lucky and get an invention that is hugely valuable just like that, very little cost, but you still get a monopoly for 20 years and you still get the ability during that time to charge what you like, and that is why the patent is so important in terms of working out what one can take into account when one is saying: you cannot charge whatever you like, there are limits, and it is the elision of these three cases -- face mask, patent and continuity of supply -- that I think lies at the heart of this case, assuming it is a case 2 case.

MR HOLMES: Yes, so the patent example, sir, is rightly

treated differently because of the need to incentivise innovative activity and competition over innovation. It is about pro-competitive incentive effects which makes enforcement of the competition rules, the rules on exploitative abuse, where an exclusive right happens to coincide with a monopoly market extremely fraught and difficult. You do not want competition law as we put it in our written closing submissions to defeat patent protection by a side wind.

So there is pro-competitive effort, maybe not in the individual case, but across economic activity generally, which is rewarded, and that we entirely agree is an appropriate situation to take into account, but what is already emerging, sir, if I may say so, from this discussion is that there is more heterodoxy, there is more variety, diversity, in these examples under the case 2 rubric than might at first sight appear, and we think that when applying the question of justification and value at the fairness stage, that should not be overlooked. So you cannot pigeon-hole a case into case 2 and then decide on the consequences. You need to look at what it is that puts a case in case 2, having regard to whether there is competitive effort that you are seeking to recognise, as is the case with genuine product differentiation, as is the case with patent

rights, as is the case with the face mask example, absent some circumstance which renders the market incontestable, but we say is not the case with continuity of supply.

THE PRESIDENT: Just pausing there, in terms of heterodoxy of what goes into case 2, absolutely agree: patent bargain, continuity of supply, scarcity, these are all very different factors. The question is whether they are factors that enable you legitimately to differentiate your product, and that is the debate that we are in a sense having, but the second point is that the mere fact that a case is allocated into case 2 -- and I think it may be that there is a mismatch in how we are seeing the significance of an allocation to case 2 -- all that an allocation to case 2 does is widen the range of factors that should be looked at beyond the rate of return that we have been discussing already. It says nothing about the significance of those factors in terms of justifying price. That is what is up for grabs in this hearing.

MR HOLMES: Yes. That is very, very helpful, sir.

THE PRESIDENT: It would, I think, be entirely consistent to say that a factor, whatever it might be, justifies the shifting of a product from case 3 into case 2, but at one and the same time to say that the additional value

is in fact de minimis. I see no inconsistency there.

MR HOLMES: Well, sir, this has been extraordinarily useful, and as so often in these cases the Owl of Minerva flies at dusk.

THE PRESIDENT: It does and I have just been handed a note about a break for the shorthand writer.

MR HOLMES: Indeed, sir. Shall we say 10 minutes?

THE PRESIDENT: We will say 10 minutes. We will have to stop -- it is going to be a very short second half.

MR HOLMES: We still have 20 minutes in play which will be very useful, sir.

THE PRESIDENT: Indeed, but I think I have taken up rather a lot of your time and the offer of a 10 o'clock start is certainly still there.

MR HOLMES: Well, sir, if we end up finishing early, that is to everyone's advantage, but sir, if we could perhaps have that temporal shift --

THE PRESIDENT: We will have a temporal shift.

MR HOLMES: -- that would be useful.

THE PRESIDENT: We will start at 10.00 tomorrow. We will rise for 10 minutes now.

(3.47 pm)

(A short break)

(4.01 pm)

THE PRESIDENT: Mr Holmes.

MR HOLMES: Sir, you have no doubt been continuing the conversation and so have I. There are a few points, if I may, arising out of our earlier discussion, just very briefly to put them on the table.

So, first of all, time value of money and risk. We agree that these are highly relevant factors, and it is a useful way of deconstructing the process of assessing a reasonable rate of return. In this case, we would note of course that there was very limited investment made for the purposes of assessing time value of money, and, as regards risk, you have seen the Tribunal's findings in the first appeal which we say are entirely robust in the light of the evidence you have heard: the guaranteed volumes, the no real competitive threat, the unlimited indemnity in relation to the product enjoyed by Flynn, and the high liability insurance that was in place.

So while this was not a totally risk-free business, it was also not a risky business, and that needs to be assessed when looking at the chasm between price and cost.

THE PRESIDENT: Mr Holmes, I was saying nothing about the facts of this case.

MR HOLMES: No, understood, sir. Well, I was making submissions by reference to this --

THE PRESIDENT: You certainly are and that is entirely fair and understood.

MR HOLMES: Yes, very good.

THE PRESIDENT: But you have not identified, and if overnight anything occurs to you, any factors over and above time value of money and risk that goes in.

MR HOLMES: Sir, not once one takes costs broadly in the way that we apprehend that you are.

THE PRESIDENT: Yes, to include --

MR HOLMES: Well, investments.

THE PRESIDENT: Indeed.

MR HOLMES: Now, so second question, second point concerned your knotty problem of the face mask scenario where there is no change to the product itself, there is just a spike in demand which supply cannot meet.

We see a key differentiating factor from the current situation of continuity of supply there as lying in the fact that that is a happenstance in a well-functioning or potentially well-functioning market. It is a market which will self-correct within reasonable timeframes.

Here this is a market which will not self-correct. The effect of continuity of supply guidance is once a product is selected, any manufacturer's product for a new patient, there is lock-in, and that is the end of competition, it renders the market uncontestable, and we

say that whether that places this case in case 2 or case 3 in the end, sir, we understand where you are coming from. We do think it is relevant when one comes to consider what value to assign at the fairness stage.

THE PRESIDENT: Mr Holmes, I could not agree more, and in a way, this is a very difficult instance because of the patient need, precisely because of that, and let me just unpack that.

The need renders the differentiation clear and so the ability to price high, but at the same time, the need renders the importance of controlling price important because it is not an option that the patient has that they have epilepsy and that they have a line 3 drug that happens in this case to be phenytoin that happens to come from Pfizer. This is something which renders the patient and so the NHS as the protecter or supplier of the patient peculiarly vulnerable. So this is a very interesting factor because it seems in terms of location of price and unreasonableness or unfairness to cut in two directions, and it may be they cancel each other out, who knows, but it is that that is the very difficult question that arises out of a case 2 situation.

If this was a Rolls-Royce where you want to have it because it is nicely branded and I happen to like,

you know, Rolls Royces where you can only hear the clock tick, well, that is great: charge what you like and if I want to pay it then that is that, because there is always, you know, some other car that will do, broadly speaking, what I want.

PROFESSOR WATERSON: The Aston Martin.

THE PRESIDENT: The Aston Martin, Mr Brealey's Aston Martin.

MR HOLMES: Poor Mr Brealey's Aston Martin, no longer with him.

THE PRESIDENT: We have another example, so there is the alternative, but that is not so here, so need versus desire is quite possibly a very important factor in ascertaining what constraints exist in the case 2 case, and that is why we are so interested in case 2, not because this is necessarily a case 2 case, but because case 3 is a damn sight easier.

MR HOLMES: Yes. Well, sir, we respectfully endorse the point that you canvass with me there. We endorse it both as regards the patient and we endorse it as regards the NHS which, because of the patient need, has no choice for strong, powerful, ethical reasons but to continue procuring this particular product. The lock-in captures both. Now, the final point concerns how we go about stabilising value if this is a case 2 situation, and I want to take that head-on, if I may, sir.

I cannot give a complete answer now, I have given one element of the answer, looking at the value which is here at stake, factoring in the essentiality and the lock-in, we do think that is important, but also to anticipate a submission that I will make, we do have another circumstance here which we say is helpful and should give comfort to the Tribunal which is the example of tablets.

In tablets you have the same continuity of supply characteristic, but, for whatever reason, the way that that is played out in the tablet space, perhaps because of the timing of this reinforcement of continuity of supply in the November 2013 MHRA guidance, there was more entry before the constraints resulting from continuity of supply crystallised as powerfully as they did thereafter.

So whereas in capsules all we had was Pfizer/Flynn product and NRIM, in tablets we had seen three players enter the market, and we had seen, before November 2013, a process unroll that does appear to have had more of a competitive edge to it, not, we say, effectively competitive, but nonetheless, more competition, and we say that in that environment of higher competition, despite the imperfections, the manifest imperfections of it, you still arrive, once that unrolls, at a level of

price which is significantly below the price which Flynn at the equivalent level of the market was charging during the relevant period, and we say that is a highly significant factor, and we also say that once this process had really played out and you saw its potential beginning to emerge in the market, you saw prices come down to levels substantially below Pfizer's price at the upstream level, and we say that that serves as a proxy for the value, the demand side value, factoring continuity of supply in under not effective conditions of competition but more effective conditions of competition, and so we do say that if anything, the tablets ASP comparator, now that it has been fully and properly investigated on the remittal does provide this Tribunal with some comfort that a price reflecting the value from this unusual type of differentiation is not at the level of price that was imposed in the less competitive context of Pfizer/Flynn capsules.

THE PRESIDENT: So when you talk about stabilising value, what you mean is determining the price that should be paid; I mean, you are equating value with the price that should be paid in terms of what is a fair price?

MR HOLMES: The price that would be paid under a more competitive scenario.

THE PRESIDENT: Well, yes, I mean that is reframing the

Lord Justice Green test.

MR HOLMES: Yes, indeed, sir.

THE PRESIDENT: Which is saying: extract the dominance and ask yourself what would be the price that would be charged in workable competition. So however you frame it, I think we are in the same ballpark, but what you are saying is that value is the equivalent of the price that would be paid in that competitive regime.

Now, that is a single figure which we are told, entirely rightly by the Court of Appeal, we should not be aiming for. We do not want to be ascertaining a single price. What we are asking is: is the price that was in fact charged excessive?

MR HOLMES: Yes.

THE PRESIDENT: And fairness is the way in which one -- sorry, unfair -- and fairness is the way in which one works out whether it is wrong or right.

MR HOLMES: Yes.

THE PRESIDENT: Now, it seems to me that one ought to be asking not what is the single value but what are the factors that enable an adjustment -- and I am afraid the mezzanine is coming back -- what are the factors that adjust the level of what is a fair or what is a not unfair price within the range that we are talking about, and I want to be very clear, I have not forgotten about

Mr Brealey's attic, the attic is still there, that is at least the consumer surplus that exists above the price that is paid. By definition, the mezzanine cannot go above the ceiling that is the price, but its existence, the consumer surplus above the price line is a reason for pushing the mezzanine closer to or at the ceiling, and what we are doing, I think, is trying to articulate those factors that enable us to locate the mezzanine somewhere between the floor and the ceiling and working out in which direction they go, which is not even in and of itself that straightforward.

So there are a whole list of factors which we put in the guide to inform where one locates the mezzanine in broad terms so that one can, on a, well, broadbrush way say, given all the margin of appreciation, all the burdens being on the CMA, all the fact that this is a quasi-criminal process, one can say: yes, this price does not meet the fairness test by reference to these factors, and that is, I think, what we are trying to do, and it is a question of attributing weight to them, not perhaps value.

MR HOLMES: Sir, you put it extremely well, if I may say so. Once the mezzanine is understood not as a fixed competitive price benchmark but rather as a set of factors which weigh in the assessment of fairness and

seek to stabilise or shed light on whether the price is unfair by reference to relevant benchmarks, then we have no difficulty. What the mezzanine then is nothing more than Lord Justice Green's recognition that there needs to be a benchmark, there needs to be some comparators that are used at the fairness stage --

THE PRESIDENT: Yes.

MR HOLMES: -- and of course we have no difficulty with that.

THE PRESIDENT: One can colour it any manner of ways. It might be we have a gap between cost and price. Can one defensibly fill that gap by reference to legitimate factors? One of those facts is rate of return. Other factors, well, they have to be enumerated in the specific case, and how weighty or how much of the gap they fill, well, that is another way of putting it, but, if you end up with a series of factors that push up or push down the ceiling or the floor but still leave you with an unexplained gap that is material, well, then, you have a price which is both excessive and unfair.

MR HOLMES: Yes. Well, sir, on that concordant note -- I am conscious that the Tribunal has places to go -- shall we draw stamps?

THE PRESIDENT: We will draw stumps. The only point I want to mention, because it relates to what is an unfair

price with greater granularity, is how that connects with the penalty jurisdiction of an intentional or a negligent infringement, because there is obviously some form of nexus not between the infringement itself but with its intentionality, and there I would be interested to know whether one needs a greater specificity about what is the price that should be paid, what is the fair price, than is required for an infringement of Chapter II.

MR HOLMES: Well, sir, as you apprehend, on that point I will gratefully pass the baton to Mr Bailey to assist you.

THE PRESIDENT: He has certainly drawn the short straw there, but we will leave it with that. 10.00 tomorrow morning. Thank you very much.

(4.17 pm)

(The hearing adjourned until 10.00 am on Wednesday, 13 December 2023)