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IN THE COMPETITION APPEAL TRIBUNAL

Case Nos: 1524/1/12/22 and 1525/1/12/22

Salisbury Square House
8 Salisbury Square
London EC4Y 8AP

20 November 2024

Before:

THE HONOURABLE MR JUSTICE MARCUS SMITH
(Chair)
MR EAMONN DORAN
PROFESSOR MICHAEL WATERSON

Sitting as a Tribunal in England and Wales

BETWEEN:

(1) PFIZER INC
(2) PFIZER LIMITED

Appellants

- v -

THE COMPETITION AND MARKETS AUTHORITY

Respondent

AND BETWEEN:

(1) FLYNN PHARMA LIMITED
(2) FLYNN PHARMA (HOLDINGS) LIMITED

Appellants

- v –

THE COMPETITION AND MARKETS AUTHORITY

Respondent

Heard at Salisbury Square House on 6 November 2023 to 13 December 2023

JUDGMENT

APPEARANCES

Mr Mark Brealey, KC, Mr Robert O'Donoghue, KC and Mr Tim Johnston (instructed by Clifford Chance LLP) appeared on behalf of Pfizer

Ms Jemima Stratford, KC, Mr Tom Pascoe and Mr Alastair Richardson (instructed by Macfarlanes LLP) appeared on behalf of Flynn

Mr Josh Holmes, KC, Professor David Bailey, Ms Jennifer MacLeod, Ms Julianne Kerr Morrison and Mr Conor McCarthy appeared on behalf of the Competition & Markets Authority

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A. INTRODUCTION

1. By a decision entitled *Unfair pricing in respect of the supply of phenytoin sodium capsules in the UK* (Case 50908) (the **Decision**[1]), the Competition and Markets Authority (the **CMA**) found that the above-named appellants (respectively, **Pfizer** and **Flynn**, and collectively the **Appellants**) had infringed the Chapter II prohibition of the Competition Act 1998 by abusing their dominant position in two markets (which we will describe in due course) by selling packs of various strengths (or dosages, the terms are interchangeable)[2] of Pfizer-manufactured phenytoin sodium capsules (**Capsules**) at unfairly high prices.

2. The period over which these infringements are found to have occurred (the **Relevant Period**) is 24 September 2012 to 7 December 2016.[3] The Decision finds that both Pfizer and Flynn infringed the Chapter II prohibition by charging excessive prices for Capsules over the course of the Relevant Period. Thus, each of Pfizer and Flynn have been found to have committed four distinct abuses of the Chapter II prohibition, by overcharging for 25mg, 50mg, 100mg and 300mg Capsules.[4]

3. Fines of £63,300,000 and £6,704,422 were respectively imposed on Pfizer and Flynn as a result of the findings in the Decision.[5]

4. The Decision is a lengthy document, comprising a main body of over 450 pages, supported by various Annexes (Annexes A to M), bringing the total page count to 563 pages. The Appellants appeal the Decision on various grounds, which we shall in due course describe.

5. The Decision is a remittal decision, following appeals to the Competition Appeal Tribunal and the Court of Appeal of the CMA's decision of 7 December

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[1] The terms and abbreviations used in this Judgment are listed in **Annex 1** hereto, which identifies the paragraph in the Judgment where the term/abbreviation is first used. The Judgment contains various figures and tables. A list of Figures/Tables is at **Annex 2**.
[2] The strengths of the Capsules were: 25mg, 50mg, 100mg and 300mg.
[3] Decision/[2.1].
[4] Decision/[1.5] to [1.12].
[5] Decision/[9.255].

2016 (the **Phenytoin 1 Decision**), which found that the Appellants had abused their respective dominant positions by imposing unfairly high selling prices for Capsules in the UK during the Relevant Period. Both the Tribunal and the Court of Appeal handed down judgments in respect of the Phenytoin 1 Decision. They are referred to as the ***Phenytoin 1*** **(CAT)/CAT Decision**[6] and the ***Phenytoin 1*** **(CoA)/CoA Decision**.[7]

B. UNCONTROVERSIAL FACTUAL BACKGROUND

(1) Approach

6. This Section sets out some of the uncontroversial facts that are important to an understanding of these appeals. Many facts, as well as the significance of those and other facts, were controverted and controversial between the parties. These controversial aspects are dealt with when we come to consider and resolve the various grounds of appeal brought by the Appellants against the Decision. They are not addressed in this Section.

(2) Phenytoin sodium

7. Phenytoin sodium is an **Anti-Epileptic Drug** or **AED**, available in the United Kingdom in a variety of forms, including as capsules and tablets.[8] It is a prescription drug. The economic cost of the drug is borne not by the patient to whom it is prescribed, but by the National Health Service (**NHS**).[9] The mechanisms by which prescription drugs are paid for and provided to those who need them are important and are considered later in this Judgment. For present purposes it is sufficient to note that the Capsules were not sold in a traditional buyer/seller market, but in an altogether more complex and regulated market structure.

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[6] [2018] CAT 11.
[7] [2020] EWCA Civ 339.
[8] Decision/[1.20]. Greater detail is provided at Decision/[2.3].
[9] Decision/[1.20].

8. Phenytoin sodium is an old drug. It was originally synthesised in 1908 and first commercialised in 1938. It became the first widely available treatment for epilepsy.[10]

9. Phenytoin sodium is no longer a "first-line", or even a "second-line" anti-epileptic drug. It has long been superseded by newer drugs.[11] However, some first-line and second-line anti-epileptic drugs are ineffective, not tolerated by a patient or are only suitable for treating certain types of seizure. In such cases, the prescription of phenytoin sodium may be appropriate.[12] For these reasons, phenytoin sodium is rarely used as a treatment for new patients, and the number of patients taking the product is declining over time.[13]

10. Phenytoin sodium has what is known as a narrow therapeutic index. There is a relatively small difference between the level of the drug that is necessary to achieve therapeutic efficacy and the level which, if exceeded, might result in adverse side effects. Additionally, phenytoin sodium's pharmacokinetics – how the drug moves through the body from its absorption to its eventual breakdown and excretion – are non-linear. These factors make dosage subjective to each patient, and clinical guidance recommends that patients stabilised on a particular manufacturer's phenytoin sodium product should be maintained on that product and should not be switched to another manufacturer's product.[14] This is referred to as **Continuity of Supply**. The reasons for the clinical guidance, which are not straightforward, will be described in due course. Although it was common ground that Continuity of Supply was a factor in the prescription of phenytoin sodium, the significance of that factor in terms of demand elasticity was controversial, and we say nothing more on this point at this stage.

[10] Decision/[1.21].
[11] Decision/[1.21], [2.4].
[12] Decision/[1.21].
[13] Decision/[1.21]. Sometimes these patients are referred to as "legacy patients": Decision/[2.5].
[14] Decision/[1.22], [2.6].

(3) Sale of phenytoin sodium by Pfizer and Flynn

(a) Initial acquisition by Pfizer

11. Phenytoin sodium is produced in tablet and capsule form. Pfizer produces phenytoin sodium capsules in various dosage strengths (which we refer to as "Capsules": see [1] above).

12. The drug was acquired by Pfizer in 2000. At the time of acquisition and until 23 September 2012 it was sold under the brand name **Epanutin**.[15] In 2000, the drug had already been off patent for decades. As a branded drug, its price was regulated in the United Kingdom.[16] As an unbranded drug, its price was not regulated: the thinking behind the relevant rules was that competition between "generic" (i.e. unbranded) products would keep prices competitive and under control.

(b) Arrangements between Pfizer and Flynn in 2012

13. In the course of 2012, Pfizer entered into arrangements with Flynn with regard to the distribution of Capsules in the United Kingdom.[17] These arrangements involved: the transfer of Pfizer's marketing authorisations (**Marketing Authorisations** or **MAs**) for the Capsules to Flynn for a "nominal" consideration;[18] Pfizer supplying Capsules to Flynn on an exclusive basis, instead of to multiple wholesalers and/or pharmacies;[19] and de-branding the product (i.e. no longer using the brand name Epanutin), so that the product was no longer subject to price control.[20] Flynn then commenced sale of the unbranded Capsules to Pfizer's previous customers (i.e. wholesalers and/or

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[15] Decision/[1.23].
[16] Decision/[1.23]. The pre-Pfizer history of the drug is described in Decision/[2.11]*ff*.
[17] The agreements are described in greater detail at Decision/[2.193]*ff*.
[18] Decision/[1.24.1], [2.15]. The consideration was in reality not nominal at all. Whilst the money paid for the MA (viewed in isolation) was indeed nominal, the MA was obtained by Flynn as part of a wider transaction as between Pfizer and Flynn, which enabled both Pfizer and Flynn to make very considerable profits on each Capsule sold. The provision of the MA was necessary to enable Flynn to perform its side of the bargain.
[19] Decision/[1.24.2].
[20] Decision/[1.24.3]. Approval to de-brand was received on 29 August 2012: Decision/[2.15].

pharmacies) under the name **Phenytoin Sodium Flynn Hard Capsules**.[21] Although, these wholesalers/pharmacies did not themselves use the Capsules – patients did – we will refer to these purchasers as the **Pfizer/Flynn Customers**. We will refer to the patients – those suffering from epilepsy, to whom the Capsules were prescribed and who in fact used them – as the **Pfizer/Flynn Patients**. During the Relevant Period, Flynn supplied Capsules in four different strengths: 25mg, 50mg, 100mg and 300mg Capsules, all manufactured by Pfizer.[22] From the time the arrangements between Pfizer and Flynn became effective, the Decision notes that the price of Capsules increased.[23] The CMA found those price increases could not be justified by any change in the nature of the product sold nor in any other way.[24] Although it is controversial – and we will consider that controversy – it is the finding of the Decision that Flynn was interposed into the supply chain for the Capsules without adding any value to the product being sold.[25]

(c) Annex 3: Capsule costs and prices over the Relevant Period

14. **Annex 3** sets out various data regarding Capsule costs and prices. The source of this data will be described in due course. But because prices and costs are fundamental to the Decision and to this Judgment, the data in Annex 3 needs to be described at an early stage. Annex 3 sets out costs and pricing data for all Capsule strengths over the entirety of the Relevant Period (the data for the periods before and after the Relevant Period are not stated) on a month-by-month basis, designated "Month 1", "Month 2", etc. In respect of each Relevant Period Month, the following data is set out under letters *(a)* to *(h)*:

    (1) Product unit cost[26] incurred by Pfizer in respect of each Capsule strength *(a)*.

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[21] Decision/[1.24], [2.16]. It will be noted that there is an element of branding in this name ("Flynn"). This was necessary for Continuity of Supply purposes and did not count as branding so as to bring the product within the scope of the price control that applied to branded products.
[22] Decision/[2.7.1]. The pack sizes are described in Decision/[2.8].
[23] Decision/1/25].
[24] Decision/[1.26].
[25] Decision/[1.26], [1.27], [1.28].
[26] Annex 3 uses a number of cost and price terms that will be specifically defined in this Judgment. For the present, it is sufficient for the general nature of the data in Annex 3 to be described.

(2) The total volumes of Capsules of each strength sold by Pfizer to Flynn *(b)*.

(3) Pfizer's product unit price – the price at which Pfizer sold Capsules to Flynn *(c)* pursuant to the arrangements we have described. From this it follows that this metric *(c)* can equally be described as a cost to Flynn: Pfizer's price is a cost to Flynn. As will be seen, the cost to Flynn of obtaining Capsules from Pfizer was Flynn's main cost in its business of distributing Capsules. Flynn did, however, incur other costs, over-and-above the cost of acquiring Capsules from Pfizer, in distributing them to Pfizer/Flynn Customers.

Pausing there, although this data is not set out in Annex 3, it is straightforward to calculate Pfizer's monthly revenue (product unit price *(c)* multiplied by volumes sold *(b)*) and Pfizer's monthly per Capsule profit ((product unit price *(c)* less product unit cost *(a)* multiplied by volumes sold *(b)*). Moving on to the remaining data in Annex 3:

(4) Flynn's product unit cost in respect of each Capsule strength *(d)*. This cost includes what Flynn paid to Pfizer (i.e. *(c)*), but (as noted) Flynn incurred other costs in addition to what it paid to Pfizer. This accounts for the difference between *(c)* and *(d)*.

(5) The total volumes of Capsules of each strength sold by Flynn to Pfizer to Pfizer/Flynn Customers *(e)*. There is no particular month-by-month correlation between the volumes of Capsules purchased by Flynn from Pfizer and the volumes of Capsules sold by Flynn to Pfizer/Flynn Customers.

(6) Flynn's product unit price *(f)* – the price Flynn sold Capsules to Pfizer/Flynn Customers.

The remaining two metrics are calculated from the metrics already described. Pfizer's profit margin *(g)* is the difference between Pfizer's product unit price *(c)* and Pfizer's product unit cost *(a)*. The difference between *(c)* and *(a)* is an

absolute monetary amount. The profit margin is also expressed as a percentage of product unit cost. Flynn's profit margin has similarly been calculated (at *(h)*).

15. We will consider the manner in which the data in Annex 3 has been compiled, and the implications of this, in due course. For the present, it must be noted that the CMA has elected to compile this data in a static and not a dynamic fashion. The cost of Capsules, and the prices they were sold at, have been captured as a "snapshot" in time (a static measure) and not taking into account the cash flow implications of the sale and purchase of Capsules (a dynamic measure). It is not possible, from the Annex 3 data, to work out Pfizer's or Flynn's on-going cash-flow requirements for selling or distributing the Capsules (which a dynamic measure would imply). A dynamic measure would require a modelling of cost outflows and revenue inflows that has not been undertaken and which would (we anticipate) be extremely complex to undertake. On the other hand, the static model adopted by the CMA, enables the cost of a Capsule to be ascertained as an average in any given month and the price of a Capsule similarly to be ascertained. As we have noted, it is possible to derive a measure of the profit obtained through the sale of Capsules by deducting cost from revenue, but it must always be appreciated that this a static measure of profit, disregarding the dynamics of cash flow that will inform the operation of any commercial enterprise. We stress that this is no criticism of the CMA: but it is important and necessary to understand from the outset the manner in which the CMA has approached the cost and price metrics in this case, for that informs the manner in which the competition law infringements found by the CMA have to be viewed. We cannot, and do not, seek to reinvent the methodological approach that the CMA has chosen to adopt in this case.

(4) Other or alternative products to Capsules

(a) First-line and second-line AEDs

16. First-line and second-line AEDs are the drugs currently deployed when treating patients. Phenytoin sodium is currently deployed as a third-line AED, where (for whatever medical reason) the first-line and second-line AEDs are insufficiently effective as an anti-epilepsy treatment. That, for present purposes,

is sufficient to locate the medical value of the Capsules amongst the range of AEDs, although the CMA went further than this and contended that phenytoin sodium and/or the Capsules lacked all economic value beyond a "cost plus" price.

(b) Alternatives to the Capsules

17. During the Relevant Period, potentially alternative products to Capsules were available to be prescribed. Possible alternatives comprised: (i) the parallel importation of the Capsules;[27] (ii) non-Pfizer capsules, specifically 100mg strength capsules sold as **Phenytoin Sodium NRIM Capsules**, manufactured by Accord;[28] and (iii) phenytoin sodium tablets (**Tablets**) produced by a variety of manufacturers.[29] Additionally, there were phenytoin (but not phenytoin sodium) based products on the market.[30]

18. Phenytoin based products are pharmacologically different to phenytoin sodium-based products. Capsules that were imported other than by way of Flynn (parallel imports) are, of course, pharmacologically the same, but they were not material to the Decision and did not feature in the appeals before us. We have no data in regard to their use in the United Kingdom, and they are (for these reasons) of peripheral relevance to this Judgment. Phenytoin Sodium NRIM Capsules and Tablets are also pharmacologically the same as the Capsules sold by the Appellants. Yet, as will be seen, these products do not fall within the same product market. That is for reasons of Continuity of Supply which we will come to.

(5) The environment in which pharmaceutical products are sold

19. The market for the sale of pharmaceutical products was extensively described in the CMA's decision in Case No 50277 (the **Hydrocortisone Decision**),

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[27] Decision/[2.265]*ff*.
[28] Decision/[2.7.2] and [2.17]. The identification of these capsules as "NRIM" capsules was for Continuity of Supply purposes, and did not constitute branding. There was, therefore, no applicable price control.
[29] Decision/[2.9].
[30] Decision/[2.10].

which decision was affirmed by this Tribunal (differently constituted) in *Allergan plc v. CMA* (***Hydrocortisone 1***) so far as the Chapter II unfair pricing infringement was concerned.[31] The regulatory environment was described in Section D of *Hydrocortisone 1*. To the extent appropriate and necessary, we will adopt (with all necessary modifications) that description for the purposes of this Judgment. The parties were content with this approach, which was broached before the hearing of the appeals began.

C. PROCEDURAL HISTORY

(1) Introduction

20. The Decision is a remittal decision, following an appeal against the Phenytoin 1 Decision. The Phenytoin 1 Decision was challenged in both this Tribunal and in the Court of Appeal. The Phenytoin 1 Decision and the appeals to which it was subject are of importance to this Judgment and reference will be made to them throughout. Accordingly, it is necessary to set out the procedural history and summarise the outcomes.

(2) The CMA's first investigation

21. The CMA commenced an investigation into the Appellants in May 2013, having determined that it had reasonable grounds for suspecting that the Appellants had infringed the Chapter I and Chapter II prohibitions.[32] The CMA originally pursued no Chapter II case against Flynn, but extended the investigation to include their pricing conduct in February 2014.

22. That investigation resulted in the Phenytoin 1 Decision in 2016, which found that the Appellants had abused their dominant position in the UK markets for Capsules under the Chapter II prohibition. The CMA imposed a fine of

[31] [2023] CAT 56. Other aspects of the Hydrocortisone Decision were considered in other judgments of the Tribunal but are not material for present purposes.

[32] The UK was still a member of the European Union, and so the CMA's investigation included consideration as to whether the Appellants had infringed competition law under Articles 101 and 102 TFEU. We propose to refer generally to the Chapter I and Chapter II prohibitions, and these should be read as generally embracing reference to Articles 101 and 102 TFEU.

£84,196,998 on Pfizer and £5,164,425 on Flynn for intentionally or negligently charging excessive and unfair prices for the Capsules. The Phenytoin 1 Decision also required that the Appellants reduce their prices, which they did between January and April 2017.

(3) First appeal to the Tribunal

23. The Appellants appealed the Phenytoin 1 Decision to the Tribunal. On 7 June 2018, the Tribunal (differently constituted) handed down *Phenytoin 1* (CAT), a judgment determining those appeals. *Phenytoin 1* (CAT) found that the Phenytoin 1 Decision had correctly identified the relevant geographical and product markets, and correctly concluded that the Appellants were dominant in those markets. However, the Tribunal in *Phenytoin 1* (CAT) concluded that the findings of abuse in the Phenytoin 1 Decision were vitiated by errors of law and fact for the following reasons:

(1) The "cost plus" approach adopted by the CMA was an insufficient basis for making the findings that it did under the excessive limb of the *United Brands* test. We will come to consider *United Brands* and Cost Plus in due course. For the present, we would only note that:

(i) The *United Brands* test lays down a well-known test for determining whether a price of a dominant undertaking is unfairly abusive. It involves two limbs: the first is concerned with whether the price in question is excessive, and we refer to this as the **Excessive Limb**; the second is concerned with whether a price found to be excessive is also unfair, and we refer to this as the **Unfair Limb**.

(ii) The Excessive Limb is thus best seen as a "gateway" condition that needs to be satisfied before the Unfair Limb falls to be considered; and if the Excessive Limb is not met, then consideration of the Unfair Limb does not arise.

(iii) Cost plus – what it means and how it is applied – is central to the issues arising in these appeals.

(2) The CMA was wrong in law to restrict its assessment of excessiveness to a cost-plus approach, and to exclude other methodologies. *United Brands* did not establish that cost plus was, in isolation, a sufficient method for establishing the satisfaction of the Excessive Limb if other methods were available, particularly if those other methods suggested different outcomes. In other words, it was not open to the CMA simply to choose the method of calculating the excess that was most favourable to establishing an infringement, to the exclusion of other methods.

(3) The CMA was wrong in law in failing to establish a "benchmark" price or price range that would have pertained in circumstances of normal and sufficiently effective competition. There must be a benchmark for the normal competitive price to estimate the excess under the Excessive Limb.

(4) The CMA was wrong to adopt a cost-plus methodology that relied too extensively on outcomes that would pertain in a state of perfect or idealised competition, rather than the circumstances that would arise in the real world. In this case, the CMA's reliance on a reasonable rate of return approach was unconvincing. The CMA's approach owed more to a theoretical concept of idealised competition than to the real world. It avoided making comparisons with other products or companies and failed to put the prices charged for the Capsules in their proper commercial context.

(5) The CMA failed correctly to assess whether the prices it found to be excessive under the Excessive Limb were also unfair under the Unfair Limb. The CMA wrongly relied, in its assessment of unfairness, on whether the prices were unfair in themselves, and failed properly to assess the possible impact of meaningful comparators for the purpose of determining whether the prices charged were unfair under the Unfair Limb.

(6) The CMA erred in its treatment of the economic value of the Capsules to the Pfizer/Flynn Patients to whom the Capsules were prescribed. The Capsules are used in the avoidance of epileptic seizures, and it was common ground before us (as it was before the previous Tribunal) that the benefits to a patient of avoiding an epileptic seizure are (simply viewed in human terms) immense. There were also cost savings to the NHS budget in terms of avoided costs of treatment far higher than the prescription of Capsules. In addition to this, there was societal benefit in avoided seizures. The CMA carried out no qualitative and no comparative assessment as regards the economic value of the Capsules, and simply (and, in the Tribunal's view, erroneously) assessed the economic value of the Capsules at nil above cost plus.

(7) The CMA was wrong to use the same data, that is to say the disparity between the prices charged by the Appellants during the Relevant Period and cost plus, to justify its findings under both the Excessive and Unfair Limbs. Moreover, the CMA wrongly used the difference between the Capsule prices as charged during the Relevant Period and the prices previously charged by Pfizer for Epanutin as a stand-alone ground for finding an infringement.

24. The Tribunal quashed the Prior Decision as a result of these findings and made an order for remittal (the **Remittal Order**).

(4) Appeal to the Court of Appeal

25. The CMA and Flynn were given permission by the Court of Appeal to appeal the decision in *Phenytoin 1* (CAT) on certain, specific, grounds. The CMA subsequently sought permission to raise additional issues of law, in particular addressing arguments they had conceded before the Tribunal. The Court of Appeal granted permission for the CMA to include these new points in their grounds of appeal on the basis that the issues were of considerable public importance.

26. The Court of Appeal partially upheld the CMA's appeal and rejected Flynn's appeal. The Court of Appeal upheld the outcome in *Phenytoin 1* (CAT) that the Phenytoin 1 Decision had to be remitted to the CMA for the decision to be re-made. But the outcome of the appeal was more nuanced than this bottom line would suggest. It is important to understand those areas where the Tribunal's decision was upheld and – even more relevantly – those areas where it was not.

27. By its decision in *Phenytoin 1* (CoA), the Court of Appeal upheld the *Phenytoin 1* (CAT) decision, and rejected the CMA's appeal, in the following regards:

(1) The alternative tests for "fairness" in *United Brands* were not strict alternatives.[33] Where the respondent to a CMA investigation adduces *prima facie* relevant evidence based upon a method not used by the CMA, then the CMA is under a duty to investigate it. How the CMA evaluates that, and other evidence will be fact and context specific. There was an obligation upon the CMA properly and fairly to evaluate the comparator evidence because it was adduced by the undertakings as part of their defences. The CMA could not, when making a finding of infringement in a decision, simply disregard points that indicated away from its inclination to find an infringement.[34]

(2) The Tribunal did not wrongly interfere with the CMA's margin of appreciation in finding that the CMA's investigation into comparators was insufficiently deep or intense. There was an obligation upon the CMA properly and fairly to evaluate the comparator evidence because it was adduced by the undertakings as part of their defences. The Tribunal had identified where it found the evaluation lacking and why this error could be material.[35]

(3) The Tribunal was entitled to find that the CMA had proceeded on an insufficient assessment of the evidence, in particular as regards the existence of benefit to the Pfizer/Flynn Patients and the consequential

[33] *Phenytoin 1* (CoA) at [51] to [117].
[34] *Phenytoin 1* (CoA) at [97(vii)], [110] to [117], [127].
[35] *Phenytoin 1* (CoA) at [136] to [152].

economic value of the Capsules. The CMA failed to take account of evidence of "some" value attributable to patient benefit and so economic value. In short, patient benefit was a factor that suggested an economic value other than zero. The level of benefit provided would be a matter of fact and degree.[36]

28. The Court of Appeal disagreed with the Tribunal on a number of other aspects regarding economic value. The essence of the Court of Appeal's difference with the Tribunal was that economic value was at heart an economic, and not a legal, concept, which "describes what it is that users and customers value and will reasonably pay for".[37] It formed a part of the overall description of the abuse and was not the test itself. Economic value had to be considered somewhere in the test, but the competition authority might decide where in the analysis this occurred.[38]

29. The Court of Appeal upheld the CMA's appeal against the holding in *Phenytoin 1* (CAT) that the CMA should have constructed hypothetical benchmark prices, or price ranges, against which to measure the actual price charged. There was no need in every case to create a hypothetical benchmark, and counterfactuals of the greatest practical value were often drawn from the real world. All that was required was a benchmark or standard against which to measure excess and unfairness, which might include various measures.[39] The Court of Appeal held that the CMA had a margin of appreciation or discretion as to how it went about making its decision. To the extent that the Tribunal compelled the use of a particular test on the part of the CMA, then it misconstrued the case law.

(5) The Decision

30. The CMA formally commenced its remittal investigation on 2 June 2020, following the decision in *Phenytoin 1* (CoA). The CMA characterised the investigation as involving, inter alia, "extensive evidence gathering in respect

[36] *Phenytoin 1* (CoA) at [165] to [173].
[37] *Phenytoin 1* (CoA) at [171].
[38] *Phenytoin 1* (CoA) at [172].
[39] *Phenytoin 1* (CoA) at [118] to [125].

of Tablets from a variety of sources", information gathering about Capsules' therapeutic characteristics, meetings with certain Clinical Commissioning Groups (**CCG**s), and consideration of publicly available data relating to sales volumes of generic and branded versions of other AEDs put forward by the Appellants as potential comparators".[40] One of the points that the Appellants made on appeal was that the CMA had not, in fact, undertaken very much different or new in comparison with the Phenytoin 1 Decision, but rather had served up in substance the same fare that had been rejected when the Phenytoin 1 Decision came under appellate scrutiny.

31. A statement of objections was issued on 5 August 2021, and the Decision was issued on 21 July 2022. The CMA's findings in the Phenytoin 1 Decision regarding market definition and dominance were upheld by the CAT in *Phenytoin 1* (CAT) and not appealed further.

32. The key findings in the Decision, for the purposes of these appeals are as follows:

    (1) Pfizer abused their dominant position in the market for the manufacture of Capsules for distribution in the UK by imposing unfair selling prices during the Relevant Period.

    (2) Flynn abused their dominant position in the market for the distribution of Capsules in the UK by imposing unfair selling prices during the Relevant Period.

    (3) In accordance with the legal test set out in the Court of Justice's judgment in *United Brands*, these prices were excessive and unfair and bore no reasonable relation to the economic value of the Capsules.

    (4) In assessing whether the Appellants' prices were excessive, the CMA adopted a cost-plus approach. We will refer to this as **CMA Cost Plus**, as a convenient label for identifying (without necessarily endorsing) the

[40] CMA Defence/[132] to [133].

CMA's approach in the Decision. It will be necessary to unpack the CMA's approach. In order to do so, we use the following definitions:

(i) The product said to have been sold at an unfair price is referred to as the **Focal Product**. In this case, there are eight Focal Products, being the various Capsule strengths sold by Pfizer and by Flynn.

(ii) The cost of producing and selling the Focal Product is referred to as the **Product Unit Cost**. It will be necessary to consider the extent to which CMA Cost Plus uses cost in this sense (we consider that it does), but at this stage we are setting out terms of reference.

(iii) The "plus" in CMA Cost Plus refers to a reasonable rate of return accruing to the seller for selling the Focal Product (the **Reasonable Rate of Return**). This is the difference between the selling price of the Focal Product and the Focal Product's Product Unit Cost that cannot be impugned under the *United Brands* approach.

The price of the Focal Product and its Product Unit Cost are both static or summative measures derived from the figures set out in Annex 3. The difference between the two is the profit which is not to be equated with the Reasonable Rate of Return but rather the profit, which needs then to be tested by reference to the Reasonable Rate of Return in order to determine whether it is or is not defensible.

(5) The prices charged by the Appellants bore no reasonable relation to the economic value of the Capsules. There were no demand side factors within the assessment of excessiveness and unfairness which reflected economic value. The Capsules were old, generic, off-patent drugs, and the Appellants made no improvements or enhancements to them. Newer AEDs generally offered superior therapeutic benefit. The Department of Health and Social Care (**DHSC**) had also made clear its concerns

regarding the prices of Capsules (as well as Tablets). The NHS (in particular CCGs), and patients, were harmed by the infringements found by the CMA.

33. As Pfizer and Flynn had each charged different prices and incurred different costs for each of the different strengths of the Capsules, the CMA found that the Appellants had each engaged in four separate abuses of dominance, making a total of eight findings of infringement.

34. The CMA decided to treat all four of the Appellants' respective infringements as one single infringement for penalty purposes. The CMA only has jurisdiction to impose a penalty where they are satisfied that the infringements were committed intentionally or negligently. The CMA found that the infringements were "committed intentionally or, at the very least, negligently".[41] The CMA imposed a penalty of £63,300,000 on Pfizer and £6,704,422 on Flynn, presumably (the Decision consistently hedges on this point) on the basis that there had been an intentional infringement of competition law by both Pfizer and Flynn.

(6) The grounds of appeal

35. The Decision is appealed by both Pfizer and Flynn. Separate grounds of appeal were articulated by each of the Appellants, which we will refer to as the **Pfizer Grounds of Appeal** and the **Flynn Grounds of Appeal**. It would not be helpful, at this stage, to set out in detail the grounds of appeal advanced by the Appellants: that can only meaningfully be done once the CMA's detailed reasoning in the Decision has been unpacked. We do no more than note at this stage that the grounds of appeal, although specific, were wide-ranging in terms of the aspects of the Decision that were challenged:

(1) Both Flynn and Pfizer contended that the CMA Cost Plus approach was in error and erroneously applied. These attacks had both negative and positive aspects: negative in the sense that it was suggested that aspects

[41] Decision/[9.5].

of the CMA's approach were simply wrong; positive, in the sense that the CMA had failed to consider material aspects of pricing and cost that rendered the CMA's decision wrong.

(2) A general theme – reprising the attack in relation to the Phenytoin 1 Decision – was that the CMA had failed to take into account real world facts and matters, and had instead followed, and followed slavishly, a theoretically over-rigid approach. The CMA had rejected the real world comparators proposed by the Appellants as benchmarks, and instead benchmarked prices against the CMA Cost Plus model. The model was not fit for purpose in this case. The CMA had (as it had in the Phenytoin 1 Decision) ignored: (i) the Tribunal's criticisms of the CMA Cost Plus model; and (ii) the regulatory and market context in which Pfizer operated in 2012.

(3) Another general theme was that the Decision did not really constitute a proper re-consideration of the Phenytoin 1 Decision as required by the Remittal Order. Again, this theme had both positive and negative aspects. In some regards, it was contended that the CMA had failed to change course, when it should have done; and in other instances, it was contended that the CMA had inappropriately moved to a different analysis.

(4) It was also contended that the CMA had erred in ascribing no economic value to Capsules beyond that already captured in the CMA Cost Plus analysis.

Both Pfizer and Flynn appealed in regard to penalty also.

D. THE EVIDENCE BEFORE THE TRIBUNAL

(1) The Decision

36. Although appeals to this Tribunal are "on the merits", the ambit of the Tribunal's merits jurisdiction is confined to the grounds of appeal. Outside these grounds of appeal, the decision of the CMA stands.

37. Even where a finding of the Decision is challenged by way of appeal, it is often the case that the facts on which the Decision is based are not challenged. In this case, an excellent example concerns the costs of production of the Capsules incurred by both Pfizer and Flynn. These were agreed at the most granular level, and we have used them (for instance, in Annex 3) without having to hear evidence as to their compilation. Some aspects of these figures – notably, whether common costs should be allocated according to volume or revenue – were challenged, and we will consider those points as they arise. But, generally speaking, the findings of fact on cost – and many other findings of fact – can be derived from the Decision or from material underlying the Decision.

38. On points of fact, therefore, the Decision will constitute our starting point, to be followed unless challenged in a ground of appeal and by reference to sufficient evidence. Where the question is one of inference from fact, we are more prepared to question it, particularly where the question is one of "economic fact" or the application of economic theory or principles to established fact.

(2) The Phenytoin 1 Decision

39. The Phenytoin 1 Decision is of importance in two particular regards:

    (1) In a number of respects, aspects of the Phenytoin 1 Decision survived the appeals we have described, were adopted in the Decision, and were not the subject of the present appeals. The clearest example of this concerns the related topics of market definition and dominance. These were decided in the Phenytoin 1 Decision, were not the subject of further consideration in the Decision and were not appealed. It would be

inappropriate to revisit these issues, even if we had jurisdiction to do so (as to which we say nothing).

(2) The Phenytoin 1 Decision was rendered after an extensive hearing, during the course of which the Tribunal heard evidence from persons not called before us, in respect of which findings were made in the Phenytoin 1 Decision. Although we do not consider such findings to be binding on us, they are clearly of important persuasive effect, and we treat them in that way.

(3) Other documentary evidence

40. We will refer to such evidence, and its significance, as and when it arises in the course of this Judgment.

(4) Witnesses of fact

41. We heard from the following witnesses of fact. Listing these witnesses in the order that they were called:

(1) *Dr David Fakes*. Dr Fakes was called on behalf of Flynn. He is the Chief Executive Officer of Flynn. He has been a shareholder and Director of Flynn since 2004 and has worked for Flynn full-time since 2006. He is also a registered pharmacist. Prior to working at Flynn, he had worked as a Director of R&D at Norton Healthcare, and then at a business he started where he provided consultancy services in the areas of product and business development. He gave two witness statements dated 12 October 2022 and 31 March 2023 (**Fakes 1** and **Fakes 2**). He gave oral evidence on Day 5 of the hearing (13 November 2023). He was an authoritative and clear witness, obviously and rightly concerned to explain to the Tribunal the true costs and risks incurred by Flynn in producing and selling the Capsules. To this extent he was unavoidably *parti pris*. We consider the specifics of Flynn's proper return on cost in detail below. The fact that we do not, in all respects, accept the substance of Dr Fake's evidence does not mean that Dr Fakes was not doing his

best to assist the Tribunal. He was: he was an honest and extremely competent witness.

(2) *Mr Andrew White*. Mr White gave evidence on behalf of the CMA. He is ICS Chief Pharmacist at Lancashire and South Cumbria Integrated Care. He was previously the head of medicines optimisation at the NHS Greater Manchester Shared Service. He gave one witness statement for this appeal dated 19 December 2022 (**White 2**). He had provided an earlier witness statement for the purposes of the appeal against the Prior Decision, which was dated 10 January 2017 (**White 1**). He gave oral evidence on Day 5 of the hearing (13 November 2023). He was an honest and straightforward witness, doing his best to assist the Tribunal. Acting, as he did, on the purchasing side of the market, he was firm in his view that the Capsules were overpriced. Indeed, that was the purpose of his evidence – as it was in the case of Mr Green and Ms Smith (see below). The extent to which such assertions of overpricing assist us in resolving these appeals is a matter altogether distinct from the quality of the evidence of Mr White, Mr Green and Ms Smith.

(3) *Mr Shaun Green*. Mr Green gave evidence on behalf of the CMA. He is Deputy Director of clinical effectiveness and medicines management for NHS Somerset. He has performed his current role for approximately 20 years. He is responsible for the production of prescribing guidance for GP practices in Somerset CCG and for the efficient use of Somerset CCG's prescribing budget. He gave one witness statement for the purposes of this appeal, dated 13 December 2022 (**Green 2**). Like Mr White, he had also provided one witness statement for the purposes of the appeal against the Prior Decision, dated 10 January 2017 (**Green 1**). He gave oral evidence on Day 5 of the hearing (13 November 2023). The quality of his evidence was as with Mr White.

(4) *Ms Susan Smith*. Ms Smith gave evidence on behalf of the CMA. She is Head of Education at PrescQIPP Community Interest Company and is a Medicine and Prescribing Associate for NICE. She is also a registered pharmacist. She provided one witness statement dated 16 December

2022 (**Smith 1**). She gave oral evidence on Day 5 of the hearing (13 November 2023). The quality of her evidence was as with Mr White.

(5) *Mr James Hawkins*. Mr Hawkins is a Senior Health Economist at NICE. Previously, he worked as a Senior Health Economist at the National Guidelines Alliance, an external body commissioned by NICE primarily concerned with developing NICE guidelines. Although Mr Hawkins was a witness of fact, his evidence was considered alongside the expert evidence of Messrs Skedgel and McGuire given his experience with NICE. He gave one witness statement dated 17 December 2022 (**Hawkins 1**). He gave oral evidence on Days 13 and 14 of the hearing (29 and 30 November 2023). As we come to describe, all of the experts gave careful and helpful evidence entirely in accordance with their duties as experts. Although not formally an expert, we have treated Mr Hawkins' evidence in this light, and we are very grateful for his assistance.

42. As we have described, the Phenytoin 1 Decision was informed by evidence that was not recalled before us. That evidence was, therefore, received by us at second-hand, generally through the intermediation of the *Phenytoin 1* (CAT) decision or the transcripts of evidence before the Tribunal on the hearing of the appeal from the Phenytoin 1 Decision. This, unsurprisingly, goes to weight, but we certainly take this evidence into account:

(1) *Mr John Beighton*. Mr Beighton was Managing Director at Teva UK Limited from October 2002 to January 2009. He then joined Goldshield Limited (which later integrated with Amdipharm Limited) and became the CEO of Amdipharm Limited from 2013 until 2016. He was called by Flynn and provided evidence relating to the Department of Health's negotiations with Teva in relation to the pricing of Tablets, in which he participated.

(2) *Mr Steve Poulton*. Mr Poulton was the Joint Venture Operations Lead for Pfizer between February 2009 and January 2013. He gave evidence

on Pfizer's negotiations with Flynn regarding Epanutin and the rationale for the deal with and supply price to Flynn.

(3) *Mr David Walters*. Mr Walters was a director of Flynn. He gave evidence on the rationale for Flynn's deal with Pfizer, Flynn's discussions with Pfizer and the Department of Health, Flynn's efforts to improve the supply chain, competition with other products, and Flynn's approach to cost allocation.

(5) The expert witnesses

(a) Generally

43. The expert evidence in this case was extensive. The Tribunal heard evidence from nine experts, who submitted 14 reports for this appeal, with an additional 18 reports submitted in connection with the appeal against the Phenytoin 1 Decision. We list the experts according to their discipline below. We do not provide an individual evaluation of each expert. In the case of each expert, they provided their evidence in accordance with the highest standards, and we are grateful to them for their assistance. In general terms, the medical experts provided – particularly in their oral evidence – real and helpful insight into the medical value of the Capsules, and into the vital importance of treating sufferers from epilepsy appropriately on a preventative basis. The economists (with the exception of the health economists who did not participate, but including Mr Williams, an accountant) were not only cross-examined, but responded patiently and helpfully to the Tribunal's questions when conducting examination by way of concurrent evidence (colloquially known as a "hot tub").

(b) The medical experts

44. The Tribunal heard evidence from two medical experts:

(1) *Professor Josemir Sander.* Professor Sander gave evidence on behalf of the CMA. He is a Consultant Neurologist in the NHS and a professor of neurology and clinical epilepsy at UCL. He produced one expert report

(**Sander 1**). He gave oral evidence on Day 6 of the hearing (14 November 2023).

(2) *Professor Matthew Walker*. Professor Walker gave evidence on behalf of the Pfizer Appellants. He is a Consultant Neurologist at the National Hospital for Neurology and Neurosurgery and is a professor of clinical neurology and head of the department of clinical and experimental neurology at UCL. He produced two reports for this appeal (**Walker 4** and **Walker 5**) and three reports in relation to the appeal of the Phenytoin 1 Decision (respectively, **Walker 1**, **Walker 2** and **Walker 3**). He gave oral evidence on Day 6 of the hearing (14 November 2023).

(c) The economic experts

45. The Tribunal heard evidence from an additional five experts with a mixture of economic and industry expertise, who also participated in a hot-tub evidence session:

(1) *Dr Adrian Majumdar*. Dr Majumdar was called on behalf of Pfizer. He is a partner at RBB Economists. Prior to taking that position in 2004, he was the Deputy Director of Economics at the OFT. He produced one expert report, filed with the Notice of Appeal (**Majumdar 1**) and a further additional report (**Majumdar 2**). He gave oral evidence on Days 7 to 10 of the hearing (15, 16, 20 and 21 November 2023).

(2) *Ms Rachel Webster.* Ms Webster was called on behalf of the CMA. She is a Director at Frontier. She produced one expert report, filed with the CMA Defence (**Webster 1**). She gave oral evidence on days 7, 8, 11 and 12 of the hearing (15, 16, 22 and 27 November 2023).

(3) *Dr Raphaël De Coninck.* Dr Coninck was called on behalf of Flynn. He produced three reports for this appeal (**De Coninck 5**, **De Coninck 6** and **De Coninck 7**), four reports for the 2017 appeal (**De Coninck 2**, **De Coninck 3** and **De Coninck 4**), and one report in response to the original

statement of objections (**De Coninck 1**). He gave evidence on Days 7 to 10 of the hearing (15, 16, 20 and 21 November 2023).

(4) *Mr Greg Harman*. Mr Harman was called on behalf of the CMA. He produced one report for this appeal (**Harman 3**) and two reports for the appeal in regard to the Prior Decision (**Harman 1** and **Harman 2**). Mr Harman is a Managing Director at BRG. Previously, he was a Partner and Senior Managing Director at FTI. He gave oral evidence on Days 7, 8, 12 and 13 (15, 16, 27 and 29 November 2023).

(5) *Mr Richard Williams*. Mr Williams gave evidence on behalf of the Flynn Appellants. He produced three reports for these proceedings (Williams 5, Williams 6 and Williams 7) and four reports as part of the appeal in regard to the Prior Decision (**Williams 5**, **Williams 6**, and **Williams 7**). Mr Williams is a chartered accountant, and not an economist. However, he gave concurrent "hot tub" evidence with the economists. In doing so, he appropriately ensured that he confined his responses to those areas where he could contribute expert evidence, and not merely (in)expert opinion evidence. That cannot have been as straightforward as it sounds, and we are grateful to him. He gave oral evidence on Days 7 to 10 of the hearing (15, 16, 20 and 21 November 2023).

46. As we have said, the expert evidence was without exception of the highest quality and of real assistance on the questions of economic fact that arise for decision. We have only one thing to say in addition to our unqualified endorsement of the evidence tendered by the experts. This concerns the evidence of Mr Harman:

(1) Mr Harman – both in regard to the Phenytoin 1 Decision and the Decision under appeal – was brought in by the CMA after the event to assess the reasoning and conclusions that had already been reached by the CMA.

(2) During the course of his evidence, it became clear that whilst Mr Harman generally accepted the conclusions of the Phenytoin 1 Decision

and the Decision, he either was not able to speak to the entirety of the CMA's reasoning or did not agree with aspects of the methodology adopted by the CMA. This is evident from the extracts below of the cross-examination of Mr Harman conducted by Ms Stratford, KC, Flynn's leading counsel. We will come to the technical issues raised in these exchanges in due course. Our purpose in setting out the exchanges at this stage is to identify a fragility in Mr Harman's evidence that arose not because of Mr Harman's quality as an expert (which was considerable) but because of the way in which he was deployed as an expert by the CMA:

[1] **Q (Ms Stratford, KC)**[42]	But you did, Mr Harman, actually conduct your own, bottom-up, ROCE calculation at that time, so you have said a number of times that the CMA had not done the work, and that was the reason why you felt, you are now saying, in some way constrained despite your instructions, but you did conduct this as a cross-check first time round?
[2] **A (Mr Harman)**	That is not true. I did not do it in any detail. I asked the CMA to provide me with figures for working capital, it had not done any analysis on intangibles, I did not consider the value of intangibles and on the Weighted Average Cost of Capital I merely took a range from 8% to 12% without any analysis. So I was not seeking to do a full Return On Capital Employed analysis, I was simply trying to make sure that a ROS of 6% was not understated. If I had done that analysis and worked out that you really needed a ROS of 10%, then I would have asked the question 6% cannot be right based on this analysis.
	…
[3] **Q (Ms Stratford, KC)**[43]	[Cross-examining Mr Harman on [5.92] of the statement of objections preceding the Phenytoin 1 Decision, which states: "The CMA considers that ROCE is challenging to apply for Flynn and has limitations given that its activities in supplying phenytoin sodium capsules, namely ordering and

[42] Transcript Day 12/p.51 (cross-examination of Mr Harman).
[43] Transcript Day 12/pp.57 to 60 (cross-examination of Mr Harman).

	managing customer relations, are people intensive, meaning that Flynn employs minimal capital assets. As a result the CMA considered that ROCE was not appropriate for assessing what a reasonable return would be for Flynn."] In your previous reports, you did not disagree with the CMA's findings that Flynn's activities were people-intensive, did you?
[4] **A (Mr Harman)**	I do not think I commented on that, but the reality is that the level of employees in the cost stack for phenytoin sodium is something like 3%, so I would not describe this as labour-intensive business, given that only 3% of its costs relate to labour.
[5] **Q (Ms Stratford, KC)**	Well, Mr Harman, if you had actually disagreed with that, maybe that is what you are now saying, it would have been your duty as an expert to raise that and you did not raise that in your first or second reports for the first appeal?
[6] **A (Mr Harman)**	I did not comment on that because the CMA did not rely on a Return On Capital Employed approach, and I was instructed to look at their Return on Sales methodology, so I do not think that I was – it fell to me to consider that, I was using it simply as a cross-check at the time. I took no position as to whether the capital employed could be determined more fully at that time.
[7] **Q (Ms Stratford, KC)**	Nor did you disagree with the relevance of that finding to the question whether ROCE was a suitable measure for Flynn. You did not expressly say anything about that.
[8] **A (Mr Harman)**	I was not instructed to consider whether the conclusion not to use the Return on Capital Employed approach in the first decision was reasonable. I was asked, instructed, to consider whether the determination of the Return on Sales was appropriate. … What I have done in my third report is to consider whether what actually the CMA says in this paragraph [i.e. [5.92]] is true.
[9] **Q (Ms Stratford, KC)**	Right, so do you now disagree with [5.92] of the CMA's statement of objections?
[10] **A (Mr Harman)**	But I did not agree or disagree with that paragraph.

[11] **Q (Ms Stratford, KC)**	I am asking you now: do you now disagree with it?
[12] **A (Mr Harman)**	Yes, I disagree with it because I think that for Flynn its capital can actually be determined, and I have made clear in the first report, I think it was under cross-examination or it was a question from the Tribunal where I made clear that if the intangible assets can be determined or be shown to actually not exist, that they do not need to be included, I explain that the ROCE can be applied to asset-light businesses. There is no – the problem with an asset-light business is the fear there may be assets that are missing from the analysis, but if you conduct your analysis and find there is no evidence of those additional assets, plus other cross-checks, then the methodology is reasonable.
[13] **Q (Ms Stratford, KC)**	I put it to you that the CMA must have had an intelligible reason for linking the people-intensive nature of Flynn's business to the fact that ROCE was an inappropriate metric. The reason was the people-intensive side of the business cannot reliably be quantified, meaning that Flynn's returns might look very high based only on the minimal capital assets that it employs, and I put it to you that is the only sensible interpretation of this paragraph.
[14] **A (Mr Harman)**	That is what they believed at the time without performing a full investigation on to the ROCE method, but I am not aware of what analysis they did, I was not instructed to look at it at the time, and, therefore, I cannot really add any more…
	…
[15] **Q (Ms Stratford, KC)**[44]	…What I am putting to you is that there has been no truly new evidence between the first and second appeal. Rather, what has happened is that the CMA has cast around to try to justify its change of position and that you, as an independent expert, as you have candidly accepted, cannot really say that anything new has emerged?
[16] **A (Mr Harman)**	Well, in relation to those first three points, I mean, I do not know why the CMA changed its mind. My review has to be, having changed its mind, has it come up with a reasonable

[44] Transcript Day 12/p.79 (cross-examination of Mr Harman).

	conclusion, but I agree that those three factors were known to me; I do not know to what extent the CMA based on new evidence placed more weight on them. I cannot answer that question.
	…
[17] **Q (The President)**[45]	You see, Mr Harman, the reason why I am pressing you on this is because at some point we are going to have to work out exactly what you are and what you are not saying, and I do not want to be – when that time comes – reading into these things more than you are in fact saying…That is why I am picking up Ms Stratford on her tying you and the CMA into these things…I am very happy to proceed on whichever basis that you prefer, namely that you are hand-in-glove with the CMA on this, that you absolutely will go to the wall on these points because they are your opinion as well as the CMA's findings, or that you are taking the CMA's findings and looking at them and seeing whether they did not disclose, you know, a point that you disagree with?
[18] A (Mr Harman)	Yes, I think it is mostly the latter, apart from where I have done an independent piece of analysis to cross-check the CMA's overall contentions.

(3) The technical aspects of these exchanges will, as we have said, be considered below. Return on Sales (or ROS) and Return on Capital Employed (or ROCE) are measures of return variously deployed by the CMA at various times during the course of its investigations. These exchanges show that the methodological changes adopted by the CMA over time were not done at the behest of Mr Harman nor indeed anyone else called to give evidence by the CMA. To this extent, the Phenytoin 1 Decision and the Decision stand or fall on their own terms, without further explanation or justification by expert evidence heard by us. All that Mr Harman did was to say that – looking at these matters after the event – the CMA's various positions were not unreasonable ones to adopt.

[45] Transcript Day 12/pp.126 to 127 (cross-examination of Mr Harman).

(4) The perils of importing an independent expert after the event to validate a final report that cannot be changed are obvious. At best, the expert can give a qualified endorsement. But there is always the risk – manifest in the exchanges set out above – of a mismatch between the reasoning and conclusions of the CMA and reasoning and conclusions of the expert instructed to opine. More to the point, there is a real risk that the expert, subsequently instructed, will come under pressure to endorse reasoning and conclusions that they do not actually hold: there is a real threat to expert independence.

(5) We stress that Mr Harman navigated these difficulties as well as circumstances (not of his making) allowed. He had the integrity and independence of mind to give his own opinion. But this sort of approach, where the expert supports the conclusions of the authority, but not necessarily its reasoning, diminishes the value of the expert evidence. Furthermore, and conversely, the reasoning of the authority is effectively left undefended, because the expert can only speak to a decision reached without their specific input.

(d) Health economist experts

47. The Tribunal heard evidence from two health economist experts:

(1) *Dr Chris Skedgel.* Dr Skedgel gave evidence on behalf of the Pfizer Appellants. He is a Health Economist and Director and the Office of Health Economics. Prior to that role, he was a Senior Consultant at IQVIA. He produced two expert reports (**Skedgel 1** and **Skedgel 2**), the first of which was filed alongside the Notice of Appeal. He gave oral evidence on Days 13 and 14 of the hearing (29 and 30 November 2023).

(2) *Professor Alistair McGuire*. Professor McGuire gave evidence on behalf of the CMA. He has been a Professor of Health Economics at the LSE since 2002. He produced one expert report (**McGuire 1**). He gave oral evidence on Days 13 and 15 of the hearing (29 and 1 December 2023).

48. As with the other experts, Dr Skedgel and Professor McGuire gave helpful evidence entirely in accordance with their obligations to the Tribunal as experts. We are grateful to them both.

E. STRUCTURE OF THIS JUDGMENT

(1) *United Brands*

49. The starting point for any analysis of the abuse of unfair pricing is the decision of the European Court of Justice in Case 27/76, *United Brands v. Commission*. *United Brands* set out a two-stage test for ascertaining whether the price charged by a dominant undertaking for a product was abusive,[46] where stage one (the Excessive Limb) turns on whether, in relation to cost, the price for the product can properly be termed "excessive";[47] and where stage two (the Unfair Limb) turns on whether the price is "unfair"[48] in itself or when compared to competing products.

50. It is accepted that the role of the Excessive Limb is to serve as a "gateway" condition to the Unfair Limb. If it cannot be said that a price is excessive and that the requirements of the Excessive Limb are met, the Unfair Limb does not have to be considered.

51. Whilst there are doubtless other ways in which an unfair price can be tested for, the *United Brands* test is well-established and represents the approach taken by the CMA in the case of both the Prior Decision and the Decision:[49]

> One possible method for determining whether or not a price is unfair is set out in paragraphs 251 and 252 of *United Brands* and is commonly referred to as the "*United Brands* test". The *United Brands* test involves comparing the selling price of the relevant product and its cost of production, which discloses the amount of the profit margin. Under this method a price will be abusively high where the following cumulative, two limb, test is met:
>
> 4.6.1 "the difference between the costs actually incurred and the price actually charged is excessive" (Excessive Limb); and

[46] The relevant passage is set out at Decision/[4.4] and at *Hydrocortisone 1*/[308].
[47] *United Brands* at [250].
[48] *United Brands* at [252].
[49] See Decision/[4.6].

4.6.2 "a price has been imposed which is either unfair in itself or when compared to competing products" (Unfair Limb).

(2) Subsequent sections of this Judgment

52. No-one suggested – or could suggest – that the *United Brands* approach was an inappropriate approach. The Excessive and the Unfair Limbs thus inform the structure of this Judgment, following the approach in the Decision. Having set out the background in Sections A to D above, the remainder of this Judgment deals with the following points in the following order:

(1) Section F considers questions of market definition and dominance. These can be dealt with straightforwardly, because matters of market definition and dominance were resolved in the Phenytoin 1 Decision and survived the subsequent appeal process. They are findings that were not challenged before us, and we adopt them. Nevertheless, it is important to understand precisely what was decided in the Phenytoin 1 Decision.

(2) Sections G, H and I consider the various grounds of appeal advanced by the Appellants against the substance of the Decision. Specifically:

(i) Section G considers the challenges of the Appellants to the CMA's findings in regard to the Excessive Limb. This involves detailed consideration and unpacking of (i) the CMA's approach and reasoning and (ii) the grounds of appeal, as well as our assessment and analysis of these grounds of appeal.

(ii) Section H considers, in like fashion, the challenges of the Appellants to the CMA's findings in regard to the Unfair Limb.

(iii) Section I considers a self-standing ground of appeal advanced by Pfizer, namely that the Decision was procedurally unfair.

(3) For the reasons given in Sections G, H and I, most of the grounds of appeal articulated by the Appellants succeed. In consequence, the Decision must be set aside. Section J records our conclusions in this

regard and considers the consequences of these conclusions, including in particular whether the Tribunal should exercise its jurisdiction to remake the Decision. To anticipate, our conclusion is that this is a jurisdiction that we should exercise; and we proceed to re-make the Decision both as against Pfizer and Flynn in Section K.

(4) Both Pfizer and Flynn appealed against the penalties imposed by the CMA in the Decision. Given our conclusions on substance of the Decision, it is inevitable that the CMA's conclusions on penalty must be substantively re-visited, and this done in Section L.

(5) Finally, Section M sets out how we dispose of these appeals.

F. MARKET DEFINITION AND DOMINANCE

(1) Market definition

53. The defined markets for the Relevant Period are:

(1) The manufacture of Pfizer-manufactured Capsules that are distributed in the United Kingdom (including parallel imports as they are distributed in the United Kingdom).[50] We shall refer to this market as **Market 1 (Manufacture)**.

(2) The distribution of Capsules in the United Kingdom (including parallel imports as they are distributed in the United Kingdom).[51] We shall refer to this market as **Market 2 (Distribution)**.

(2) Dominance

54. Findings of dominance follow from these market definitions. Thus, it has been found that:

[50] Decision/[3.3].
[51] Decision/[3.4].

(1) Pfizer held a dominant position in Market 1 (Manufacture).[52] Since Market 1 is defined by reference to Pfizer-manufactured Capsules, that conclusion is inevitable.

(2) Flynn held a dominant position in Market 2 (Distribution).[53] Since Market 2 is also defined by reference to Pfizer-manufactured Capsules, and since Flynn was the exclusive distributor of these Capsules, the conclusion is again an inevitable one.

(3) Significance

55. These conclusions necessarily imply certain findings about the product substitutes for the Capsules. Other forms of AED capable of treating epilepsy exist, as we have described, but Market 1 (Manufacture) appears to have been defined as:

(1) Excluding from the product definition forms of treatment other than by way of phenytoin sodium.

(2) Excluding from the product definition forms of treatment involving phenytoin sodium but delivered differently – for instance, by way of tablet, rather than capsule.

(3) Excluding from the definition of the market other forms of phenytoin sodium capsule. Thus, the Phenytoin Sodium NRIM Capsules have been excluded from the definition of Market 1 (Manufacture).

56. In short, the relevant product comprises Capsules alone. Given this definition of Market 1 (Manufacture), the definition of Market 2 (Distribution) follows – and Flynn's exclusivity in that market makes the finding of dominance assured.

[52] Decision/[3.6].
[53] Decision/[3.7].

G. THE EXCESSIVE LIMB

(1) Cost, price and the Profit Margin

57. *United Brands* holds that "excess" is measured by the difference between cost and price, referring to the difference between the costs actually incurred and the price actually charged for the Focal Product. Neither of these two measures is necessarily straightforward.[54] The difference between the two is the **Profit Margin** (i.e. price minus cost). The Profit Margin is not the same as the Reasonable Rate of Return. Whereas the Profit Margin describes the profit that the seller actually receives and is an absolute figure measured in money terms and which may or may not be excessive, the Reasonable Rate of Return is a percentage, a relative figure, representing the return that is unimpeachable in competition law terms.

58. The terms "cost" and "price" – whose difference constitutes the Profit Margin – refer to the cost and price of the Focal Product, isolated from all other costs and revenues. In the case of price, it is usually straightforward to identify the price at which the Focal Product was sold, but for clarity we will refer to this as the **Product Unit Price**. In the case of the Focal Product's cost (i.e. the cost of producing and selling the Focal Product only), it is necessary:

    (1) To exclude unrelated costs, that is costs incurred that have nothing to do with the Focal Product.

    (2) Where costs have been incurred in part in relation to the Focal Product and in part in relation to other matters, to include only that proportion of those costs that can properly be allocated to the Focal Product.

    Thus, the **Product Unit Cost** is derived. In this case, the calculation of Product Unit Cost was a matter of some complexity, as we describe. The calculation of

[54] As to cost, the problems are identified, at least in general terms, in Decision/[4.13] to [4.18]. The Decision does not address the difficulties in assessing price at all, presumably because of the assumption that the price is known, and in this case straightforward.

Product Unit Price was (in this case[55]) straightforward, being the price at which Capsules of each strength were sold.

59. In the real world, Product Unit Cost and Product Unit Price are unlikely to be the metrics primarily used by the undertakings, firms or companies (**Enterprises**) involved in selling goods and services. Most Enterprises sell multiple products, where the product of interest to the competition regulator – the Focal Product – will be one of many. It is unlikely that the Enterprise will treat the costs of the Focal Product as "siloed", capable without more of being attributed to that single product. Product Unit Cost generally will have to be derived from other data held by the Enterprise (which the Enterprise may or may not keep). The Decision rightly notes the difficult judgmental questions that arise.[56] Whilst Product Unit Prices are more likely to be referable to a single product, the Profit Margin (as we define it) is not necessarily a meaningful figure to the Enterprise. The Enterprise will be more concerned with its total costs (i.e. the cost of carrying on business) set against its total revenue (i.e. the revenues received by selling products), and it will have regard to the profitability or otherwise of a single Focal Product in that context. Its aim will be to ensure that total revenue exceeds total costs by a margin that enables it to stay in business. Of course, the Enterprise will be interested in the revenues brought in by individual product lines, including those of the Focal Product: but it will look at individual prices and revenues within a broader context. Put simply, an Enterprise will look at its business dynamically, whereas the approach taken in the Decision and so in this Judgment is static and not dynamic. Neither the Decision nor this Judgment is concerned with how an Enterprise would conduct its business: both the Decision and the Judgment are concerned with the price of the Focal Product and whether it is excessive.

[55] One can imagine more complex cases: the bundling of multiple products at a single price, of which only one is the Focal Product; or cases of dynamic pricing, where the price of the Focal Product varies according not merely to demand for the Focal Product, but by reference to demand for other products.
[56] Decision/[4.13] to [4.17].

(2) Factors of production

60. There are four **Factors of Production** as defined by economists. The meaning of two of these Factors of Production – "capital" and "entrepreneurship" – and their calculation were central to the Decision, the grounds of appeal and this Judgment:

(1) Products, including any Focal Product, are the output of certain inputs, known as Factors of Production, which economists class under four heads: **Land**, **Labour**, **Capital** and **Entrepreneurship**. Although these labels (particularly "Land") are not necessarily clear, they are sufficiently entrenched so as to render their use unavoidable. It is important is to be clear about their meaning:

(i) Land comprises all those gifts of nature, such as land, forests, minerals, etc – more prosaically referred to as raw materials or natural resources but including intermediate or manufactured products.

(ii) Labour comprises all human resources, mental and physical, both inherited and acquired.

(iii) Capital comprises those man-made aids to further production, such as tools, machinery and factories, which are used in the process of making other goods and services, rather than being consumed for their own sake. A dictionary definition of capital will bring up two different meanings. Capital can be used to mean "goods such as plant, machinery and equipment which are used to produce other goods and services". But it can also refer to "the funds invested in a business in order to acquire the assets which the business needs to trade".[57] For purposes of the *United Brands* test, the second definition (or a variant of it) is to be

[57] See, for example, Pass, Lowes Pendleton and Chadwick, *Dictionary of Business*, 1st ed (1991) under "capital".

preferred because it is "process independent": it does not require the identification of particular plant, machinery or equipment, but only the costs incurred in the carrying on of business. The primary definition of Capital is thus:[58]

The money required to acquire the inputs (i.e. Factors of Production) needed to make the Focal Product.

It will still be necessary to refer to plant, machinery and equipment: we will use the term **Physical Capital**. It is helpful to note that Mr Harman's (and we infer, the CMA's) definition of capital is exactly that set out above, namely "the amount of money that you would need to find upfront to commence your operation, and it is that sum of money that people want a return on".[59]

(iv) Finally, Entrepreneurship. Those who take risks by organising the other Factors of Production, introducing new products and new ways of making old products, so developing new business and new forms of employment and taking the risk of failure (insolvency) are entrepreneurs or innovators. The resource they provide is Entrepreneurship.

(2) Each Factor of Production will have a cost: an employee (Labour) receives a wage or salary; a machine needed for manufacture (Physical Capital) will have a price of acquisition and a cost of operation. Those costs are embedded in a static way in the Annex 3 data, but of course would be incurred dynamically by the Enterprise. Thus, there will be a mismatch between, for example, the date when the Enterprise incurs the

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[58] It is possible to parse this meaning more narrowly. Thus, the "working capital" is often used to refer to the liquid balances used to pay for wages (i.e. Labour) and raw materials (i.e. Land). It may extend to the acquisition of Physical Capital, as we define that term. The CMA's definition of working capital is close to this definition (Decision/[5.231]:

> Working capital is the amount of capital that is employed in financing short-term assets, net of the capital provided by short-term liabilities. Working capital is typically calculated by taking the value of stock and debtors less the value of creditors.

Working Capital is different to Physical Capital and a subset of Capital as we define it.

[59] Transcript Day 12/p.40 (cross-examination of Mr Harman).

cost of Labour (typically paid on a monthly or weekly basis) and when the price for the product made by Labour is received (which will be on sale and in accordance with the contractual terms of that sale). These points are obvious, cash flow, points. As we have emphasised, they do not feature in Annex 3. Two further points bear (re-)emphasis:

(i) The cost of a Factor of Production is not, typically, easy to relate to a specific Focal Product. An employee may not directly be involved in production or sale of the Focal Product, and yet contribute to the overall process of production (contrast a machinist making the Focal Product with the Enterprise's head of accounting or managing director).

(ii) There is, or there can be, competition between the same Factors of Production; and competition amongst different Factors of Production. Thus, different sellers of Land will compete on price (*intra* Factor of Production competition). But there will also be competition between Physical Capital and Labour, for Physical Capital can replace Labour in the making of products, or *vice versa* (*inter* Factor of Production competition). It is perfectly possible for different sellers of products to use different technologies or different mixes of Factors of Production to produce the same product with similar cost outcomes. Thus, one speaks of labour-intensive and capital-intensive processes.

(3) The Consumer Surplus and the Producer Surplus

61. Two other economic concepts need to be introduced: the Consumer Surplus and the Producer Surplus:

(1) The **Consumer Surplus** is the premium received by a purchaser of a hypothetical product (respectively, the **Buyer** and the **Product**) where the Buyer pays <u>less</u> for the Product than they would otherwise be willing to pay. Consumer surplus is the amount (typically measured in money) that a consumer – i.e. the Buyer – would have been prepared to pay for

the Product over and above the market price at which the Product was in fact purchased by the Buyer.[60]

(2) The **Producer Surplus** is the difference between how much a **Seller** would be willing to accept for a Product compared to how much they can receive by selling the Product at the market price. Producer Surplus is the premium or economic value (again, measured in money terms) received by a Seller of a Product where the Seller received more for the Product than they would (had the Price been lower) actually have been prepared to accept.[61]

(4) Considering "excess" for the purpose of the Excessive Limb

(a) Profit Margins and "excessive" Profit Margins

62. The Excessive Limb will be satisfied where the Profit Margin is "excessive", not where Product Unit Price exceeds Product Unit Cost. It is not the case that all Profit Margin (i.e. any amount over Product Unit Cost) is excessive. It is accepted by all that an Enterprise is entitled to receive a profit, an amount above cost, which will not be regarded as "excessive". That is its Reasonable Rate of Return, which is the cost of Entrepreneurship. For reasons we have explored, that Reasonable Rate of Return must be localised in or calculated by reference to the Focal Product; and not by reference to the operations of the Enterprise as a whole. CMA Cost Plus is the Product Unit Cost plus the Reasonable Rate of Return.

(b) Reasonable Rate of Return and Normal Profit

63. What constitutes a Reasonable Rate of Return and whether a Product Unit Price that generates a Profit Margin greater than the Reasonable Rate of Return is "excessive" and contravening of the Excessive Limb is central to these appeals. It may be that the Reasonable Rate of Return is defined by reference to what an economist would call the **Normal Profit**. This is the level of profit equal to the

[60] See [312] to [315] of *Hydrocortisone 1*.
[61] See [316] to [317] of *Hydrocortisone 1*.

opportunity cost of Entrepreneurship. Normal profit is the fair reward for the effort that the entrepreneur puts into running an Enterprise and the risk that they take on. Levels of profitability higher than this tend to stimulate entry into an industry, and levels of profit lower than the normal tend to cause exit.[62] Normal Profit exists at the equilibrium point where the entrepreneur stays in business, with no exit from the market and no new entry caused by the level of profit.[63]

64. Normal Profit is a measure that is not necessarily localised to the Focal Product. Normal Profit will usually be assessed at the level of the Enterprise. For the purposes of *United Brands*, for Normal Profit to be meaningful, it needs to be tied to the Focal Product, as our other terms of reference (Product Unit Cost, Product Unit Profit, Profit Margin, Reasonable Rate of Return) all are.

(c) Reasonable Rate of Return, the Consumer Surplus and the Producer Surplus

65. The relationship between the Reasonable Rate of Return, the Consumer Surplus and the Producer Surplus can be stated as follows:

(1) The Consumer Surplus refers to what the individual Buyer would be prepared to pay for the Product. If the individual Buyer would have been able and willing to pay £X for the Product, but only had to pay £¼X, then that Buyer's Consumer Surplus is £¾X. The level of Consumer Surplus will vary according to the individual. Different Buyers will attach different values to the Product as measured by reference to willingness and ability to pay.[64]

(2) Similarly, the Producer Surplus will vary according to the Seller's individual position, in particular the Seller's costs, which will inform

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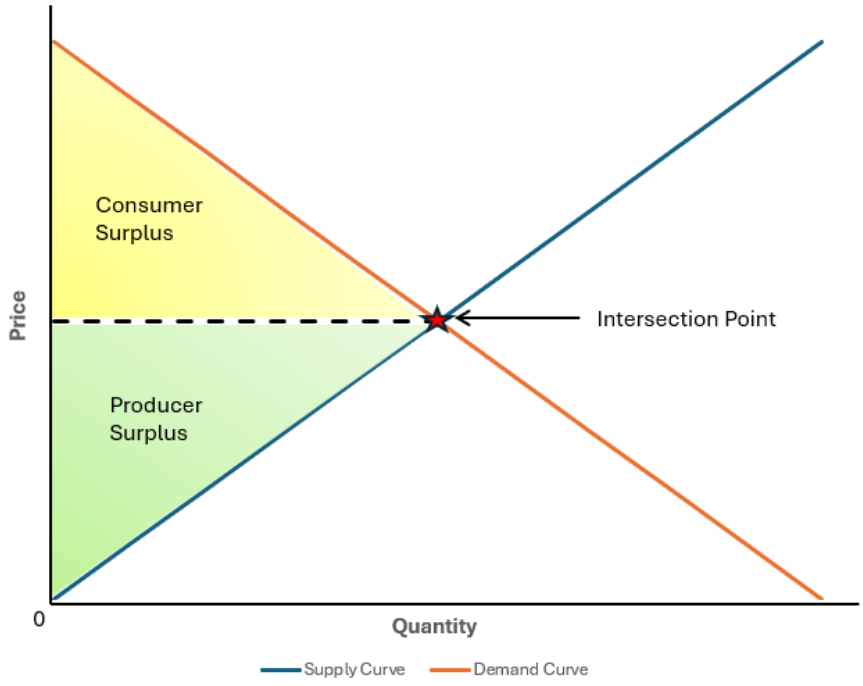
[62] Black, Hashimzade and Myles, *Dictionary of Economics*, 3rd ed (2009) under "normal profit".
[63] As we shall come to consider in greater detail, Normal Profit, like the Reasonable Rate of Return and "perfect competition", is a construct or standard against which the real world is measured, in this case for competition law purposes and for ascertaining whether there has been an infringement of the Chapter II prohibition.
[64] Both willingness and ability to pay are relevant. Many Buyers, lacking the money, may want to buy the Product, but will be unable to do so. Consumer Surplus is the difference between what the Buyer did pay and what they would have been able and willing to pay. Not only is the measure a counterfactual one, it also varies according to individual Buyer characteristics.

how much the Seller must receive in order to achieve at least a Normal Profit. If the individual Seller would have been prepared to accept £¾X for the Product, but in fact there was a Buyer who paid £X, then that Seller's Producer Surplus would be £¼X.

(3) Consumer Surplus and Producer Surplus relate to the individual Buyer and the individual Seller. It is possible to aggregate both the Consumer Surplus and the Producer Surplus by adding together the individual Consumer Surplus of all Buyers and the individual Producer Surplus of all Sellers to produce **Aggregate Consumer Surplus** and **Aggregate Producer Surplus**. Taking normal demand and supply curves, as in the figure below, the Aggregate Consumer Surplus is the yellow triangle above the price line (itself informed by the intersection between the demand and supply curves) and below the demand curve.[65] The Aggregate Producer Surplus is the green triangle below the price line and above the supply curve under perfect competition.



[65] This diagram is obviously a construct, based upon a number of assumptions (including perfect market knowledge and aspects of perfect competition). It is unnecessary to expand upon these for the purposes of this Judgment.

Figure/Table 1: A diagrammatic representation of Aggregate Consumer Surplus and Aggregate Producer Surplus

(4) Aggregate Consumer Surplus and Aggregate Producer Surplus refer to all quantities of the Focal Product Sold, and there will be times when that is the appropriate measure for purposes of the Excessive and Unfair Limbs. However, our starting point for assessing Product Unit Cost, Product Unit Price and Profit Margin will be the individual unit sold – a single unit of the Focal Product. Aggregate Consumer Surplus and Aggregate Producer Surplus can be unitised by dividing the aggregate value by the quantity of the Focal Product sold, so as to achieve an average: the **Average Consumer Surplus** and the **Average Producer Surplus**.

66. It was common ground that to the extent the Profit Margin was wholly eroded by or equivalent to the Reasonable Rate of Return, there could be no "excess" and the Excessive Limb would not be satisfied. There was substantial dispute – which we will need to resolve – as to whether the converse was the case: is the existence of any (material[66]) Average Producer Surplus conclusive of the satisfaction of the Excessive Limb? The Decision does not go so far as this, for it notes that:[67]

> For the avoidance of doubt, [CMA] Cost Plus does not determine the maximum price for a product. It is possible for an undertaking to price above Cost Plus without those prices being either excessive or unfair.

The Decision does not, however, articulate the circumstances in which a price above Cost Plus will not be excessive or unfair. The Appellants contended that the Decision in fact proceeded on the basis that the Excessive Limb and the Unfair Limb were satisfied where Product Unit Price exceeded CMA Cost Plus. That was disputed by the CMA.

[66] In all cases, we disregard the *de minimis*. When we refer to measures in this Judgment, we look only to the material and will disregard the *de minimis*.
[67] Decision/[5.30].

(5) The Product Unit Cost of the Focal Products

(a) The work done underlying the Decision

67. It is necessary to identify Product Unit Cost for eight different Focal Products. Although only four Capsule dosages were sold (25mg, 50mg, 100mg and 300mg Capsules) these Capsules were produced by Pfizer, sold by Pfizer to Flynn and then sold by Flynn to Pfizer/Flynn Customers. The costs in producing the Capsules incurred by Pfizer will bear little relationship to the costs incurred by Flynn, save in this regard:

The Product Unit Price charged by Pfizer to Flynn for the Capsules will constitute an irreducible part of Flynn's Product Unit Cost in procuring those Capsules for distribution and sale by Flynn to Pfizer/Flynn Customers.

68. Before the hearing, the CMA provided us with Excel spreadsheets describing how the Product Unit Costs for each Focal Product had been calculated over the Relevant Period, broken down by month (the **Focal Product Spreadsheets**). The Focal Product Spreadsheets inform the content of Annex 3. In terms of the calculations, the Focal Product Spreadsheets were agreed between the parties. The Product Unit Cost derived from these figures was substantially agreed between the parties. Subject to one, limited, area of disagreement, it is therefore possible to take the Focal Product Spreadsheets as read.

(b) Derivation of Product Cost

69. The CMA was dependent on Pfizer and Flynn for the provision of costs data. Pfizer, more so than Flynn, is a large and complex undertaking, and it should go without saying that when seeking to ascertain Product Unit Cost, the CMA is entitled to a broad measure of judgmental discretion. We have commented on the manner in which these data were compiled in [15], and we do not repeat that description of the CMA's approach. It is unsurprising that the granular detail of the CMA's calculations was largely not challenged on appeal. Absent serious computational error (which ought to be resolved during the investigation and before any appeal), it is right that the Tribunal be presented with agreed, and not disagreed, metrics.

70. The CMA's approach differentiated between variable costs and fixed costs of (separately) Pfizer and Flynn. These were allocated to the four different Capsule dosages sold by each of Pfizer and Flynn, so as to derive, for each dosage, the following metrics:

(1) *The total cost of producing each Focal Product.* This involved identifying the fixed and variable costs of each Enterprise, ascertaining those implicated in the production of the Focal Products generally, and then allocating these to specific Focal Products (i.e. differentiating by reference to strength of dose). Generally speaking, this allocation was done not by reference to revenues received (i.e. the price at which the Focal Products were sold) but by reference to the volumes sold. Mr Williams, the expert called on behalf of Flynn, took issue with this manner of allocation, and that is the objection that we consider further below.

(2) *The volumes of Focal Product sold, differentiating by Capsule dosage.* Volumes sold are important in respects that we will come to consider. For present purposes, they enable us to derive a "per unit" (i.e. per pack of Capsules) cost for each Capsule strength. The outcome of the process is the Product Unit Cost of the Capsules.

(c) Allocation of cost by volume or revenue

71. This was not a formal ground of appeal on the part of Flynn, but was an objection made by Mr Williams to the manner in which costs had been allocated to Capsule dose.[68] Mr Williams' point was that allocation of cost by reference

[68] The point was considered in the course of the hearing of the appeal in relation to the Prior Decision. The CAT Decision records at [351]:

> "We note Mr Davies' evidence that it is not common practice in the pharmaceutical industry, or at least in this part of it, to allocate common costs to individual products. However, it was necessary to do so for the purpose of the CMA's analysis to ascertain the profitability of individual products. The merits of different methods can be debated. It is clear, and indeed was common ground, that there is no single over-riding preferred method and that different methods may be used for different purposes. In the present case, Mr Harman cross-checked the CMA's overall findings by using a number of different allocation methods, more favourable to Flynn than the volume method used, which in his view confirmed that the CMA's choice of allocation

to volumes sold was inappropriate, and that it was better to allocate by reference to revenue. To be fair to Mr Williams, he did not, when giving evidence, press the point so far as to say that allocating cost by reference to volumes sold was wrong, merely that a revenue-based allocation was better. That was because (according to Mr Williams) an Enterprise would typically allocate costs in accordance with revenue. Thus, if (for instance) there is a common cost of £100 that must be allocated across four different Focal Products, each selling 25 units, but with one Focal Product generating 70% of the revenue (the other products generating 10% each), the appropriate allocation was not (according to Mr Williams) 25/25/25/25, but 70/10/10/10.

72. We consider this to be precisely the sort of judgmental question to be left to the CMA, and not to be challenged before an appellate tribunal, even when deciding an appeal on the merits and even if the point constituted a formal ground of appeal. For this reason alone, we reject the objection made by Flynn to the allocation of cost in the Focal Product Spreadsheets.

73. However, we also consider that Mr Williams is, at least in the context of unfair pricing cases, wrong in his contention; and that the reasoning in *Phenytoin 1* (CAT) is correct. There is no general way in which an Enterprise allocates common costs to given products. In any event Enterprises will not be engaged in the process we and the CMA are engaged in. The essence of the matter before us is that the prices charged by Pfizer and Flynn for each different Capsule strength was unfair. It would introduce a major distortion into the allocation of Product Unit Costs were those costs to be allocated by reference to revenue derived from prices that the CMA had found in the Decision to be excessive and

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methodology was reasonable. Moreover, that exercise showed that Flynn's prices materially exceeded Cost Plus regardless of the choice of allocation method. Given that Flynn does not itself allocate costs to individual products and that there is no clearly preferable method of allocation, the CMA's approach is in our view reasonable and we uphold it."

It is, thus, clear that this is not a point that we should re-visit lightly. However, given that Mr Williams raised it, and given that it is important that Product Unit Cost be reliably established, we consider the substance of the point.

unfair.[69] For these reasons, therefore, we reject this limited attack on the Focal Product Spreadsheets.

(6) The Product Unit Price of the Focal Products

(a) The data

74. Price is that which is charged by the Enterprise for each Focal Product. Just as with Product Unit Cost, in this case there will be eight relevant prices, one for each Capsule strength. The Focal Product Spreadsheets contain data setting out total revenue for each strength as received by Pfizer and (separately) total revenue for each strength as received by Flynn. Because we have the data for the volumes sold, it is possible to calculate an average sale price by Pfizer and by Flynn for each Capsule strength, which constitutes the Product Unit Price. These figures in the Focal Product Spreadsheets were uncontentious, and we adopt them without more. As we have described, this data is set out in Annex 3.

(b) Some general observations

75. There is some correlation between Product Unit Cost and Product Unit Price:

(1) *Within a supply chain, upstream price informs downstream cost.* The Product Unit Price charged for a Focal Product by a Seller constitutes (part of) the Product Unit Cost to the Buyer.[70] The same value is simply described in two different ways. The Product Unit Price charged by the Seller and paid by the Buyer is a cost to the Buyer, particularly where (as here) the Buyer sits within the supply chain,[71] and must form at least a part of the Buyer's Product Unit Cost.[72] Here, because Pfizer sold

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[69] This point was put to Mr Williams, albeit in the abstract, at Transcript Day 8/pp.67 to 72. This is, clearly, a question of judgment, as Mr Williams acknowledged, and we should be slow interfere with the CMA's approach, even if we considered Mr Williams' approach to be preferable. In this case, we do not consider Mr Williams' approach to be preferable. For the reasons we give, the approach of the CMA in the Focal Product Spreadsheets is better.

[70] The point is generally true as regards prices and costs differently defined. Here, however, our concern is with the Focal Product, and so metrics tied to that Focal Product are specifically referenced.

[71] The person at the end of the supply chain, who neither on-sells nor incorporates the product into another product for onward sale (the "ultimate consumer") probably would say that they are just paying a "price".

[72] There will, almost certainly, be other costs to the Buyer that will inform the overall Product Unit Cost of the Focal Product to the Buyer.

Capsules to Flynn and Flynn paid Pfizer a price for those Capsules, the price charged by Pfizer for the Capsules is the same as the cost of those Capsules to Flynn. At various points in the Decision – and during the course of the hearing – it was suggested by the CMA that the price paid by Flynn to Pfizer could not simply be taken as a cost to Flynn. That was because of an innuendo, running throughout much of the Decision, that there was something improper, even anti-competitive, in the supply-chain arrangements between Pfizer and Flynn. This point is a matter that will require specific consideration, for it formed an element in the grounds of appeal.[73]

(2) *Upstream cost does not necessarily inform downstream price.* The converse is not the case. A central question in the Decision is the extent to which it can be said that price is properly to be informed by cost. To use our Focal Product terminology, the question is the extent to which the Product Unit Price charged by a Seller for the Focal Product should be informed by the various Product Unit Costs that go to making and selling the Focal Product. Clearly, price ought not generally to fall below cost: the seller makes a loss, and there may be a suggestion of margin squeeze or predatory pricing where the Enterprise pricing at a loss is dominant. Generally, price will, and should, sit at above cost. The question, fundamental to CMA Cost Plus and to the Decision, is the extent to which the price of a Focal Product (specifically, its Product Unit Price), in order to be proper, must track the costs (specifically, the Product Unit Costs) incurred by the Seller in producing that Focal Product.

76. The Focal Product Spreadsheets thus provide the essential data for the Relevant Period, broken down by month, of Product Unit Cost, Product Unit Price and

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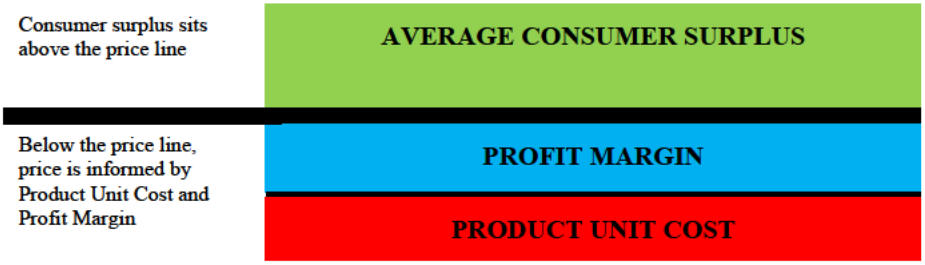
[73] Decision/[4.18] notes:

> "…it is well-established that any costs must be reasonably and efficiently incurred. As the CAT explained in *Albion Water II*: "Community jurisprudence only permits the inclusion of efficiently incurred costs.""

It may be that the Product Unit Price for the Capsules charged by Pfizer to Flynn rendered Flynn's Product Unit Cost unreasonably and inefficiently incurred; or it may be that the Product Unit Costs of the Capsules to Flynn need to be differently handled. For the present, we simply note that the point will need to be addressed.

Profit Margin. Although the relevant data is fully set out in Annex 3, it is helpful to present this data graphically. This is done in the form of eight graphs (one for each Focal Product, four relating to Pfizer and four relating to Flynn) in Annex 4:[74]



Figure/Table 2: The Profit Margin, graphically represented

By way of further explanation of these Annex 4 graphs:

(1) The thick black line represents the monthly Product Unit Price charged for each Focal Product as derived from the Focal Product Spreadsheets.

(2) Product Unit Cost, as derived from the Focal Product Spreadsheets, is coloured red, and the difference between Product Unit Price and Product Unit Cost – the Profit Margin – is coloured blue.

(3) The Consumer Surplus is coloured green and its extent in the present case is not known in any measurable way. It is necessary to be aware of the place of Consumer Surplus in the relationship between cost and price, for the Appellants stressed the importance of the Consumer Surplus (particularly when considering the Unfair Limb) and contended that the Consumer Surplus in regard to the Capsules had insufficiently been taken into account in the Decision.[75]

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[74] The approach we have taken is to disaggregate the supply chain and consider Pfizer's Profit Margin distinctly from Flynn's. Thus, in Pfizer's case, the Product Unit Price is the price charged by Pfizer to Flynn, whereas in Flynn's case, the Product Unit Price is the price charged by Flynn to the Pfizer/Flynn Customers.

[75] In Case C-177/16, *Biedriba Autoriesibu un kommunicesanas konsultaciju agentura – Latvijas Autoru apvieniba v. Konkurences padome*, ECLI:EU:C:2017:286 at [101], the Advocate General noted:

(4) Producer Surplus does not feature in the graphs, because the Reasonable Rate of Return is not (yet) known. All that can be said is that the Reasonable Rate of Return comprises all or part of the Profit Margin. Central to the Excessive Limb is not what constitutes an excessive price, but what constitutes an excessive Profit Margin.[76] The next question that needs to be addressed is the meaning of "excessive".

(7) "Excessive"

77. "Excessive" is not a term used in statute. It derives from *United Brands* – and is an ordinary term. In *Albion Water Ltd v. Water Services Regulation Authority*,[77] the Tribunal stated:

> The term "excessive" is an ordinary English word, which may be applied in accordance with its ordinary meaning, having regard to the overall purpose of the Chapter II prohibition. We note that the Authority submitted that a price may not be "excessive" within the meaning of the first United Brands question where the price exceeds costs but not by a material extent…While we are prepared to accept that a material difference between price and cost must be shown, we see no need to specify, in this case, when a particular difference is sufficiently large to be deemed excessive. In our judgment, a price at least 46.8% above the costs reasonably attributable to the supply of non-potable water to non-potable users generally is material and excessive. The same is true of a price at least 68.1% above the costs reasonably attributable to the supply of non-potable water through the Ashgrove system in particular.

78. In the Latvian Copyright Case,[78] the Advocate General stated that "a price can be qualified as excessive under Article 102 TFEU only if two conditions are fulfilled: it ought to be both *significantly* and *persistently* above the benchmark price".[79] This goes beyond "material" (the test used in *Albion Water*) as a test for excess. In these proceedings, the Tribunal suggested the phrase

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> "At the outset, let us start by recalling the economic rationale of the unfair pricing abuse: when a dominant undertaking applies prices above competitive levels, there is an inefficient allocation of resources and consumer welfare is reduced (part of the welfare is transferred to the dominant company, whereas part is simply lost). Accordingly, from a theoretical point of view, any deviation from the competitive price in a regulated market might justify an intervention of the competition authorities. Indeed, any difference between the benchmark price and the actual price implies a certain loss in consumer welfare that would not have been there had the market been competitive."

[76] The *United Brands* test refers to the difference between the costs actually incurred and the price actually charged, which is the Profit Margin.
[77] [2008] CAT 31 at [199].
[78] See fn 75.
[79] At [106] (emphasis in the original).

"demonstrably immoderate" as another articulation of "excessive", which the parties did not resist.[80]

79. Whether a price or a profit margin is "excessive" is a question of fact. It is counterproductive to seek to introduce a spurious sense of certainty by evoking ever more lengthy articulations of what is or might be "excessive". The following limited points can, however, be made:

(1) *Excess ought to be "demonstrable".* A finding of an abuse – including as to the satisfaction of a "gateway" condition like the Excessive Limb – must be grounded in reason. Finding an abuse of dominance by way of unfair pricing is difficult because price, properly understood, is the outcome of market forces. It is very difficult for courts and regulators to second guess what the outcome of those forces might be in a case where (as with abuse of dominance) the market is not necessarily functioning properly and the price of the product sold is itself under challenge. The satisfaction of both the Excessive Limb and the Unfair Limb cannot properly be grounded in subjectivity ("I think this price is excessive", "I think this price is unfair") but must be objectively determined. It is not enough just to look at the Profit Margin in the graphs at Annex 4 and to say: "That looks excessive to me".

(2) *Persistence of the Profit Margin at a certain level is important.* In markets – particularly dynamic markets – one would expect Product Unit Cost, Product Unit Price and Profit Margin to fluctuate. The Advocate General in the Latvian Copyright Case made the valuable point that excess needs to be seen in its overall context. In this case reliance on the individual monthly figures in Annex 3 is likely to be misleading. The findings of infringement by the CMA in the Decision relate to the Relevant Period, and for that reason we will, when considering the prices and costs of Pfizer and Flynn generally, look to

[80] Tribunal's phrase, accepted by the CMA (CMA Closing/[67]). See also the case law cited at CMA Closing/[65], [66].

averages in relation to each Capsule strength across the entirety of the Relevant Period.

(3) *In the ordinary case, price should sit above cost: the question is by how much?* As we have noted, the loss-making price may in itself be troubling to the competition lawyer, but that is not a matter that needs to be considered here. The question is what level of Profit Margin is "excessive": the words "material", "significant" or even "immoderate" take matters very little further. *United Brands* referred to a price being unfair when a "dominant undertaking has made use of the opportunities arising out of its dominant position in such a way to reap trading benefits which it would not have reaped if there had been normal and sufficiently effective competition".[81] The term "normal and sufficiently effective competition" is helpful: it implies (i) a "real world" case that is not the theoretical construct of perfect competition;[82] but also (ii) a world that is not afflicted by anti-competitive practices such as those described in the Chapter I and Chapter II prohibitions. We will refer to this state as a state of **Real World Competition**.[83]

(8) CMA Cost Plus

(a) What does this mean according to the Decision?

80. The CMA's analysis of the Excessive Limb in Section 4 of the Decision devotes a number of paragraphs to the concept of CMA Cost Plus.[84] Given its importance to the Decision and to these appeals, it is necessary to unpack these paragraphs:

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[81] *United Brands* at [249].
[82] As we have noted, the Appellants contend that Decision is over-reliant on theoretical constructs, and fails to pay due regard to the "real world". The nature of the "perfect competition" model is considered further below.
[83] In preference to the term "workable competition", which was used during the hearing, but which is less clear.
[84] Decision/[4.13] to [4.24].

(1) The Decision recognises that calculating the cost attributable to the supply of the Focal Product is, in and of itself, a difficult question.[85] We agree: but for the reasons given above have concluded that the isolation of what we call Product Unit Cost has appropriately and carefully been done in the Decision; is set out in the Focal Product Spreadsheets; and is not a matter central to these appeals.[86]

(2) The Decision notes that the relevant costs are not necessarily the actual costs of the Focal Product, but the costs "reasonably and efficiently incurred" in production.[87] We will consider this in the context of the cost to Flynn of the Capsules purchased from Pfizer, but it is worth noting that this was a point that featured as a material point in the CMA's oral opening submissions by Mr Holmes, KC:[88]

> …The effect of Pfizer's excess profits is heavily distortive of Flynn's input costs, rendering them highly abnormal. The result is to depress Flynn's return on sales margin, which is simply the percentage by which revenue exceeds costs, and the abnormality of that situation renders any simple comparison of that percentage margin with the percentage margins earned in other contexts unsuitable as a means of assessing Flynn's economic profitability on Capsules.

(3) The costs set out in the Focal Product Spreadsheets comprise the costs of the three Factors of Production that are described in this judgment as Land, Labour and Capital (although they are not described in these terms in the Decision). The costs of the fourth factor of production – Entrepreneurship – are not included in the Focal Product Spreadsheets. This is not a criticism, but it is an important fact to understand. There was a helpful clarification of the position by Mr Holmes, KC, during the CMA's oral opening submissions:[89]

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[85] As recognised in Decision/[4.13].
[86] As we have noted, there was a peripheral challenge to the allocation of Costs between Focal Products, which we have rejected.
[87] Decision/[4.18] and the authorities cited in that paragraph of the Decision. The reason for this "reasonably and efficiently incurred" qualification is twofold: (i) in cases of dominance, the dominant undertaking may – precisely because of its dominance – be less efficient in terms of controlling its costs. This is the case of the "lazy monopolist"; (ii) in cases where an abuse of dominance through unfairly high pricing is alleged, there will be a temptation to lower the Profit Margin by causing costs to inflate.
[88] Transcript Day 3/p.110 (CMA opening).
[89] Transcript Day 3/pp.114 to 119 and 122 to 123 (CMA opening).

(i) The cost of Entrepreneurship is not included in the Focal Product Spreadsheets.[90] Entrepreneurship is our term. From the point of view of the CMA Cost Plus, it is the Reasonable Rate of Return and – as Mr Holmes, KC stated – the "plus in Cost Plus".[91] Given the central importance of the two elements of CMA Cost Plus (Product Unit Cost and the Reasonable Rate of Return), it is and was entirely appropriate for Product Unit Cost to be kept separate from the Reasonable Rate of Return.

(ii) The Decision calculates (at least in some cases) the Reasonable Rate of Return by reference to the capital employed in the Enterprise: the **Return on Capital Employed** or **ROCE**. The other measure used was the **Return on Sales** or **ROS**. In opening, Mr Holmes, KC said this about measuring the Reasonable Rate of Return:[92]

> …the starting point is that a simple return on sales measure is not in itself a good basis for understanding the economic profitability of any activity. To understand economic profitability, one needs to assess the cost of capital and the return that is required to cover it, either directly or indirectly.
>
> Two businesses may have very similar returns on sales but vastly differ in their economic profitability depending on how much capital they have invested, which is not captured in the return on sales figure…
>
> So just to give a couple of homely examples, if I may…So take a street vendor with no capital costs, and a high street store with substantial capital tied up. Let us say they both sell coffee and let us say they achieve the same return on sales: they sell a cup of coffee for £3 and their input costs are £2. So that is the same return on sales, same margin of price over costs. But they obviously have hugely different capital invested which

[90] Transcript Day 3/p.122 (CMA opening): "The answer, I am told, is that cost of capital is both a cost and a return, depending on whose perspective you look at it from…For the business it is a cost which they have to pay to investors to get them to invest their capital, so for them it is a cost. But, equally, for the investors it is a return, it is what they get on their capital. There is, it transpires – you are quite right, Sir, that [the Focal Product Spreadsheets] lack a line which reflects the CMA's assessment of that element of cost or return, the plus in Cost Plus, and that is because, I am afraid…they provided the direct and the fixed costs, but they did not provide that element of their calculation. That can be very rapidly rectified." To be clear – and is discussed in greater detail elsewhere – we consider that the Focal Product Spreadsheets were correctly compiled so as to exclude this item, even if it can be classified (at least in certain contexts) as a cost.

[91] Transcript Day 3/p.122 (CMA opening).

[92] Transcript Day 3/pp.110-112 (CMA opening). Emphasis added.

> should have the benefit of a return, and the underlying profitability, taking account of the cost of capital, would differ significantly between the businesses once that is factored in.

This is a careful and helpful summary of Mr Harman's ROCE approach, to which we will come. It is a problematic example, however, because it is impossible to understand how two Enterprises can sell a Focal Product (i) at the same price, (ii) having similar costs (i.e. Product Unit Costs) and yet (iii) have dramatically different capital costs implicated in the making of the Focal Product. Propositions (ii) and (iii) cannot both be true at the same time. If the high street store in Mr Holmes' example has capital tied up in the production of the cups of coffee sold, then that capital is a Factor of Production having a cost that needs to be included in the Product Unit Cost of each cup of coffee sold.

(iii) We did not press Mr Holmes, KC on the nature of the capital employed by the high street store and not employed by the street vendor. We will come to such differences in due course, when we consider the evidence of the economic experts. Probably Mr Holmes, KC was thinking of Physical Capital in his example. The high street store may have invested in premises, at which the coffee sold could be consumed. The costs of the Physical Capital – to the extent attributable to the production and selling of the cup of coffee – ought to form part of that cup of coffee's Product Unit Cost. Thus, the costs of the high street store would be different to, and higher than, those of the street vendor. This underlines the importance of the distinction between Physical Capital and our primary definition of Capital, namely the money required to acquire the inputs needed to make the cup of coffee. Suppose in order to fund its premises, the high street store borrowed money. That Capital, like Physical Capital, will have a cost that (if it is related to the production of the cup of coffee) will have to feature in the Product Unit Cost of that cup of coffee. This difference in capital employed affects the Enterprise's cost

base or Product Unit Cost. The high street store will, by reason of its greater use of capital, have higher Product Unit Costs than the street vendor.

(iv) All of this concerns Product Unit Cost and not the Reasonable Rate of Return. We are quite prepared to accept, for present purposes, that there is a relationship between capital employed and the Reasonable Rate of Return; just as there must be some form of relationship between Product Unit Cost and Reasonable Rate of Return. Mr Holmes, KC's example, interesting and helpful as it is, says nothing about the Factor of Production that is not included in the Focal Product Spreadsheets, namely the Reasonable Rate of Return or (the same thing by a different label) the cost of Entrepreneurship. For present purposes, it is sufficient to say that we are comfortable with the CMA's exclusion of this element from the Focal Product Spreadsheets.

(4) All of this reflects the approach in the Decision, which is in similar, if less colloquial, terms:

> 4.19 The judgment in *United Brands* only refers to the costs of production, without further definition.
>
> 4.20 The European Commission recognised in *Scandlines* that it is legitimate that a company may want to cover its cost of capital and stated in *Aspen* that "companies are entitled to make a reasonable rate of return, in order to cover their cost of capital". Similarly, the CAT recognised in *Albion Water II* that the relevant components of costs should ordinarily comprise a return on capital. Therefore, when establishing the "costs actually incurred" it will normally be necessary to allocate a reasonable rate of return to cover the cost of capital.
>
> 4.21 It is not necessary to adopt any particular approach to the determination of the "plus" part of the Cost Plus calculation. The identification of a reasonable rate of return is not a matter of "precise mathematics". It is a question of judgement and appreciation on which experts may take differing views. In exercising that judgement, where relevant, regard may be had to the interests of patients and the NHS.

(b) Parsing Profit Margin

81. Product Unit Cost, as we (and the Decision) have defined it, means:

All Product Unit Costs except for Entrepreneurship (aka the Reasonable Rate of Return).

"Cost" in CMA Cost Plus is the cost of all Factors of Production attributable to the production and sale of the Focal Product, except the cost of Entrepreneurship or the Reasonable Rate of Return. The "Plus" in CMA Cost Plus is the Reasonable Rate of Return (aka the cost of Entrepreneurship). Thus, Decision/[4.22] states:

> Having established the "costs actually incurred" plus a reasonable rate of return, it is then necessary to compare it with the selling price and determine whether that margin is excessive.

Similarly, Decision/[5.29] states:

> Once a party's direct and indirect costs have been determined, a comparison of these costs with the selling price will disclose the actual return earned on the product. It is then necessary to determine whether that return is excessive.

The "actual" return can only be a reference to the Profit Margin.

82. These passages are entirely consistent with the cost of Entrepreneurship constituting the "Plus". Indeed, it is dangerous and wrong to regard Entrepreneurship as a cost in the traditional sense at all. That implies some sort of negotiated limit to what the entrepreneur will earn. Such limits exist in the case of the other Factors of Production.[93] The entrepreneur's return will consist of what the market brings: if the entrepreneur's venture fails, then the business will go under, and loss will be sustained. If, on the other hand, the entrepreneur's venture succeeds, then there is no limit (beyond market forces) to the entrepreneur's return. Unlike with costs, where the entrepreneur (or the

[93] The price will be negotiated *ex ante* between providers of Land, Labour and Capital. Of course, it may be that the price is by agreement adjustable by reference to subsequent events, but this is still qualitatively different from the case of the provider of Entrepreneurship, where the return to the entrepreneur depends upon subsequent profitability.

entrepreneur's Enterprise) will negotiate a price, the entrepreneur's return is what the market gives, which is the Profit Margin.

(1) CMA Cost Plus thus draws a necessary and important distinction between two very different items, cost and profit. In the case of a Focal Product, that distinction becomes Product Unit Cost and Profit Margin, as we have defined those terms.

(2) The point about unfair pricing and the Chapter II prohibition is that, in cases of dominance, it is recognised that the entrepreneur's ability to price at will may be abused, resulting in prices that themselves result in Profit Margins that are indefensible and anti-competitive.

83. The importance of the Reasonable Rate of Return to the Excessive Limb is now clear. Bearing in mind that the Reasonable Rate of Return (a relative figure) and the Profit Margin (an absolute figure) are not strictly comparable, if the Profit Margin in any given case is in line with the Reasonable Rate of Return, then no question of excess arises. The Excessive Limb will not be satisfied. It is only where the Profit Margin is materially more than the Reasonable Rate of Return (i.e. where there is a material level of Average Producer Surplus) that questions of excess arise. We do not say – at this stage – that the existence of a material level of Average Producer Surplus *ipso facto* renders the Profit Margin excessive. But it certainly makes such a conclusion available and permissible.

(9) Articulation of the Reasonable Rate of Return in the Decision

(a) Introduction

84. The CMA considered the Reasonable Rate of Return for both Pfizer and Flynn twice, once in the course of framing the Phenytoin 1 Decision and once in the course of framing this Decision. In these appeals, it was suggested that the CMA had paid only lip service to the extent to which the Phenytoin 1 Decision had been overruled on appeal; and that the Decision constituted no more than a re-

working of that which the CMA had done first time round.[94] For this reason, we will describe the approach taken by the CMA over time.

(b) Two methodologies

(i) ROCE and ROS

85. The CMA identified two methodologies by which the Reasonable Rate of Return could be assessed: a Return on Capital Employed approach (ROCE) and a Return on Sales approach (ROS).[95]

(ii) First methodology: ROCE

86. The Decision[96] defines the capital employed by an Enterprise as "the amount of capital deployed in supplying the reference product. This includes all relevant tangible and intangible assets, such as buildings, machinery, office equipment and intellectual property, as well as (net) working capital to cover day-to-day operational financing requirements of the business (e.g. stock, debtors and creditors)". Although it commingles what we call Physical Capital with Capital, this definition is in essence consistent with our definition of Capital.

87. The Decision describes the ROCE approach in the following terms:

> 5.33 The ROCE approach is based on the principle that, under normal market conditions, profits are generated from the use of capital and are related to the level of risk taken. Where capital employed can be reliably measured, the ROCE methodology is generally accepted as the most objective way of calculating a reasonable rate of return and is usually preferable to other methods. Put simply, the ROCE approach assumes that sufficient profits need to be made to pay providers of capital a market-based return on their investment.
>
> 5.34 In other to determine a reasonable rate of return following a ROCE approach, two inputs are required:
>
> 5.34.1 Capital employed: this is the amount of capital deployed in supplying the reference product. This includes all relevant tangible and intangible assets, such as buildings, machinery, office equipment and intellectual property, as well as (net)

[94] These points are fully set out in the grounds of appeal. A sense of the line of attack can be obtained from the cross-examination of Mr Harman by Ms Stratford, KC, examples of which are set out at [46(2)].
[95] Decision/[5.31].
[96] Decision/[5.34.1].

working capital to cover day-to-day operational financing requirements of the business (e.g. stock, debtors and creditors[97]).

5.34.2 Cost of capital: this is the average percentage return that debt and equity investors expect in return for providing funds to a company.

5.35 The reasonable return is calculated, in absolute terms, by multiplying the capital employed in carrying out the relevant activities by the cost of capital. This amount is then added on top of direct and indirect costs to establish Cost Plus.

88. One method of assessing the cost of capital is by use of a measure known as the **Weighted Average Cost of Capital** (or **WACC**), which is defined as a calculation of the average cost of funds used by an Enterprise, based upon the ruling interest rates for debt, the normal yield or capitalisation rate on equity, and the debt-equity ratio.[98] The Decision describes the WACC in the following (consistent) terms:

5.36 Where firms like Pfizer and Flynn fund their investments through a combination of debt and equity finance, it is appropriate to use the weighted average cost of capital (WACC) for the rate of return expected by investors. It represents the average rate of return sought by debt and equity investors, and therefore represents the average cost of capital which can be applied to each Party's capital employed, in order to measure a reasonable rate of return.

5.37 Each component of the WACC is calculated by reference to observable, real world, market data:

5.37.1 The cost of debt: Returns to debt investors take the form of interest payments. The cost of debt can be calculated from observable actual market data, such as a company's actual interest costs, or corporate bond yields on debt issued by firms with a similar credit-rating. It reflects the risks associated with lending to a particular business.

5.37.2 The cost of equity: Returns to equity investors reflect the opportunity cost of investing in one business rather than another. The cost of equity is established in the capital markets, where similar investment opportunities with similar risk profiles compete for financing. It is therefore actual investment opportunities that are available to providers of capital in the real world that set the standard for equity investors' expected rate of return (i.e. for the cost of equity).

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[97] We anticipate that this must include labour.

[98] Moles and Terry, *The Handbook of International Financial Terms*, 1st ed (1999) under: "weighted average cost of capital".

89. The virtue of this approach, according to the Decision, is that it reflects the real world:[99]

> The WACC is therefore based on empirical evidence of actual returns earned across the market over a long period of time. This includes markets of varying states of competition – some markets that have been highly competitive and others that have been less so. The WACC reflects real returns earned, on average, across a range of markets exhibiting different degrees of competition (and therefore allows for the effects of imperfect competition on returns to investors). A return equal to the WACC ensures a company is appropriately compensated for investment in its activities. The authority can then estimate the level of additional profits remaining after providers of capital have received a reasonable (market-based) return on their investment.

90. We have no issues, at least in the abstract, in the use of a ROCE-WACC approach to assessing the Reasonable Rate of Return. We would, however, stress that the risk of confusing Product Unit Cost with Profit Margin must be avoided. Where Capital in the form of money borrowed by an Enterprise to do business is implicated in the production and sale of the Focal Product, its cost as a Factor of Production needs to find its place in the assessment of Product Unit Cost and should not be confused (in any way) with Profit Margin or the Reasonable Rate of Return. That does not mean to say that a ROCE-WACC approach cannot be used to calculate a Reasonable Rate of Return. It is simply that Capital becomes relevant at two points:

(1) *As a cost to be included in the Product Unit Cost.* In producing and selling a Focal Product, an Enterprise will obviously incur costs. As we have described, whilst it is difficult to attribute these to the Focal Product so as to calculate Product Unit Cost, that is what the process of answering the Excessive Limb requires, and that is what the CMA has done in the Focal Product Spreadsheets.

(2) *As a means of assessing the Reasonable Rate of Return.* We can see no reason why a ROCE-WACC approach cannot be deployed with a view to assessing the Reasonable Rate of Return, provided the "Cost" is not confused with the "Plus".

[99] Decision/[5.38].

(iii) Second methodology: ROS

91. ROS stands for Return on Sales. It is described in Decision/[5.40]*ff*. Whereas ROCE was the CMA's preferred means of assessing Proper Return, Flynn contended that the Proper Return was most appropriately assessed by reference to ROS. The CMA disagreed with this (see Decision/[5.102]*ff*), but nevertheless used a form of ROS as a "cross-check" to confirm their (primary) ROCE analysis (Decision/[5.120]*ff*).

92. We consider that the CMA was correct to be sceptical about the usefulness of ROS. The Decision notes that:

> 5.40 ROS is a measure of profit margins. It measures returns relative to revenues, after the deduction of both direct and indirect costs.
>
> 5.41 The ROS approach involves the identification of products or companies that are sufficiently similar to the reference product. Where sufficiently similar comparators can be identified, the authority may infer a reasonable rate of return by applying the comparator ROS to the reference product. In practice, the authority does this by calculating the uplift on costs that results in the required ROS.
>
> 5.42 As ROS measures returns relative to revenues only, it is not directly informative of how returns compare with the capital, activities and risks that are necessary to supply the specific product or service. A ROS cannot be compared directly against the cost of capital for this reason. In fact, a key criticism of the ROS approach is that there is no direct link between the ROS of a company or product and an objective benchmark against which observed returns can be compared.
>
> 5.43 Given this limitation, a ROS analysis is typically only undertaken where:
>
> 5.43.1 there are significant difficulties associated with the ROCE approach (for example, where the identification and valuation of the capital employed in the relevant activities is uncertain or particularly complex); and
>
> 5.43.2 sufficiently similar products or companies can be identified which allow for reliable and meaningful comparisons to be drawn with the reference product.

93. ROS is a measure of how much profit is being produced per £1 of sales. It is a ratio that determines the efficiency at which a company converts its sales into operating profit. It is calculated by dividing operating profit by the value of the net sales. We agree with the CMA that unsatisfactory issues arise if the Excessive Limb is determined by reference to ROS:

(1) The ROS test is explicitly a comparative test. In this it differs from the ROCE approach, which assesses return by reference to objective factors, and which may (as we will come to consider) incorporate reference to comparables.[100]

(2) The problem with comparators is that where one is considering unfair pricing by an undertaking that is *ex hypothesi* dominant, comparators are never direct, because they are only in a limited sense substitutes for the dominant Focal Product. In short, in this context, the ROS comparators are non-substitutable products to which consumers will not default where there is a SNIPP applied to the Focal Product.

(3) ROS can be calculated at many levels of generality, from a specific product up to the ROS of an Enterprise. Here we are interested in the excess of Product Unit Price over Product Unit Cost, which are both metrics calculated by reference to the Focal Product. Where the ROS has been calculated at a less granular level, its value in determining the Excessive Limb is diminished. We do not say it is of no value, but caution must be exercised. A ROS measure will not provide a great deal of information regarding the relationship between Product Unit Cost and Product Unit Price, simply because data relating to another Enterprise's Product Unit Cost is unlikely to be available. To the extent that cost data is available at all, it is much more likely to relate to the comparator Enterprise's overall costs and the relationship of those costs to overall revenue. That is very far from an assessment of Profit Margin by reference to the difference between Product Unit Cost and Product Unit Price.

[100] It may be that the ROS of comparators can inform the Reasonable Rate of Return and/or the WACC, a point we return to below. That is very different from a self-standing ROS test for the Excessive Limb.

(c) The CMA's approach to calculating Pfizer's Reasonable Rate of Return

(i) An admission

94. The Decision says very little in support of its conclusion that Pfizer's prices for the Capsules were excessive. Significant weight appears to be placed on what the CMA appears to have regarded as an admission by Pfizer that its prices were excessive. During the course of the original investigation, the Decision notes that Pfizer's economic expert (Mr Ridyard, who was not involved in the proceedings before us) accepted that Pfizer was making above Normal Profit:[101]

> …Pfizer's own economic expert accepted during the appeal before the CAT that Pfizer's prices were clearly in excess of the costs of supply and above "normal profits":
>
> > Since there is no dispute that the post-genericisation supply prices created margins that comfortably exceeded the costs of supply, and therefore generated profits above the textbook definition of "normal profit", this means that Mr Harman's conclusions on the technical question of whether prices were "excessive" is at best only a very partial part of the total picture. If Mr Harman's conclusion is in effect that the supply prices charged by Pfizer created returns in excess of normal profit, then this is not a point of contention…

95. The Decision appears to treat this as an admission that the Excessive Limb was met in the case of Pfizer. Whilst we accept that the existence of Average Producer Surplus (that part of the Profit Margin above the Reasonable Rate of Return) can be an indicator of excess, the Decision itself does not find that a conclusion of excess inexorably follows from the existence of Producer Surplus.[102]

(ii) Overview of the approach in the Decision

96. Over-and-above this admission, the Decision summarises the basis for its conclusion as follows, beginning with its conclusion in the Phenytoin 1 Decision:[103]

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[101] Decision/[5.53].
[102] Decision/[5.30].
[103] Decision/[5.52].

> In its [Phenytoin 1 Decision], the CMA stated that ROCE would be its preferred measure of return for Pfizer's Products, but considered that there were limitations in the available asset data which reduced reliability when estimating the value of Pfizer's capital employed. In particular, the CMA found that there were difficulties in allocating Pfizer's capital assets to individual capsule strengths. The CMA therefore adopted ROS as its primary method for determining a reasonable rate of return for Pfizer's Products. The CMA considered various benchmarks for what would be a reasonable ROS for Pfizer's Products and…carried out a ROCE assessment to cross check the results of its ROS analysis.

97. The Decision then goes on to say:[104]

> Having reconsidered the matter, and in particular the points made by the CMA in the [Phenytoin 1 Decision] and by the experts during the appeals, the CMA considers that the approach to establishing a reasonable rate of return for Pfizer's Products set out in the [Phenytoin 1 Decision] remains appropriate. That is, the CMA considers that:
>
> 5.54.1 it is able to identify ROS comparators with sufficiently clear characteristics to Pfizer's Products, taking into account relevant factors such as those identified in [Decision/[5.48][105]]; and
>
> 5.54.2 difficulties remain in allocating Pfizer's capital base to individual capsule strengths but sufficient asset data is available to apply the ROCE method as a cross-check.

(iii) <u>The Reasonable Rate of Return calculated by reference to ROS</u>

98. The Phenytoin 1 Decision allocated a ROS of 6% to the Capsules sold by Pfizer.[106] On remittal, that Reasonable Rate of Return was increased to 10%.[107] The explanation and justification for these figures is at Decision/[5.144]*ff*. Because Pfizer did not, in the Pfizer Grounds of Appeal, specifically challenge a finding of excess based upon ROS,[108] we do not consider this aspect any further. That being said, we cannot disregard the question of comparators. Ground 3 of the Pfizer Grounds of Appeal raised – in the context of the Unfair Limb – the CMA's rejection of comparators as properly informative of what constitutes a "fair" price. We will come to consider comparators in due course.

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[104] Decision/[5.54].
[105] This sets out various factors – capital intensity, cost structure, level of risk – that should inform consideration of ROS comparators.
[106] Decision/[5.141].
[107] Decision/[5.143].
[108] That is very far from saying that the approach of the CMA was accepted: it was not.

(iv) The ROCE "cross-check"

99. The CMA's ROS analysis was supplemented by a ROCE "cross-check".[109] Given that we are not examining the CMA ROS-derived Reasonable Rate of Return for Pfizer, consideration of what was explicitly a "cross-check" requires justification. It important to examine the CMA's "cross-check" ROCE analysis for these reasons:

(1) As the Decision explains, ROCE was the CMA's preferred methodology for assessing the Proper Return, in this specific case jettisoned in favour of ROS because (in the CMA's judgment) a ROCE analysis could not robustly be carried out.[110] If, as is our conclusion, the CMA's approach to and understanding of ROCE is defective, such that a ROCE analysis can robustly be undertaken, then that is something that (even absent any appeal by Pfizer on the point) we consider falls within the purview of these appeals because of the issues raised by the Flynn Grounds of Appeal.

(2) The Unfair Limb is informed by the outcomes of the determination of the Excessive Limb:

(i) The Excessive Limb's primary function is to act as a "gateway" to the Unfair Limb. A Profit Margin that is not excessive does not warrant consideration under the Unfair Limb.

(ii) Where a Profit Margin is found to be excessive under the Excessive Limb, it is important to know for purposes of the Unfair Limb how much of that Profit Margin can be justified as constituting a Reasonable Rate of Return. For the purposes of the Unfair Limb, the Reasonable Rate of Return acts as a partial justification of a Profit Margin that has been found to be

[109] Decision/[5.142].
[110] See Decision/[5.52].

excessive under the Excessive Limb.[111] Put another way, the Unfair Limb is concerned with whether the extent to which the Profit Margin exceeds the Reasonable Rate of Return is "unfair".

(3) Given that the ROCE "cross-check" of Pfizer's Reasonable Rate of Return is short and relatively straightforward, it is possible to use it as an illustration as to why the CMA's approach to ROCE is misconceived as regards Flynn, where ROCE was the primary methodology for determining the Reasonable Rate of Return.

100. Accordingly, we turn to the ROCE "cross-check" of Pfizer's ROS-calculated Reasonable Rate of Return:

(1) The CMA ascertained the capital employed by Pfizer in the production and supply of the Capsules.[112] This was calculated as amounting to £3.5m for all Capsule dosages, since "difficulties remain in allocating Pfizer's capital employed to individual capsule strengths".[113]

(2) We will not set out in detail the workings of the Decision as set out in Annex K (which states the CMA's calculation of Pfizer's capital employed). It is sufficient to note that this was a top-down analysis, looking at Pfizer's operations as a whole, which then localised the capital employed to the Capsules as Focal Products, the CMA taking the view that further localisation to specific Focal Products was not possible. An illustration of the complexity of the process is given by Decision/[5.168]/fn 835:

> The CMA has used net book value (NBV) as the basis for valuing Pfizer's fixed assets. Fixed asset values are affected by the age of the assets and the entity's depreciation policy. As such, they are usually revalued to reflect value to the entity. In this case, a top down approach using the total assets of the entity was used as a revaluation was not practical. For this purpose, the CMA considers the net book value

[111] It may be that the point is particularly important here, where Pfizer's Capsule prices are an input cost to Flynn's Capsule prices. On a number of occasions – as we shall see – the Decision comments that Flynn's costs are "inflated" by reason of Pfizer's Capsule prices, thereby artificially eroding the extent of the Profit Margin earned by Flynn in relation to each Capsule dose.
[112] The Decision/[5.168], which refers to the CMA's detailed workings in Annex K to the Decision.
[113] Decision/[5.168].

(NBV) of assets to be a more reliable measure of the current replacement value of fixed (tangible) assets than gross book value (GBV).

(3) A capital allocation of £3.5 million was arrived at in relation to the Capsules (all strengths). The manner in which this figure came to calculated is not apparent from the Decision, and the Tribunal sought further elucidation from the CMA, which is described at [105]. However, the untransparent nature of the Decision does need to be articulated now:

(i) It appears from the face of the Decision (for example, Decision/[5.168]) that this is an annual capital allocation and not one for the entire Relevant Period. Given that the Relevant Period is just over 4 years (September 2012 to December 2016), the capital allocation is either £3.5 million (if that figure relates to the entire Relevant Period) or is in excess of £14 million (if the £3.5 million is an annual figure).

(ii) Table 5.11 of the Decision allocates the capital employed by dosage strength (these total £3,535,133, although the reader must do the totalling). The table is entitled: "Flynn's annual capital employed during the Relevant Period allocated to Flynn's Products, September 2012 to December 2016".

(iii) However, Table 5.12 then calculates a reasonable rate of return, based upon the data in Table 5.11, but in circumstances where the data is expressed across the entire Relevant Period (see Decision/[5.281]), but where the allowance for a reasonable rate of return appears nevertheless to have been calculated by reference to £3.5 million, not a figure north of £14 million.

(iv) The problem is that the workings in Tables 5.12 and 5.13 are difficult if not impossible for the reader to replicate and we sought further elucidation from the CMA (see [105]).

(v) Given its importance, it was imperative that the Decision be clear as to Flynn's capital allocation, and it is not. The figure of £3.5 million and the use that figure is put to are shrouded in a regrettable uncertainty. We have, in the Judgment, treated the capital allocation of £3.5 million as a figure for the entire Relevant Period, despite Decision/[5.168] but because of the difficulties inherent in Tables 5.11 and 5.12. At the end of the day, addressees of a decision are entitled to clarity, and this reading is the one most favourable to Flynn. The figures for the Product Unit Cost of producing and selling the Capsules contained in the Focal Product Spreadsheets were as follows:

Capsule 25mg	**Capsule 50mg**	**Capsule 100mg**	**Capsule 300mg**	**Total**
£1,746,777	£3,422,167	£4,361,959	£2,940,850	£12,471,753

Figure/Table 3: Pfizer's Product Unit Cost of the Capsules over the whole of Relevant Period

There is thus (and bearing in mind the reservations on clarity in the Decision we have articulated) a mismatch between the top-down capital employed figure used by the CMA for purposes of calculating the capital employed in the production of the Capsules (£3.5 million) and the total Product Unit Cost involved in the production of those same Capsules (£12.5 million). The result is that Pfizer's Reasonable Rate of Return on the Capsules is being calculated by reference to a capital employed figure that is around one quarter the size of the total Product Unit Cost of the same Capsules. This mismatch and more generally the relationship between the two needs to be explained.

(4) The reason for independently calculating the capital employed by Pfizer on a "top down" basis is nowhere explained in the Decision. The calculation appears to be based upon an assessment of the level of Physical Capital employed by Pfizer in the production of the

Capsules.[114] Yet, as we have noted, the better definition of Capital is that set out at [60(1)], namely the money required to acquire the inputs needed to make the Capsules. As to this:

(i) Capital so defined is calculated by the Focal Product Spreadsheets and gives the far higher figure of £12.5 million as the Capital employed by Pfizer in the production of all of the Capsules. The CMA's use of a dramatically lower figure (even as a "cross-check") requires justification given that this is a key metric in any finding of excess and given the deliberate disregard of cash flow questions in the Focal Product Spreadsheets. The entrepreneur, in Pfizer's position, seeking to produce the Capsules, will incur costs of £12.5 million, which will have to come from the entrepreneur's pocket (as Capital) or be borrowed as debt (also Capital) or consist of equity (again Capital). Put another way, the entrepreneur, in this case, is at risk to the tune of £12,471,753: yet the Reasonable Rate of Return to the entrepreneur is being computed by reference to a far lesser sum. Of course, the static model shows that the entrepreneur's risk taking was beneficial to the Enterprise to the extent of the Profit Margin. The Profit Margin is, itself, a static or summative measure. To increase that margin by *discounting* Product Unit Costs (because those costs would be less given the existence of future revenues) without also *discounting* Product Unit Price to take account of the way in which Profit Margin is calculated is something that needs to be carefully justified. The mixing of static and dynamic modelling needs to be closely justified.

[114] It is unclear to us precisely what definition of capital was being used. We use the term Physical Capital as the best approximation, but it seems to us that (as we have defined the term) it is too narrow. But equally, this was not an assessment of "working capital" and still less an assessment of Capital as defined in this Judgment and by Mr Harman.

(d) Calculation of Flynn's Reasonable Rate of Return

(i) An overview

101. In the Phenytoin 1 Decision, the CMA considered that the ROCE methodology would not be appropriate in order to determine the Reasonable Rate of Return to Flynn on the Capsules. This was due to difficulties in measuring the level of capital assets employed by Flynn. The CMA therefore adopted a ROS methodology.[115]

102. As to the ROS methodology:[116]

> Having identified a relevant ROS benchmark (the PPRS), the CMA then assessed the risk and investment profile of Capsules against that benchmark. The CMA concluded that Flynn's supply of Capsules was less risky and required less investment than the benchmark average. The CMA chose to adopt the benchmark average ROS as a conservative proxy for a reasonable rate of return for Flynn's products.

103. By way of "cross-check", Mr Harman was deployed before the Tribunal to apply a ROCE methodology in order to test the reasonableness of that ROS methodology.[117] On reconsideration for purposes of the Decision, the CMA pivoted away from ROS to a ROCE methodology.[118] As to this:[119]

> In view of all the available evidence, including the evidence obtained after the [Phenytoin 1 Decision], the CMA considers that the difficulties previously perceived in measuring Flynn's capital base are no longer well founded. In practice, the evidence shows that the ROCE methodology can be applied to Flynn's products because:
>
> 5.61.1 the information and submissions provided by Flynn clearly identify the capital that is employed in its supply of Capsules;
>
> 5.61.2 the data provided by Flynn allows this capital to be quantified and valued reliably (and for sensitivities to be applied); and
>
> 5.61.3 the CMA is able to identify a reliable estimate of Flynn's cost of capital.

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[115] Decision/[5.56].
[116] Decision/[5.56].
[117] Decision/[5.57].
[118] Decision/[5.62], [5.64].
[119] Decision/[5.61].

Aside from its general preference of ROCE over ROS, the CMA was – by the time of the Decision – less in favour of the ROS methodology it had espoused in the Phenytoin 1 Decision, considering there to be "significant conceptual issues which render the use of a ROS analysis problematic in Flynn's case".[120] The specific reasons for abandoning ROS were:[121]

(1) The CMA had "reviewed the data provided by Flynn",[122] and concluded that "[i]n view of all the available evidence, including the evidence obtained after the [Phenytoin 1 Decision]…the difficulties previously perceived in measuring Flynn's capital base are no longer well founded".[123]

(2) The "high input cost that Flynn agreed to pay to Pfizer as part of the Parties' arrangement suppresses Flynn's profit margins, such that significant profits earned by Flynn can be associated with low computed percentage margin. Profit margin analysis thus allows Flynn to rely on its position in the supply chain and its arrangement with Pfizer to insulate Flynn's own supply prices from the effective application of Chapter II".[124]

(3) The "combination of a number of product-specific factors (including high sales volumes and a very low level of commercial risk as well as the high input cost incurred by Flynn) result in unusual economics of supply, with the consequence that it is very difficult to identify meaningful ROS comparators for Flynn's supply of Capsules".[125] This reason overlaps with the immediately previous reason (i.e. that the price to Flynn is "unusual" in regard to Flynn's costs.)

[120] Decision/[5.63].
[121] A version of the ROS methodology was, however, used as a "cross-check" of the ROCE approach that came to be used: Decision/[5.66].
[122] Decision/[5.58].
[123] Decision/[5.61].
[124] Decision/[5.63.1].
[125] Decision/[5.63.2].

(ii) The ROCE methodology as applied to Flynn

104. We consider the CMA's ROCE analysis in the case of Flynn in greater detail because Flynn did challenge the finding that its prices were excessive,[126] and specifically challenged the ROCE approach adopted in the Decision.[127]

105. The approach taken was as follows:[128]

(1) The CMA began by estimating capital employed by Flynn in the supply of the Capsules during the Relevant Period by combining amounts for Flynn's stock requirements and working capital requirements.[129] As in the case of the Pfizer ROCE assessment, that assessment of capital employed was done independently of the exercise of assessing Capsule Product Unit Costs as derived from the Focal Product Spreadsheets.

(2) The CMA used a figure of £2.8 million as the value of Flynn's stock requirements based on the value of Flynn's observable closing stock balances as at 31 March 2014.[130] Flynn's observable stock balances were split between capsule strengths as set out in the table below:[131]

	Capsule	Stock Balance
[1]	25mg	£113,490
[2]	50mg	£314,938
[3]	100mg	£1,300,738
[4]	300mg	£1,073,754
[5]	**Total**	**£2,802,920**

Figure/Table 4: The CMA's assessment of stock requirements

[126] See Grounds 1 and 2 of Flynn's Grounds of Appeal.
[127] See Ground 1 of Flynn's Grounds of Appeal.
[128] See CMA letter to the Tribunal dated 31 July 2024.
[129] Decision/[5.222], [5.234], [5.235].
[130] Decision/[5.235].
[131] See CMA letter to the Tribunal dated 31 July 2024 and XD2/3/1.

(3) The CMA estimated that Flynn's working capital requirements were £0.7 million based on its average net position in relation to debtors and creditors. The CMA calculated this amount using Flynn's purchase and sales data and estimates of average debtors and average creditors days based on Flynn's contractual terms.[132] Estimates were calculated in relation to each capsule strength as set out in the table below:[133]

	Capsule	Trade Debtors	Trade Creditors	Net position (debtors minus creditors)
[1]	25mg	£207,084	£79,103	£127,981
[2]	50mg	£422,947	£238,493	£184,454
[3]	100mg	£1,455,139	£1,219,533	£235,605
[4]	300mg	£990,733	£806,561	£184,173
[5]	**Total**	**£3,075,903**	**£2,343,690**	**£732,213**

Figure/Table 5: The CMA's assessment of working capital requirements

(4) By combining the stock requirements and working capital requirements, the CMA estimated the annual value of the capital employed by Flynn in distributing the Capsules during the Relevant Period to have been £3.5 million. Combining the stock requirements and working capital requirements amounts by capsule strength gives the total capital employed figures set out as follows:[134]

	Capsule	Capital employed	
[1]	25mg	£241,471	
[2]	50mg	£499,392	
[3]	100mg	£1,536,343	

[132] Decision/[5.234].
[133] See CMA letter to the Tribunal dated 31 July 2024.
[134] Decision/[5.258] and Decision/[Table 5.11]. The process by which this conclusion was reached – which was controversial – is described in Decision/[5.223] to [5.257].

[4]	300mg	£1,257,927	
[5]	Total	£3,535,133 (100%)	

Figure/Table 6: The CMA's assessment of the capital employed by Flynn in the production of the Capsules

Given that Flynn's costs of acquiring the Capsules from Pfizer were £70.2 million across the Relevant Period,[135] the mismatch between the discretely assessed capital employed for the Capsules and the Product Unit Cost disclosed by the Focal Product Spreadsheets of the Capsules is again evident, just as it was in the case of Pfizer, and for exactly the same reason.[136]

(5) A WACC was then applied to these figures to find a percentage Reasonable Rate of Return, which the Decision put at 9%[137] but increased to 10% out of deference to Flynn's submissions.[138]

(6) It is necessary to set out very clearly the mismatch between the Decision's assessment of the capital employed by Flynn in the distribution of the Capsules (£3.5 million or perhaps £14 million plus, without differentiating between strengths)[139] and the total Product Unit Costs disclosed by the Focal Product Spreadsheets, which were £74,156,575, broken down as £70,791,347 (direct costs) and £3,365,228 (common costs). Flynn's total Product Unit Cost (£74 million) is thus some 21 times higher than the CMA's assessment of the capital employed (£3.5 million). As in the case of Pfizer, what is here evident is a "mixing and matching" of the static and dynamic approaches, without any justification or explanation as to how the critical figures are obtained and operate together.

[135] Of course, this figure is very high because of the high price of the Capsules as charged by Pfizer to Flynn.
[136] See [100(4)].
[137] Decision/[5.261].
[138] Decision/[5.277].
[139] In fact, the capital was £3,535,133, the total of the figures in Table 5.11 of the Decision.

As described in the case of Pfizer, this is a mismatch that requires careful consideration. Since the assessment of the Reasonable Rate of Return was a central part of the Flynn Grounds of Appeal in regard to the Excessive Limb, we turn now to describe all aspects of Flynn's challenge to that aspect of the Decision.

(10) Flynn's challenge of the CMA's findings

(a) The Grounds of Appeal

106. Apart from penalty, Flynn's Grounds of Appeal largely focussed on the Excessive Limb, although a number of these points had "two barrels" and also involved an appeal against the findings in the Decision as regards the Unfair Limb. The Grounds of Appeal are lengthy. To the extent that they relate to the Excessive Limb, they were as follows:

(1) *The use of an inappropriate measure (that is ROCE, as described above) to compute the Reasonable Rate of Return.*[140] Given that the selection of a proper measure is unequivocally one of matters that falls within the judgmental discretion of the CMA, the mere fact that a different approach could have been taken – or perhaps should have been taken – is insufficient to justify any interference with the approach in the Decision. Appreciating this, this ground of appeal goes well beyond suggesting that the test for the Excessive Limb could have been better selected, and so was inappropriate. The challenge articulated in the Flynn Grounds of Appeal in substance contends that the approach taken by the CMA was an arbitrary and irrational one, and that its adoption, put bluntly, was not capable of being defended on objective grounds.[141] Flynn's point was that the CMA's approach involved an indefensible shifting away from ROS (the measure used in the Phenytoin 1 Decision) to ROCE (the measure used in the Decision). The CMA's reasons for

[140] See generally, Flynn Grounds of Appeal/[102]*ff*, although we have disaggregated what is a somewhat wide-ranging ground of appeal.
[141] See Flynn Grounds of Appeal/[104]: "Flynn submits that ROCE is not a suitable nor rational measure for assessing Flynn's prices or profitability, nor is it aimed at the correct legal test. The CMA should instead have used a ROS measure, as it did in its Original Decision."

the shift did not hold water,[142] and constituted an inappropriate deployment of discretionary judgment.[143]

(2) *The Reasonable Rate of Return as assessed by the CMA is wrong.* The essence of Flynn's challenge in this regard was that the CMA's finding that a return of £350,000[144] per year from Flynn's capsules was a Reasonable Rate of Return was so wrong as to be indefensible.[145] Thus, it is said that ROCE (at least as applied by the CMA) was an irrational or unsuitable measure.[146] In particular:

(i) The ROCE-WACC as deployed in the Decision was not measuring a Reasonable Rate of Return at all:[147]

> In an instructive interaction between Mr Harman and the Tribunal [during the course of the first appeal]…Mr Harman accepted that a WACC-based analysis of the kind relied upon by the CMA was based on the theory that a company's returns on capital would over the long-term converge with its WACC; was only its "break-even" price for the product; and could not itself be used to determine whether a price is excessive. The CMA has applied precisely this analysis as its (sole) measure of excessiveness in its latest Decision, the only difference being that it has substituted a 9% WACC benchmark taken from Pfizer's internal documents with a 10% WACC benchmark taken from Pfizer's internal documents with a 10% WACC benchmark taken from a presentation given by Jefferies investment bank.

The point is taken further in Flynn's Grounds of Appeal/[123]:[148]

> …the CMA's chosen methodology is aimed at identifying a floor below which investors would not be incentivised to invest in and supply the product. This was precisely the limited role that ROCE played in the Original Decision. At the hearing of the original appeal, Mr Lomas, it is submitted correctly, interpreted the CMA's ROCE cross-check (upon which it

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[142] See, in particular, Flynn Grounds of Appeal/[105], [108] ("…no intelligible justification for the change of position…"), [109] ("…[t]he CMA has not identified any material new evidence to justify its change of position…"), [111] ("…[t]he very fact that the CMA now purports to rest its finding of liability entirely upon a method of calculating an appropriate return that it (and its expert) previously deprecated shows the fragile underpinning of the Decision…").
[143] Flynn Grounds of Appeal/[125].
[144] The capital employed was found to be £3,500,000, and the WACC 10%, which is £350,000.
[145] Ground 1: Flynn Grounds of Appeal/[102] to [103].
[146] Flynn Grounds of Appeal/[103] to [104].
[147] Flynn Grounds of Appeal/[106(d)].
[148] Also, in similar vein, [124].

> placed limited weight as described above) as being to identify the "break-even" price below which no business would theoretically supply the product. The CMA's economist confirmed this in his report where he said "I do not suggest…that a finding of a high ROCE for a particular Flynn product would be indicative of excessive pricing…I use ROCE only to cross-check that the 6% ROS is sufficient to meet Flynn's working capital requirements.

(ii) The capital present in Flynn (Flynn's capital base) – to which the WACC was applied – was either incorrectly assessed (in which case a different measure should have been used) or else impossible to assess (in which case a different methodology should have been used).[149]

(iii) There was a failure properly to assess the risks assumed by Flynn, and so a failure to assess (at all) the Reasonable Rate of Return:[150]

> …a ROCE assessment is unable to take account of intangible assets created by Flynn's activities, and the risks inherent in that activity. The CMA appears to accept at [Decision/[5.72][151] that this represents a problem for a ROCE analysis, but does not find that it justified a different approach on the facts of this case because "the CMA has found that Flynn's capital base can be measured reliably". The CMA thus treats the issue as one of measuring (i.e. quantifying) Flynn's capital base. However, Flynn's objection is that the CMA's analysis fails to take into account intangible activities, skills and risks which by their very nature cannot be quantified. In this regard, the CMA has understated the risks faced, and the value added, by Flynn's role in the supply chain. As explained in more detail in Ground 5 below, as an MA holder, Flynn is obliged to undertake considerable pharmacovigilance activities, which in turn require the application of human skill and expertise which cannot properly be quantified in any

[149] Flynn Grounds of Appeal/[110], [114], [115], [117].
[150] Flynn Grounds of Appeal/[118].
[151] Which states: "…the identification, valuation and inclusion of intangible assets as part of the capital base would lead to substantially lower observed ROCEs. While there can been difficulties in identifying and measuring these types of assets, the CMA frequently undertakes such analysis in its assessments of firms' financial performance. The CMA, therefore, does not consider the existence of material intangible assets per se to be grounds for moving away from the ROCE framework entirely and adopting a different (potentially less reliable) measure in its place. Instead, it requires the authority to undertake careful analysis of the value of intangibles. In this case, the CMA has carefully considered Flynn's submissions on the presence of intangible assets in its supply of Capsules. The CMA has found that Flynn's capital base can be measured reliably, and the evidence and representations provided by Flynn do not support the existence of material intangible assets in the capital base required for the supply of Capsules…".

> ROCE assessment. The risks inherent in the responsibilities undertaken by Flynn are similarly intangible.

Flynn's challenge was to all aspects of the ROCE-WACC used by the CMA: (i) it was seeking to measure something other than the Reasonable Rate of Return (as we term it); (ii) in doing so, it failed properly to assess Flynn's true capital base or failed to accept that this was impossible to assess, and so should have adopted an altogether different methodology; and (iii) failed to apply a proper return to capital, instead adopting a return of 10% which was too low given the risks that Flynn was assuming when undertaking to sell the Capsules. As a result, the Decision reached a conclusion as to Flynn's absolute profitability (£350,000/annum) that was neither rational nor rationally defensible.[152]

(3) *Failure to pay due or any regard to the fact that Flynn's returns were in line with normal returns in the pharmaceutical industry.* This is Ground 2 in Flynn's Grounds of Appeal.[153] Flynn rely on a number of distinct data sets to suggest that Flynn's actual returns were not excessive because they were in line with what the industry charged. As to this:

(i) It is clear that comparators are relevant to an assessment of the Excessive Limb, and we do not understand the CMA to dispute this. What was disputed was the extent to which the CMA failed to have proper regard to this material. Flynn's case as to the failure of the CMA to consider this data was follows:

> 151. The CMA's obligation to consider comparators is addressed at [76] to [84] above. In its Original CAT Judgment, the Tribunal held that the CMA "should have examined more closely the various comparators put forward by Flynn, amongst other factors, appropriately weighted, to establish the right benchmark price" ([358]). Flynn therefore expected, and has repeatedly requested, the CMA to carry out a proper examination of profitability comparators in the

[152] Flynn Grounds of Appeal/[120], [121], [142]ff.
[153] Flynn Grounds of Appeal/[150]ff.

> market, and to use them on a weighted basis to assess the normal competitive level of returns in the industry. This is what the Tribunal did in *Napp* and the Commission did in *Aspen*; and what the Tribunal directed the CMA to do in its Original CAT Judgment.
>
> 152. Instead, the CMA has steadfastly rejected all of Flynn's comparators, on a binary basis. Its position appears to be that phenytoin capsules are so unique that no meaningful comparison can be drawn with <u>any</u> other product or company, even on a weighted basis. Thus, [Decision/[5.119]] says "it is very difficult to identify truly comparable products and companies that can be relied upon sufficiently for the purposes of the CMA's assessment". This conclusion, however, involves a double standard. The CMA has applied a counsel of perfection to Flynn's comparators, rejecting them because they do not mimic exactly the features of phenytoin capsules, while its own (sole) ROCE "comparator", the 10% figure mentioned in a document prepared by Jefferies investment bank is not tailored to the features of phenytoin <u>at all</u> and was prepared for entirely unrelated purposes…

(ii) In brief – it will be necessary to consider these in greater detail – the comparators that the CMA failed properly to consider were:[154] (i) the ROS of Flynn's other products in its portfolio;[155] (ii) the ROS of two particular companies with a similar business portfolio to Flynn (Alliance Pharma plc and Martindale);[156] (iii) the weighted average ROS of 11 comparator companies selected by Mr Williams;[157] (iv) the weighted average ROS of four particularly close competitors selling substantial quantities of AEDs;[158] (v) the percentage margins over input price earned by vendors of phenytoin tablets (specifically, Teva, Wockhardt UK and Accord UK);[159] and (vi) the findings of the EU Commission in *Aspen*.[160]

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[154] They are summarised in Flynn Grounds of Appeal/[153].
[155] Flynn Grounds of Appeal/[156]ff.
[156] Flynn Grounds of Appeal/[169]ff.
[157] Flynn Grounds of Appeal/[169]ff.
[158] Flynn Grounds of Appeal/[174].
[159] Flynn Grounds of Appeal/[185]ff.
[160] Flynn Grounds of Appeal/[187]ff.

(4) *Failure to pay proper heed to Flynn's input prices.* We have already commented on the Decision's eliding of Pfizer's prices with Flynn's costs, with a view to suggesting that Flynn's costs are somehow inflated or to be discounted. The Grounds of Appeal articulate this criticism in the following terms:

> 132. It is a repeated refrain of the Decision that Flynn and Pfizer set their prices in concert, and that Flynn was not entitled to "take advantage" of the allegedly excessive input prices charged by Pfizer for phenytoin. For example, [Decision/[1.16]] refers to an agreement between Flynn and Pfizer which enabled them to "significantly increase their prices and share the substantial profits generated between them". Likewise, [Decision/[5.111]] refers to the "distortionary effect of the (jointly agreed) Pfizer supply price on Flynn's margins".
>
> 133. This characterisation of the parties' supply arrangements colours multiple aspects of the Decision, such as the CMA's justification for using a ROCE rather than a ROS analysis; its reliance upon absolute, rather than relative, returns; and its rejection of Flynn's proposed comparators.
>
> 134. The allegation of an unlawful, or at least circumspect, agreement to share profits is not, however, sustainable in law or in fact. The allegation was not pursued at the administrative stage of the investigation. On the contrary, the CMA conducted an investigation into a possible breach of the Chapter I prohibition arising out of Pfizer's and Flynn's supply arrangements, and decided to drop it.
>
> 135. The true position is that Flynn only "agreed" to pay Pfizer's prices in the sense that the purchaser of a product in a supply chain agrees prices when it agrees to pay the price charged by the upstream seller…

(5) *Flynn's actual prices are in line with the comparators adduced by it.* This is Flynn's Ground 3.[161] The Grounds of Appeal state:[162]

> In addition to Flynn's margins being in line with comparable products and companies, Flynn's prices were also in line with those of the closest conceivable comparator: the phenytoin tablet. They were also consistent with the prices of comparably effective AEDs. Accordingly, Flynn's prices were neither excessive nor unfair, since they were not out of all proportion with the economic value of comparable products.

We do not consider that this is a Ground of Appeal that relates to the Excessive Limb. The Excessive Limb is concerned with the margin of

[161] Flynn Grounds of Appeal/[199]ff.
[162] At [199].

price over cost – the extent of the Price Margin, as we have called it. The price charged – which will almost always be an absolute price, and certainly was here – is nothing to the point. This is, for the avoidance of doubt, a Ground of Appeal that we consider in relation to the Unfair Limb: but it has no place here.[163] We mention it only because we would not want it said that we have disregarded this Ground of Appeal.

(6) *Flynn's alleged excessive prices are not sufficiently high to support a finding of excessiveness.* This is Flynn's Ground 4.[164] Flynn asserts that "the ultimate test for excessive pricing is whether the prices under examination are out of all proportion with the economic value of the product or service being supplied".[165] We do not agree that this correctly states the nature of the test under the Excessive Limb: the Excessive Limb is concerned with the Profit Margin, the excess of price over cost, not with the level of the price itself.[166] It also appears, at first sight, that this Ground duplicates the ground considered above: namely that the CMA failed properly to assess the Reasonable Rate of Return. However, this is not the essence of Ground 4:

> 268. The Decision proceeds on the basis that a price is excessive and/or unfair, and therefore meets this test, whenever a price is materially above "cost plus". Thus, [Decision/[7.32]] finds:
>
> Given that Flynn's prices significantly exceeded its Cost Plus, the CMA has concluded that they bore no reasonable relation to the economic value of Flynn's products.
>
> 269. As the Court of Appeal has held, economic value must be considered as part of the excessive and/or unfair limbs of the test for abusive pricing…In Flynn's submission, it is likely to be appropriate to consider economic value at both limbs, since they are each designed to assist the court or tribunal in deciding the overall question of whether the impugned prices bear no reasonable relation to the value of the product.
>
> 270. Flynn addresses the CMA's errors in finding that phenytoin capsules, and Flynn's activities in supplying them, have no economic value beyond "cost plus" in Ground 6 below. In this

[163] So, too, but for different reasons, is the point at [119].
[164] Flynn Grounds of Appeal/[267]ff.
[165] Flynn Grounds of Appeal/[267].
[166] It would, thus, be perfectly possible for a dominant Enterprise to price similarly to others in the market, but nevertheless, because of its lost Product Costs, to price excessively when others (selling at the same price) were not.

> Ground 4, Flynn focuses on the CMA's prior error that any material difference between "cost plus" and the prices actually charged, or margins actually earned, by an undertaking is conclusive of excessive or unfair pricing.

This ground thus raises the altogether distinct question of the relevance of the Producer Surplus. As we have described, the Average Producer Surplus is that excess over the Reasonable Rate of Return that is charged in the Product Unit Price. The question raised in this ground is whether a Product Unit Price sitting materially above the Reasonable Rate of Return (i.e. where there is an Average Producer Surplus) is inevitably excessive. Put another way, can the existence of a material Average Producer Surplus be justified so as to render the Product Unit Price charged not excessive under the Excessive Limb? Although the Decision pays lip service to the notion that a price in excess of the Reasonable Rate of Return is not necessarily excessive,[167] it does not attempt to articulate the circumstances in which this might be the case. The thrust of the Decision is that once Product Unit Cost plus a Reasonable Rate of Return has been exceeded, the Excessive Limb is satisfied.[168]

(b) Order of consideration of these Grounds of Appeal

107. These Grounds of Appeal are dealt with in the following order:

(1) Section G(11) considers whether the CMA was justified in departing from the ROS methodology used in the Phenytoin 1 Decision in favour of a ROCE methodology. Essentially, the question is the extent to which the ROCE-WACC measure used in the Decision was an arbitrary and irrational choice of measure, indefensible on objective grounds.[169]

(2) Section G(12) considers whether the CMA improperly treated Flynn's input prices for Capsules (i.e. what it paid to Pfizer) as something other

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[167] See Decision/[5.30]: "…It is possible for an undertaking to price above Cost Plus without those prices being…excessive…". This paragraph says the same about the Unfair Limb, which is not here under consideration.
[168] See, purely by way of example, Decision/[5.29] and [5.31].
[169] This is the point described at [116].

than costs to Flynn, thereby distorting its consideration of the very question before it, namely whether Flynn's Product Unit Prices were excessive and in breach of the Excessive Limb.[170]

(3) Section G(13) considers the CMA's ROCE-WACC calculation. We approach this question on the basis that the choice between ROCE and ROS in favour of ROCE was properly made by the CMA and confine ourselves to a consideration of the criticisms made by Flynn of the CMA's process and methodology. This Section thus considers the points summarised at [100] and [105], namely the CMA's use of ROCE-WACC (i.e. its assessment of the capital employed by Flynn and its calculation of the Rate of Reasonable Return). We do not, in this Section, deal with questions regarding the CMA's failure to consider comparables (see [214] and [218]), which are the subject matter of later consideration in Section G(14).

(4) Section G(14) considers questions relating to the CMA's use of the comparables advanced by Flynn in support of its contention that the Excessive Limb was not met in their case (i.e. that Flynn's prices were not excessive).

(5) The Reasonable Rate of Return sits above Product Unit Cost. Any Price materially within sight of the Reasonable Rate of Return (i.e. not materially above Product Unit Cost plus a Reasonable Rate of Return) will not be excessive. The attack by Flynn on the CMA's approach was a root and branch attack on the ROCE-WACC methodology as used in the Decision. That attack had three elements (as we have described them):

(i) The methodology did not seek to assess a Reasonable Rate of Return at all, but rather was assessing what might better be called a return to investors in the Enterprise (which is not the same thing).

[170] This is the point described at [134].

(ii) ROCE has two elements, the capital used and the return on capital. Flynn contended that both of these metrics, as used by the CMA, were wrongly assessed to Flynn's disadvantage: the capital employed was assessed at too low a level, and the return on that capital was itself too low.

Even assuming in the Decision's favour (i) that a ROCE approach was the correct one, (ii) the capital employed by Flynn had been correctly assessed and (iii) the Reasonable Rate of Return properly assessed by reference to a proper return on the capital employed or otherwise, Flynn nevertheless contended that even if the Product Unit Price sat materially above the Product Cost plus a Reasonable Rate of Return, the existence of a Producer Surplus did not render the Product Unit Price or the Profit Margin excessive. This is considered in Section G(15).

(c) Approach to appeals on the merits

108. The approach to appeals on the merits was set out in detail in *BGL (Holdings) Ltd v. The Competition and Markets Authority*.[171] Essentially:

(1) The Tribunal must determine appeals on the merits and by reference to the grounds of appeal set out in the notice of appeal. The appeal is not by way of judicial review. The question is not whether the decision under appeal is within the range of reasonable responses of the decision-maker, but whether the decision was the right one.

(2) That being said, where the decision involves an overall value judgment, based upon competing issues of policy or judgment in the context of a public policy decision by a public authority, it might be difficult for the Tribunal to conclude that a decision within the range of reasonable responses was not also right. The same is true where the decision-maker has determined the process or methodology by which the final,

[171] [2022] CAT 36 (***Compare The Market***) at [36]*ff.*

substantive, decision is to be made (e.g., a choice between ROCE and ROS; or a choice as to approach in terms of market definition).

(3) On the merits appeals are not *de novo* appeals. The decision under appeal is taken as read, save to the extent challenged in the grounds of appeal. The decision is reviewed through the prism of the specific errors alleged by the appellant in the grounds of appeal; where no errors are pleaded in the grounds of appeal, the decision will (to that extent) not be the subject of specific review.

(4) Although the decision-maker has a margin of appreciation, which gives latitude as to policy, methodology and approach, the decision-maker must conduct a fair evaluation of all of the evidence before it, including that adduced by the addressees of the final decision. The Tribunal will pay deference to the decision-maker's exercise of judgment, but at the end of the day must itself exercise a merits jurisdiction and come to its own conclusion on questions of both fact and law. The Tribunal is not bound to defer to the decision-maker's judgment call, but is empowered to come to its own conclusions, including on the basis of fresh evidence. However, the Tribunal should only interfere in a decision where that decision is wrong in a material respect. The Tribunal should not interfere with a decision upon the basis of an error that is slight or *de minimis* and must, when it does interfere, give its reasons for doing so.

109. It is trite that the legal burden of establishing an infringement under competition law is on the CMA, and that the standard of proof is the ordinary civil standard of the balance of probabilities.[172] Because competition cases are *quasi*-criminal in nature, the presumption of innocence applies.[173]

[172] *Compare The Market*/[56].
[173] *Compare The Market*/[59].

(11) Departure from ROS methodology in the Phenytoin 1 Decision

(a) Introduction

110. The CMA's original approach to assessing the Reasonable Rate of Return was based upon ROS. The ROS (set at 6%) was based upon the **PPRS** rate.[174] PPRS stands for the Pharmaceutical Price Regulation Scheme, a voluntary agreement between the DHSC and the Association of British Pharmaceutical Industry which applied to manufacturers and suppliers of branded medicines to the NHS, whether patented or not.[175] The Capsules changed from a branded product to an unbranded product on the commencement of the agreement between Pfizer and Flynn.

111. This ROS assessment was criticised by the Tribunal in *Phenytoin 1* (CAT) not because ROS was an inappropriate methodology, but because a single point of reference – the PPRS – was both too narrowly framed (i.e. other points of reference should have been taken into account) and (as a single point of reference) it was not very good.[176]

112. It is unnecessary to consider these criticisms by the Tribunal in *Phenytoin 1* (CAT) in any greater detail, for the CMA did not re-do a ROS analysis, but pivoted away from that methodology in favour of a ROCE analysis. The criticism advanced by Flynn was that the CMA had abandoned a methodology it had previously found appropriate in favour of an altogether different methodology for no sufficient reason.

113. We appreciate that in general terms ROCE is the CMA's preferred approach; and we consider that there is good reason for that preference. However, this preferred approach was not used in the Phenytoin 1 Decision, and it is this change in approach that is the subject of the Flynn Grounds of Appeal.

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[174] *Phenytoin 1* (CAT)/[326] to [339].
[175] See the description in *Hydrocortisone 1*/[106(1)].
[176] The point is obvious: the PPRS did not extend to unbranded products, and these were unbranded products. In effect, the CMA's "comparator" comprised a *de facto* extension of a price control that was limited, on its face, to branded products. We have some difficulty in seeing this as a comparator at all.

(b) The justifications for abandoning ROS

114. We note that the Tribunal in *Phenytoin 1* (CAT) criticised the Phenytoin 1 Decision not for its adoption of a ROS methodology, but because the ROS methodology selected was inflexibly and wrongly applied. *Phenytoin 1* (CAT) cannot therefore be used by the CMA as a justification for the move to a ROCE methodology and – to be clear – the CMA never advanced this as a reason or justification for the change in methodology. Nevertheless, even absent any suggestion by the Tribunal that the methodology ought to be re-considered, it is our view that when a decision is remitted to the CMA it is for the CMA to re-visit its approach in the round, including as to fundamental methodology, even where the methodology is not a reason for the remission. It is not appropriate to fetter the CMA in terms of its approach on remission, even where there is only a partial remission. The CMA will, on remission, consider all the circumstances and, in its judgment, take an appropriate course. We consider that the CMA was entitled – indeed, obliged – to consider whether the methodology used in the Phenytoin 1 Decision continued to be appropriate; and, if inappropriate or if a better methodology suggested itself, to consider a change to that better or more appropriate methodology. This is a question of judgment for the CMA, which (even on the basis of an on the merits review) the Tribunal should be slow to revisit.

115. However, we do not consider that a change in methodology such as that from ROS to ROCE here under consideration can properly be made by the CMA for no reason at all. There needs to be an essential consistency of approach between decisions in regard to the same subject-matter. In this case, therefore, some objective justification for the shift from ROS to ROCE in the case of Flynn needed to be provided in the Decision. That objective justification, however, will be approached by the Tribunal in the manner described at [114].

116. In this case, particularly given the CMA's preference of ROCE over ROS (a preference which the CMA was entitled to express and with which we agree), we consider that the change in approach from ROS to ROCE is one that has been adequately explained in the Decision and we reject this ground of appeal. More particularly:

(1) The Decision explains the CMA's original approach in the Phenytoin 1 Decision at Decision/[5.56] to [5.60], and concludes (at [5.61]) as follows:

> In view of all of the available evidence, including the evidence obtained after the [Phenytoin 1 Decision], the CMA considers that the difficulties previously perceived in measuring Flynn's capital base are no longer well founded. In practice, the evidence shows that the ROCE methodology can be applied to Flynn's Products because:
>
> 5.61.1 the information and submissions provided by Flynn clearly identify that capital that is employed in its supply of Capsules;
>
> 5.61.2 the data provided by Flynn allows this capital to be quantified and valued reliably (and for sensitivities to be applied); and
>
> 5.61.3 the CMA is able to identify a reliable estimate of Flynn's cost of capital.

As we have noted, we consider that the CMA must, when reconsidering a decision like the Phenytoin 1 Decision, keep an open mind as to how its decision-making processes and methodologies can be improved, including (i) by re-visiting the earlier decision substantively, even if there is no change in the evidential material before the CMA and (ii) by considering what new material there may be. This Tribunal should be slow to disagree with such decisions.

(2) In this case, although the ROS methodology had not, in general terms, been criticised in the CAT Decision, its specific application had been. The CMA was obliged to reconsider the question of methodology, and we see nothing surprising in the CMA moving to its (in principle) preferred ROCE methodology. Certainly, such a shift cannot, in and of itself, be criticised as arbitrary or irrational.

(3) We do not consider as relevant the criticisms advanced by Flynn of the ROCE-WACC methodology used by the CMA in the Decision itself. We will come to the correctness of that approach in due course, since it constitutes a separate ground of appeal by Flynn. But the errors that may or may not exist in the granular ROCE-WACC approach adopted by the CMA in the Decision are entirely irrelevant to the anterior

methodological decision of the CMA to move away from ROS to ROCE.

(4) Nor do we consider it appropriate to review in detail the additional material identified by the CMA as enabling it to undertake the ROCE assessment which, in the Phenytoin 1 Decision, it considered itself unable to undertake. As we have said, it is for the CMA to consider what methodology is appropriate, and this Tribunal should be slow to second-guess such consideration. The role of the Tribunal is not to re-visit in granular detail the manner in which the CMA has reached a decision, but rather to consider the substance of the decision ultimately reached by the CMA according to the methodology selected by the CMA. In short, even if (which we do not consider to be the case) there was insufficient reason to justify the move away from ROS, we do not consider this to be an error that would justify our varying the Decision, particularly when the ROCE approach is a well-recognised one. This is, we consider, a case well-within the CMA's margin of appreciation, with which the Tribunal should not interfere.

117. Although it makes no difference to our conclusion in relation to this ground of appeal, we consider the high input cost to Flynn of the Capsules it obtained from Pfizer to constitute a bad reason for abandoning the ROS methodology. This is a separate ground of appeal, which we consider in Section G(12). We should however be clear that absent a finding of improper (Chapter I) collusion or abuse of collective dominance, we do not consider that it is appropriate to characterise as "excessive" the price for Capsules that Pfizer charged to Flynn; nor to use that "excess" to drive methodological choice in terms of assessing the Excessive Limb. This was a reason articulated by the CMA for moving away from ROS to ROCE:[177] for reasons we will come to, this was an insufficient (indeed, erroneous) reason for moving away from ROS. But we consider that the CMA has articulated sufficient reasons, independent of this one, to justify the change in approach, and so this error is not a material one.

[177] See [131].

118. We are not saying that the price charged to Flynn by Pfizer for the Capsules is irrelevant. As we have noted, and as the Decision records,[178] costs need to have been reasonably and efficiently incurred when considering Product Unit Cost. That is where any adjustment to Flynn's costs ought to have been made.

(12) Flynn's input prices for Capsules

(a) The point advanced by Flynn

119. The Flynn Grounds of Appeal state that it is a "repeated refrain of the Decision that Flynn and Pfizer set their prices in concert, and that Flynn was not entitled to "take advantage" of the allegedly excessive input prices charged by Pfizer for phenytoin".[179]

120. We have already noted that this consideration informed the CMA's choice of methodology and that this was a reason why the CMA preferred ROCE over ROS as a methodology. We have concluded that this was an illegitimate consideration in terms of the CMA's selection of methodology, but that the CMA had other reasons to justify its change in approach.

121. With that introduction, we turn to consider the present ground of appeal, which has implications going well beyond the mere choice of methodology that we have already considered.

(b) The uncontroversial background

122. The Decision sets out in detail the background to the infringements.[180] The thrust of the consideration is that Pfizer and Flynn entered into agreements that resulted in the branded product sold by Pfizer – Epanutin – being (i) de-branded; (ii) taken off the PPRS (which involved price controls over branded products

[178] Decision/[4.18].
[179] See the quotation at [106(4)].
[180] Decision/[2.193]*ff*.

being side-stepped);[181] and (iii) exclusively sold by Pfizer to Flynn.[182] The Decision states:

> On 24 September 2012, Flynn launched its products under the MHRA-approved product name "Phenytoin Sodium Flynn Hard Capsules"[183] and at supply prices significantly above those historically charged by Pfizer under the PPRS.

123. The Decision notes the "significant price increases imposed by both Pfizer and Flynn pursuant to the arrangements described above",[184] with consequent increases in the **Drug Tariff** rates:[185]

> The Drug Tariff prices for phenytoin sodium capsules were based on Flynn's list price and also increased significantly [after the arrangements between Pfizer and Flynn were concluded]. The Drug Tariff price is the price that the NHS (i.e. CCGs) pays dispensers for dispensing phenytoin sodium capsules. During the Relevant Period the Drug Tariff prices of phenytoin sodium capsules increased by 2,285% compared to the Drug Tariff prices prior to Pfizer entering into the arrangements with Flynn.

It will be necessary to consider the Drug Tariff rates for the (pharmacologically similar) Tablets, which were relied upon by both Pfizer and Flynn in their Grounds of Appeal. It is therefore appropriate to set out how the Drug Tariff operated, for it is not accurate to refer to the Drug Tariff as a price:[186]

(1) Pharmacies are reimbursed (by CCGs) for each prescription that they fulfil for a patient.[187] The reimbursement level is what we refer to herein as the Drug Tariff.[188]

(2) The same reimbursement rate is paid to a pharmacy irrespective of which supplier's product it dispenses or the price the pharmacy pays for that product.[189]

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[181] See [333(5)].
[182] The arrangements concluded are summarised in Decision/[2.251] to [2.252].
[183] Although it might be said that the reference to "Flynn" was a form of branding, it was common ground before us that this reference was intended for Continuity of Supply purposes, and did not constitute branding for PPRS or any other purposes.
[184] Decision/[2.277].
[185] Decision/[2.321].
[186] We derive these propositions from *Hydrocortisone 1*. They are not controversial.
[187] *Hydrocortisone 1*/[64(3)].
[188] *Hydrocortisone 1*/[64(3)].
[189] *Hydrocortisone 1*/[64(4)].

(3) The amount of the reimbursement – or the level of the Drug Tariff – bears no necessary relationship to the amount paid by the pharmacy to obtain the medicinal product that is prescribed.[190]

It is in the interests of a pharmacy to obtain the best price possible for the medicinal products that it dispenses. That is because this maximises the margin between the pharmacy's cost (i.e. what it pays for the drug) and the rate at which it is reimbursed. Equally, even a dominant or monopoly provider of a pharmaceutical product will pay heed to the Drug Tariff rate. Although pharmacies cannot typically refuse to stock prescribed products, all providers recognise the need to provide some margin to pharmacies (i.e. some margin between the price charged to the pharmacy and the Drug Tariff rate). Of course, where competition exists as between rival providers of the same (in prescription terms) pharmaceutical product, the margin will widen to the benefit of pharmacies, because of competition between the sellers of the product.[191]

124. The effect of the increases in price on the NHS is also noted in the Decision:[192]

> Prior to the Parties' September 2012 price increases, the NHS's annual spend on phenytoin sodium capsules was approximately £2.3 million. As a result of the price rises, the NHS's spend on phenytoin sodium capsules in 2013 increased to approximately £50 million, more than 20 times its previous annual spend.

The impact of the price increases "attracted strong criticism, in particular from CCGs, which pay the cost of phenytoin sodium capsules from their prescribing budgets. A number of those CCGs wrote to the Parties, the DHSC and others voicing concerns regarding the impact of the price increases on their budgets".[193] This "compromised CCG's ability to provide other healthcare services".[194]

125. The foregoing is obviously highly relevant background; and no-one challenged the findings of the Decision in this regard.

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[190] *Hydrocortisone 1*/[64(3)].
[191] Of course, the Drug Tariff is not a static, unchanging, rate. It is adjusted (by mechanisms that we do not need to describe) so that the margins paid to pharmacies are not themselves excessive.
[192] Decision/[2.326].
[193] Decision/[2.409].
[194] Decision/[2.425].

(c) The findings of the Decision

126. It was the conclusion of the Decision that:

(1) Pfizer's prices for the Capsules were excessive and unfair; and (separately)

(2) Flynn's prices for the Capsules were excessive and unfair.

127. Because there were four Capsule strengths, there were as a result eight distinct infringements of the Chapter II prohibition, four infringements on the part of Pfizer and four infringements on the part of Flynn. However, it was not the conclusion of the Decision that there was any competition law infringement in the arrangements between Pfizer and Flynn but that independently of each other:

(1) The prices charged by Pfizer infringed the Chapter II prohibition; and

(2) The prices charged by Flynn infringed the Chapter II prohibition.

In other words, there was no finding of collusion in breach of the Chapter I prohibition; and no finding of an abuse of joint dominance.[195]

128. The starting and finishing point is that (as regards the Capsules supplied by Pfizer to Flynn) Pfizer was acting as seller and Flynn as buyer and that Pfizer's price to Flynn was a cost that Flynn had to bear. Given the absence of any finding of infringement in the arrangements between Pfizer and Flynn, Pfizer and Flynn must be regarded as independent parties in the supply chain. Any other approach – whether by the CMA in the Decision or by this Tribunal on appeal – to proceed on the basis of an infringement not found would involve a disregard for the presumption of innocence and a reversal of the burden of proof, which rests on the CMA.

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[195] As Whish and Bailey, *Competition Law*, 10th ed (2021) note at 602, this is a controversial area. It is considered at 602 to 610, but we do not need to consider this controversial area, because no finding of abuse of collective dominance was found by the CMA.

(d) The reasoning in the Decision

129. The reasoning in the Decision is at variance with the findings of infringement actually made in the Decision. The reasoning proceeds on the basis that there was an infringement of competition law going beyond that found in the Decision. Thus, the Decision states:[196]

> The high prices that the Parties imposed were the result of an agreement between them under which Capsules were de-branded and removed from the [PPRS], so that they could significantly increase their prices and share the substantial profits generated between them.

130. We do not see how the statement that there was a sharing of profits can properly be made without a finding of either (i) an infringement of the Chapter I prohibition or (possibly) (ii) an abuse of joint dominance. Neither of these findings have been made by the CMA in the Decision. Whilst, no doubt, the higher prices resulting from the arrangements between Pfizer and Flynn are relevant background, the only permissible conclusion of the fact that Pfizer was charging a high price to Flynn was that this was a cost to Flynn. Anything going beyond this constitutes an implied finding of infringement which is (as we have indicated) an improper abandonment of due process.

131. Decision/[1.16], which we have quoted above, constitutes an accurate summary of the reasoning in the Decision. This is a point that pervades the Decision:

(1) The Decision notes that "the high input cost that Flynn agreed to pay Pfizer as part of the Parties' arrangement suppresses Flynn's profit margins, such that significant profits earned by Flynn can be associated with a low computed percentage margin".[197] Although we appreciate that this paragraph concerns the Decision's choice of methodology, it betrays a sense that Flynn's cost base is somehow not real ("suppresses") and that the Profit Margin (defined as the difference between Flynn's Product Unit Price and Product Unit Cost) is artificially low. We do not

[196] Decision/[1.16] (emphasis added).
[197] Decision/[5.63.1].

consider such a conclusion to be sustainable without a finding of a Chapter I infringement between Pfizer and Flynn.

(2) Later on in Section 4, the Decision states:[198]

> In failing to recognise and control for the distortionary effect of the (jointly agreed) Pfizer supply price on Flynn's margins, Flynn's proposed ROS comparisons proceed on a flawed basis and would undermine the effective application of Chapter II.

Thus, the comparators advanced by Flynn are rejected for a bad reason. It is to our mind not relevant that Flynn deployed these comparators in connection with a ROS analysis. The comparators are also relevant to a ROCE analysis, and were similarly not taken into account.[199]

(3) We have already set out, and commented upon, those aspects of the Decision rejecting the ROS methodology in favour of the ROCE methodology. The Decision explains the converse position – why the Flynn-advocated ROS methodology was not adopted in the following terms:[200]

> The CMA sets out its views on the suitability of using the ROS approach to determine a reasonable rate of return for Flynn's Products in [5.102] to [5.119]. In doing so, the CMA explained why it considers there to be significant conceptual flaws in applying a ROS approach and that these are particularly acute in the specific circumstances of Flynn's Products. In particular, the CMA considers that:
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> 5.289.1 Flynn's standalone ROS analysis is not informative of how returns compare to the investment required by Flynn to supply

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[198] Decision/[5.111] (emphasis added).

[199] See also Decision/[5.117] (emphasis added):

> For these reasons, the CMA does not consider it appropriate to test the excessiveness of Flynn's Prices exclusively by reference to simple, unadjusted ROS comparisons with other products and other companies, which fail to take account of Flynn's arrangements with Pfizer. To do so would be to ignore specific (and highly relevant) features of Flynn's supply of Capsules and to introduce a circularity problem in the calculation of Flynn's reasonable rate of return.

Also Decision/[5.121]:

> …These conceptual issues are driven primarily by the high input cost that Flynn itself agreed to pay to Pfizer as part of the arrangements between the Parties.

And Decision/[5.217.2]:

> …a ROS approach is particularly problematic to apply in Flynn's case. This is because Flynn's agreement to pay very high supply prices to Pfizer distorts an assessment of the appropriate ROS for Flynn's Products. It means that significant profits earned by Flynn can be associated with a low computed percentage margin and that truly comparable products or companies are very difficult to identify for Flynn's supply of Capsules.

[200] Decision/[5.289] (emphasis added).

capsules and the risks assumed in doing so. A standalone ROS analysis therefore provides little insight into the underlying economic profitability of Capsules.

5.289.2 Simple ROS analyses fail to take account of Flynn's arrangements with Pfizer and thereby allow Flynn to rely on its position in the supply chain to hide the true scale of its profitability.

5.289.4 The unusual features in Flynn's supply of Capsules have the consequence that relevant ROS comparators are very difficult to identify.[201]

(4) The implied finding that Pfizer and Flynn had been acting improperly also infects those parts of the Decision dealing with the Unfair Limb. Thus, the Decision records:[202]

> The Parties implemented significant price increases which resulted in very high prices (relative to costs) and went well beyond any level that might have been required to ensure the drug was commercially viable or sustainable:
>
> (a) Pfizer increased its prices by between 783% and 1,602% and Pfizer's average excess above Cost Plus across all capsule strengths was 416%.
>
> (b) Flynn's prices were between 2,366% and 2,682% higher than Pfizer's previous prices.[203] The difference between Flynn's Prices and Pfizer's Prices (i.e. Flynn's mark up) was between 662% and 1,800% higher than the prices Pfizer previously charged for Capsules. Flynn's excesses alone (which were on average 47% above Cost Plus across all Capsule strengths) were several multiples of the prices that Pfizer previously charged.

This passage elides Pfizer and Flynn and treats them as jointly exploiting market power to their joint benefit.[204] The reason why this has been done

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[201] It is clear from other (later) parts of the Decision that Flynn's comparators were discounted because of the high cost to Flynn of the Capsules "distorted", in the CMA's eyes, the comparators that Flynn was relying on. See, for example, the detailed analysis at Decision/[5.295]*ff*, summarised at Decision/[5.289] to [5.294].

[202] Decision/[6.6.1] (emphasis added).

[203] Thus, as against Flynn, the primary driver of the finding of unfairness is the difference between Flynn's prices and the prices previously charged by a different Enterprise (Pfizer) disregarding the costs charged by that Enterprise to Flynn for the product whose prices are said to be unfair.

[204] See also Decision/[6.7] and [6.8] (emphasis added):

> The Parties imposed very significant price increases overnight on the NHS…Prior to the arrangements entered into between the Parties…

And Decision/[6.10] (emphasis added):

> …as a result of the arrangements entered into between the Parties, Pfizer no longer supplied Capsules to wholesalers and pharmacies as it had done previously. Instead, Pfizer brought Flynn into the supply chain and imposed its significant price increases at an upstream level.

appears from Decision/[6.6.1]: the CMA obviously were of the view that Flynn's own mark up – at 47% – was insufficient to justify a finding of unfairness, hence the reliance on a joint form of infringement. We say nothing about this apparent view of the CMA, save to note that 47% is not very much out of line with the comparators relied upon by Flynn and discounted by the CMA. There is, thus, a palpable sense of the Decision reasoning towards the conclusions the CMA wanted to find, without pausing to consider the evidence in the round nor the infringements actually found by the CMA.

(5) When considering the unfairness of Flynn's prices, the Decision finds:[205]

> As part of the arrangements entered into between Pfizer and Flynn, Flynn willingly agreed to pay Pfizer supply prices which were up to 17 times higher than the prices Pfizer had previously charged to wholesalers and pharmacies.[206] Flynn did this in return for the exclusive rights to supply a product which it knew had very high barriers to entry. Flynn then imposed large price increases on top of the significant price increases already charged by Pfizer,[207] resulting in supply prices to Pfizer's previous customer base that were between 2,366% and 2,682% higher than Pfizer's previous prices. As the CAT recognised, whilst Pfizer's supply price was a price floor for Flynn, "Flynn was, in practice, pricing well above this level and could have reduced its prices and still made a material profit".[208]

(e) Analysis and conclusion

132. The Flynn Grounds of Appeal record that there was no improper collusion between Flynn and Pfizer, and that "[t]he true position is that Flynn only "agreed" to pay Pfizer's prices in the sense that the purchaser of a product in a

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[205] Decision/[6.17] (emphasis supplied).

[206] In terms of comparison with previous prices, see also Decision/[6.18] (emphasis added):

> The scale of the price increases was such that Flynn's mark up alone (i.e. the differences between Flynn's Prices and Pfizer's Prices) amounted to several multiples of the prices Pfizer previously charged…

[207] The point that the Decision fails to address is that Pfizer's prices charged to Flynn were Flynn's costs. The point is really so obvious that the failure to address it simply shows that the CMA were treating Pfizer and Flynn as one entity, acting collusively, such that costs between the two could properly be disregarded.

[208] If we may respectfully say so, the (differently constituted) Tribunal rendering the CAT Decision identified the critical question, which was Flynn's Profit Margin (i.e. the difference between Flynn's Product Unit Costs and its Product Unit Price). This sentence is the Decision is one of the few – *en passent* – acknowledgements of the costs to Flynn of the prices charged by Pfizer.

supply chain agrees prices when it agrees to pay the price charged by the upstream seller…".[209]

133. We need reach no conclusion as to what the "true position" was: we can see why a regulator might have found improper collusion and/or abuse of joint dominance on the facts of this case. The point is that the CMA did not do so, and it would be improper for this Tribunal to decide an appeal against a finding of an infringement of competition law by reference to infringements not found. As is clear from the passages quoted at length above, the entire Decision is underpinned by assertions that Flynn's costs in regard to the Capsules were not true Product Unit Costs but were instead a ruse to disguise the massive profits that Pfizer and Flynn were jointly making. In other words, the Decision approaches the Profit Margin as one calculated by reference to the difference between Pfizer's Product Unit Cost and Flynn's Product Unit Price.

134. This was an illegitimate consideration, disregarding the presumption of innocence, the rights of defence and the burden of proof. It has distorted the approach in the Decision. It is difficult to say by how much, but the following distortions are plain to see:

(1) The narrative of the Decision looks to the difference between Pfizer's Product Unit Cost and Flynn's Product Unit Price, resulting in a Profit Margin that is inconsistent with the found facts. We appreciate that it could be said – and said rightly – that the Focal Product Spreadsheets contain the correct figures, such that Pfizer's Profit Margin and Flynn's Profit Margin can correctly and properly be discerned. We accept this and (as is already clear) place considerable reliance on the very careful and helpful work underpinning the Focal Product Spreadsheets. But that cannot alter the fact that when describing margins or price increases or the difference between price and cost, the Decision is making an illegitimate finding regarding the relationship between Pfizer and Flynn.

[209] Flynn's Grounds of Appeal/[135].

(2) The reason the CMA has taken this approach is easy to discern. It appears to be that when one looks to Flynn's percentage returns of profit over cost (the metric that drives ROS), they did not (at least to the CMA) look all that unreasonable.[210] Instead of assessing whether these margins infringed the Excessive and Unfair Limbs (which a fair consideration requires) or instead of entertaining the possibility that there might in fact be no infringement at all, the CMA has permitted itself to disregard an inconvenient truth and to structure its analysis to avoid addressing it.

(3) This has distorted the CMA's approach in a number of respects, in addition to those already described. Thus, it constituted a reason for moving away from ROS to ROCE. It is a reason why the CMA has placed so little reliance on the comparators put forward by Flynn in support of its prices. It is the reason why the CMA has been so keen to avoid relative (percentage) measures of margin in the case of Flynn, concentrating instead on absolute measures and – when referring to relative measures – comparing Flynn's prices to the prices previously charged to the market by Pfizer.[211] In short, in order to make good its findings, the CMA has relied on prices from a period preceding Flynn's participation in the market, which (*ex hypothesi*) were not Flynn's prices.

135. All of this undermines the legitimacy of the findings in the Decision so far as Flynn is concerned, both as regards the Excessive Limb and the Unfair Limb. The Decision cannot stand as against Flynn and – as it seems to us – the approach of the CMA is undermining of the findings in regard to Pfizer also. That is because precisely the same elision has occurred. Of course, Pfizer's Profit Margin, both in absolute and in relative terms is high (and higher than Flynn's) during the Relevant Period, and it is significant that Pfizer placed far less stress on this point than did Flynn. But it will be necessary to re-consider Pfizer's Profit Margin in due course for this reason.

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[210] We stress that this in no way should be taken as an indication of the Tribunal's views.

[211] Thus impliedly suggesting that the de-branding of the Capsules was itself illegitimate. No-one suggested that the de-branding was not something permissible; and there is no finding to this effect in the Decision.

(13) The CMA's ROCE-WACC calculation

(a) Introduction

136. The ROCE-WACC turns upon two parameters: (i) an assessment and determination of the capital employed by the Enterprise in producing the Focal Product; and (ii) an assessment and determination of the proper return on that capital. The manner in which the Decision calculated and determined these parameters has already been described.

137. The CMA calculated the capital employed without reference to the Focal Product Spreadsheets, preferring instead the approach described at [104] to [105]. It will be necessary to unpack this approach in greater detail, but before doing so it is helpful to restate the purpose of assessing the capital employed and its return:

(1) The objective is to understand whether the price charged by the Enterprise for the Focal Product is excessive for purposes of determining whether the Excessive Limb is or is not met.

(2) In this case, the question of excess needs to be addressed in relation to the entire Relevant Period. That is the period over which Pfizer's and Flynn's prices were found to be infringing. Averaging the monthly figures in the Focal Product Spreadsheets and in Annex 3 will, therefore, be appropriate, so as to avoid spikes or troughs in individual months having a misleading effect.

(3) To test whether the Excessive Limb is met, it is necessary to isolate the Product Unit Costs and the Product Unit Price. In this case, the Product Unit Price is the price at which the relevant Capsule strengths were sold. The Product Unit Cost has already been described. It comprises the costs of all Factors of Production involved in making a unit of Focal Product (i.e. a pack of Capsules of a given dosage) excluding

Entrepreneurship,[212] but including Land, Labour and Capital.[213] Entrepreneurship is excluded as a cost because it constitutes the value actually under consideration when determining the Excessive Limb. The cost of Entrepreneurship is the Profit Margin (the difference between Product Unit Cost and Product Unit Price), which may or may not be excessive.

(4) The Focal Product Spreadsheets contain this data, which was unchallenged by the parties, accepted by us and drives the data set out in Annex 3. One point of terminology needs explanation:

(i) The Focal Product Spreadsheets contain no borrowing costs for either Pfizer or Flynn. If borrowing were a cost in producing the Focal Products (and nothing turns on whether it was or was not), then that cost (i.e. interest) would be a line item in the Focal Product Spreadsheets.

(ii) Using the terminology we have adopted, the borrowing would be Capital and any interest paid, if included as a cost, the cost of that Capital.

(iii) This cost needs to be differentiated from the Reasonable Rate of Return and measures used to calculate it. One of these, the WACC, which was deployed by the CMA, itself refers to "cost of Capital". Unless we are very careful, the term cost of Capital can be highly misleading because of this ambiguity as between cost of Capital and cost of Entrepreneurship. The WACC is being used to assess the latter and not the former.

(5) The difference between Product Unit Cost and Product Unit Price is (when used for the purposes of *United Brands*) a static and not a dynamic measure. It is a measure divorced from on-going business

[212] See [93(3)].
[213] See [93(3)].

activities. The measure looks neither to the future nor the past but provides a snapshot of the costs needed to produce that particular Focal Product and the revenue that particular Focal Product generates, disregarding entirely how that product is actually made and how it is actually sold. That is what the CMA did when compiling the Focal Product Spreadsheets. Given what is being assessed, the measure is rightly divorced from the reality of how the Enterprise actually makes money.

(6) This is obvious from the manner in which the Focal Product Spreadsheets have been calculated. Fixed costs were apportioned by quantity produced, but these costs are incurred generally and can only be related to the Focal Product unit by a methodology that has nothing to do with the manner in which costs are actually incurred. To take another example, suppose an Enterprise employs a chief accounting officer, responsible for accounts of the Enterprise, producing many products, including the Focal Product. A small fraction of the chief accounting officer's salary will have to be allocated to the Focal Product, but that is entirely unrelated to how or why the cost was incurred in the first place.

(7) The process can be looked at in a stylised way as follows:

An Enterprise produces 100,000 units of product per year, comprising 50,000 of Product A, 30,000 of Product B and 20,000 of Product C. Product C is the Focal Product		50,000 units (Product A) 30,000 units (Product B) 20,000 units (Product C) **100,000 (Total)**
The costs of producing all these products is: A machine (Capital) costing £100,000 with a life of 10 years. A person (Labour) costing £25,000 per year Raw materials (Land (raw materials) [214]) costing £100,000 in total per year		Annualising these costs, the cost of producing the 100,000 units is £10,000 (Capital) £25,000 (Labour) £100,000 (raw materials) **£135,000 (Annual Total Cost)**

[214] We noted earlier (at [60]) that the labels attaching to Factors of Production sometimes left something to be desired. This is a case in point: "Land" is an inappropriate label for "materials" and it may be that a better term for "Land" as a Factor of Production is "raw materials". For this reason, we use the term "raw materials" in preference to "Land" in this table.

These costs are used to produce the three product types in the following proportions: Product A: capital 20%, labour 30%, raw materials 50% Product B: capital 30%, labour 50%, raw materials 20% Product C: capital 50%, labour 20%, raw materials 30%		Product A (50,000 units) Capital = £2,000 Labour = £7,500 Raw materials = £50,000 **Total Cost = £59,500** **Product Unit Cost = £1.19** Product B (30,000 units) Capital = £3,000 Labour = £12,500 Raw materials = £20,000 **Total Cost = £35,500** **Product Unit Cost = £1.18** Product C (20,000 units) Capital = £5,000 Labour = £5,000 Raw materials = £30,000 **Total Cost = £40,000** **Product Unit Cost = £2.00**

Figure/Table 7: Stylised example of costs allocation to generate a Product Unit Cost

It was common ground that this was the purpose of calculating Profit Margin. The matter was aired in the "hot tub", when discussing the Tribunal's hypothetical "coffee shop" example, to which we will come in greater detail:[215]

Q (The President)	…the narrower question is to what extent are we simply looking at, in regard to the individual product, a cost of that product versus the price of that product, and to what extent to we need to worry about the overall profitability of an undertaking that is selling more than just infringing products?
A (Ms Webster)	Oh, I see. So, I will ground my answer in seeking to understand whether the price of the coffee product is abusive, in which case I would say it is relevant to consider the costs associated with the supply of that product.
Q (The President)	To be clear, what you are doing is you are taking a definition of cost that is articulated by reference to the product whose price is said to be excessive?

[215] The coffee shop example is set out in Annex 5. Transcript Day 8/pp.41*ff* (expert concurrent evidence).

A (Ms Webster)	Yes.
Q (The President)	I will go across. Does anyone have anything to add or subtract from that? Mr Harman, you are in particular happy with that?
A (Mr Harman)	I am happy with that, but just to extend one of the reasons why. I think it is important to focus on the infringing product rather than the company as a whole because in part we are trying to determine what is the outcome in a normal and sufficiently effective competitive marketplace, and if you are thinking about the portfolio as a whole, you are now starting to make assumptions about the nature of competitors, that they would also have a portfolio of businesses where there may be cross-subsidisation between them and that may not be the case. I think that, if there was a particular product where there were no barriers, then competition could emerge in the supply of that product.

Mr Harman puts very clearly the imperative to consider unit costs and unit prices. This is important not merely when considering whether, in the abstract, the Focal Product's price is excessive, but also the extent to which the costs/prices of comparator products need to be adjusted in order to render them truly comparable.

(b) Terminology: "floors" and "ceilings" and the gap in-between

138. To assist in discussing the Excessive Limb and – later – the Unfair Limb, the language of "floors" and "ceilings" (and "mezzanines", to which we will come) was used. The graphs in Annex 4 show a stratum – coloured blue – which is bounded by a "floor" (the Product Unit Cost) and a "ceiling" (the Product Unit Price). This is what we call the Profit Margin and it is to the Profit Margin that the question of excess is directed. The Excessive Limb says nothing about the propriety of the Product Unit Price. That is a matter for the Unfair Limb. All that we are asking, as the threshold or gateway condition, is whether the stratum is "demonstrably immoderate" to use one of the many variants expressing the essence of the Excessive Limb. The mezzanine – a low storey between two others in a building, typically ground and first floor – concerns the question whether the Product Unit Price is correctly located or whether it is an unfair

price failing the Unfair Limb of *United Brands*. The price charged is the price charged: nothing can change that, and the ceiling in the graphs will always remain where it is located. The question is whether the price so charged is infringing of competition law or (to use our building analogy) whether the circumstances require the court to identify the need for a mezzanine that is materially lower than the ceiling constituted by the Product Unit Price actually charged. If the answer to that question is Yes, then the Unfair Limb will be met.[216]

139. For present purposes, we are concerned with the Excessive Limb. Flynn challenged the CMA's approach in this regard,[217] and it will be necessary to consider the CMA's approach, and the attack on it, in some detail. Our approach is as follows:

(1) We describe the meaning of Real World Competition, a term coined in [79(3)] above. It will be necessary to consider how this relates to the notion of Normal Profit and the Reasonable Rate of Return. This is considered in Section G(13)(c).

(2) We consider in Section G(13)(d) the judgmental factors that go into properly determining the Profit Margin and, in particular, the assessment of Product Unit Cost.

(3) We consider the Decision's assessment of the capital employed by Flynn in Section G(13)(e).

(4) We consider the Decision's assessment of the proper return on that capital employed in Section G(13)(f).

[216] The building analogy was used during the course of the "hot tub", the cross-examination of the experts and in closing. See, e.g., the exchanges at Day 8/p.125 (expert concurrent evidence).
[217] See [106].

(c) Real World Competition

140. We treat Real World Competition as synonymous with the phrase "normal and sufficiently effective competition" coined in *United Brands*. It is competition in a market that produces outcomes in terms of price that are realistically pro-competitive: in other words, a market that is operating as it should. The outcomes of such a market – specifically in terms of price – are ones that should not be second-guessed. They are the outcomes of the market economy that runs through the DNA of Western competition law.

141. Real World Competition is emphatically not perfect competition, a model that we will come to, and which the CMA was accused of being over-reliant on in the Decision. Real World Competition is that state where (according to applicable national competition law) there is no cause for competition law intervention. In short, it is that economic state that pertains where there is no collusion (contrary to the Chapter I prohibition) and either no abuse of dominance (contrary to the Chapter II prohibition) or no dominance at all.[218] We regard Real World Competition as the relevant counterfactual starting point when considering either a Chapter I or Chapter II prohibition. More specifically:

(1) Undertakings participating in markets said to be affected by competition law infringements are, when such infringements are being assessed, entitled to be judged in an environment where they are able to act in their own interests to the maximum extent permitted by law. In other words, even an infringing undertaking needs to be judged according to the standards of ordinary competition law, and not some higher standard which does not represent the environment of Real World Competition.

(2) That is why, when considering whether there has been a competition law infringement, the approach is to assume a counterfactual where the infringement does not occur. Where the alleged infringement is of the

[218] It may be that Real World Competition will be characterised by other competition law controls, notably merger control and subsidy control. These aspects of competition law did not arise in this case, and (save to recognise that they may, in other cases, be relevant to an articulation of what is a state of Workable Competition) we say no more about them.

Chapter I prohibition, the relevant counterfactual is the world as it was at the time of the infringement minus the infringing arrangement.

(3) So too in all cases of abuse of dominance, except where the allegation is that the price of the Focal Product is too high. Such cases are exceptional. It is not possible to hypothesise a counterfactual case where the abuse is removed and the consequences of this assessed, because we do not know what the counterfactual "fair" price should be: that is the very object of the inquiry. Where the allegation is that the price is too high, it is not possible without pre-determining matters to postulate what the proper price would be in the counterfactual world.

142. This definition of Real World Competition was put to Mr Majumdar during the course of the expert "teach in", and he was happy with it.[219] The nature of the "teach-in" was such that questions were put to the experts in turn, and in this case, Mr Majumdar went first. None of the other experts disagreed with the point. The concept of Real World Competition was considered in some detail by the Tribunal in *HG Capital LLP v. Competition and Markets Authority* (***Liothyronine***).[220] We refer to [126] to [137] in that decision, which we gratefully adopt as a clear statement of the relevant law:

> 126. A central theme of the appeals in the present case was the argument that, in rejecting the various comparators relied on by the Appellants to justify Advanz's prices, the CMA had ignored the basic test for unfair pricing, as set out in United Brands and Phenytoin, which was the need to show that "the dominant undertaking has reaped trading benefits which it could not have obtained in conditions of normal and sufficiently effective competition, i.e. workable competition."
>
> 127. 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 to this appeal that these 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.

[219] Day 7/pp.48 to 51 (Tribunal's questions to Mr Majumdar); Day 9/p.104 (cross-examination of Mr Majumdar).
[220] [2023] CAT 52.

128. The comparator of Post Entry prices relied on by the Appellants raised an issue as to whether, four years after new entrants began to compete in the market for Liothyronine Tablets, there was normal, sufficiently effective and workable competition, such that the prices were a valid comparator, or whether, despite the lapse of time, the prices remained contaminated by Advanz's abusive prices during the Infringement Period and hence did not reflect normal, sufficiently effective and workable competition and were not a valid benchmark. This issue is considered later in this judgment in detail in the context of the Post Entry Prices comparator.

129. Normal, sufficiently effective and workable competition, as well as being distinct from abnormal, insufficiently effective competition, is also distinct from perfect, maximally competitive or idealised competition. As the Tribunal noted in Phenytoin, normal, effective competition is the "most that should be expected in the real world" as distinct from "idealised or near perfect competition which is a theoretical concept."

130. The Appellants contended that, in rejecting Post Entry prices as a comparator on the basis that they had not yet reached an equilibrium level close to the cost of production, the CMA was applying a benchmark of perfect competition. The CMA rejected this contention. Again, this issue is considered in detail in the context of the Post Entry Prices comparator.

131. It was submitted on behalf of the Cinven Appellants that the correct way to apply the "workably competitive" criterion was first to establish what workably competitive price levels look like in the market in question and then to compare that to the challenged prices. The Cinven Appellants alleged that the CMA had failed to follow that logical sequence, pre-determining that Cost Plus is to be favoured over all else in this case for reasons of policy and marginalising any proper consideration of whether Cost Plus bears any relation to how workable competition actually functions in the market at hand.

132. In our view, the submission that the CMA's starting point should have been workably competitive prices was not well founded. As Green LJ held, there is no rule that the competition authority must establish workably competitive prices at any stage:

> "123. Third, I note that in paragraph [249] the Court says only that it is "advisable" to ascertain whether the undertaking had exploited its dominance in a way which it could not have "… if there had been normal and sufficiently effective competition", these being the words said to create the requirement for a hypothetical benchmark price. There is no specific reference to price in the paragraph and in any event the expression "advisable" is inconsistent with the Court intending to provide anything more than guidance as to best practice. It would have used more directive language had it intended to lay down a fixed rule. In my view by the nature of the abuse in issue 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 can be based upon the costs of the undertaking being investigated or it can be based upon comparables such as the prices charged by the same or different undertakings in the same or

different geographical markets or indeed any other benchmark or combinations thereof capable of providing a "sufficient" indication that the prices charged are excessive and unfair."

133. Whilst there is no rule that the competition authority must start with workably competitive prices as a benchmark, the authorities make clear that an over-rigid or exclusive reliance on a Cost Plus analysis at the expense of a proper consideration of competition is wrong. In *BHB Enterprises v. Victor Chandler*, [2005] EWHC 1074, Laddie J held that simply charging in excess of the cost of production was not in principle an abuse, that there is no necessary correlation between the cost of production and the cost of capital and the price which can be achieved in the marketplace and that in considering unfairness it is necessary to consider all of the market conditions. His approach was approved by the Court of Appeal in *Attheraces Limited v. British Horseracing Board Limited*, [2007] ECC 7. It held that Etherton J (as he then was) failed to take proper account of the economic value of the data to the purchaser and how much the purchaser could make out of it as a source of income. A competitive market might yield a rate of profit above, as well as below, the reasonable margin represented by cost plus. Mummery LJ stated as follows:

> "173. It is well recognised, in cases such as the pricing for pharmaceutical products, that it is not correct to apply the cost+ approach uniformly to the determination of all issues of excessive pricing. It is necessary to consider all the relevant circumstances and to have regard to the particular circumstances of the product in question."

134. At [217], Mummery LJ reiterated that the Article 82 prohibition on excessive pricing: "…is not a general provision for the regulation of prices. It seeks to prevent the abuse of dominant market positions with the object of protecting and promoting competition."

135. In *Phenytoin*, Green LJ, in rejecting the need for a hypothetical benchmark noted that caselaw supported the conclusion that the counterfactuals of greatest practical value are often those drawn from real life, as opposed to some hypothetical model.

136. The Appellants also submitted that the CMA erred in law in setting its Cost Plus benchmark at a price below the price level needed to incentivise entry by other competitors. This submission was advanced by Cinven on the ground that the CMA had no power to set prices below the level of workable competition. The Appellants contended that the CMA's approach was itself distortive of competition since it replaced the interplay of competition between suppliers to serve consumers with what was a monopoly benchmark that would deter entry.

137. This issue is considered in detail in the context of Entry-Incentivising prices. In short, we agree with the CMA that there is no legal principle that its Cost Plus benchmark must be no lower than the price level needed to incentivise entry by other competitors. Under the United Brands test as clarified in Phenytoin, there is no absolute requirement that a fair price must be no lower than an Entry Incentivising price. The reference to 'workably competitive' conditions is not a mandatory

> requirement but part of a flexible test in relation to which the competition authority has a margin of manoeuvre. As noted by Green LJ, it is only "advisable", i.e. not required, for the competition authority to ascertain whether the undertaking has exploited its dominance in a way which it could not have done in workably competitive conditions. Moreover, the principle contended for by the Appellants would be inconsistent with the purpose of the law against excessive pricing since, in a market with high barriers to entry, it would enable a dominant supplier to charge inflated prices which could not be achieved in circumstances of normal and sufficiently effective competition.

(d) Testing for "excess" in the Excessive Limb: the Reasonable Rate of Return

143. The test for whether the Excessive Limb is met must begin with the counter-factual of what Normal Profit the entrepreneur would earn in a state of Real World Competition. We have defined Product Unit Cost as excluding the Rate of Reasonable Return (or the reasonable cost of Entrepreneurship[221]).

144. The starting point is thus the price the entrepreneur needs to receive under conditions of Real World Competition in order to be induced to continue to sell the Focal Product. This is the Normal Profit to which the Reasonable Rate of Return correlates. The entrepreneur will not continue selling the Focal Product if the costs of producing the Focal Product are covered only. The Entrepreneur needs to be rewarded:

(1) For the effort of bringing the Factors of Production together.

(2) For the risk that costs will not be covered, for example if the Focal Product is not sold or sold for less than Product Unit Cost plus a Reasonable Rate of Return.

The Entrepreneur does not need to be compensated (as part of the Reasonable Rate of Return) for the costs of borrowing money (if needed). Such costs are costs of Capital and will be incorporated (as interest) into Product Unit Cost.

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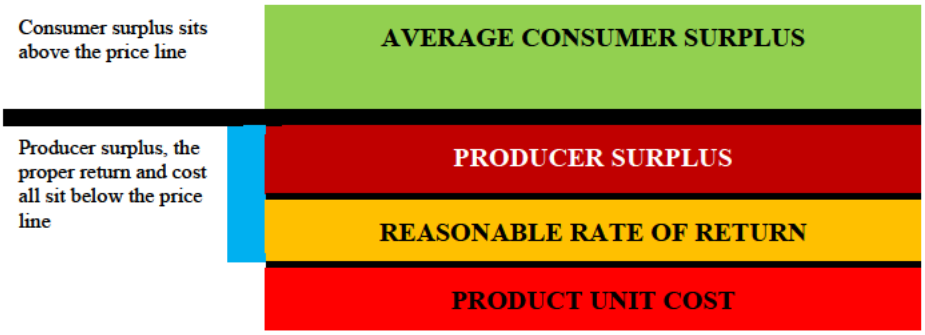
[221] The actual cost of Entrepreneurship is the Profit Margin.

145. Diagrammatically, and looking at one unit of the Focal Product only, these relationships can be set out as follows:[222]

(1) The Product Unit Price is the thick black line bisecting the table. Above the price line sits Average Consumer Surplus.

(2) Product Unit Cost, the Reasonable Rate of Return and Producer Surplus are the elements into which Product Unit Price can be broken down.



Figure/Table 8: The Profit Margin broken down into Reasonable Rate of Return and Producer Surplus

(3) The Profit Margin, the stratum identified by the blue sideline, is the difference between Product Unit Cost and Product Unit Price, but can itself be broken down into two elements, the Reasonable Rate of Return and the Producer Surplus.

146. We are not, at this stage, holding that the existence of any Producer Surplus renders the Product Unit Price or the Profit Margin excessive. The extent to which Producer Surplus can co-exist with non-excessive prices is a further ground of appeal articulated by Flynn, to which we will come. However, the converse case is indisputable. A Product Unit Price that contains no Producer Surplus (i.e. only contains a Normal Profit or a Reasonable Rate of Return) cannot be excessive. In such a case, the Excessive Limb is not satisfied.

[222] Figure/Table 6 is an evolution of Figure/Table 2, which showed only the Profit Margin.

147. The Focal Product Spreadsheets, the data that we have extracted from them (set out in Annex 3) and the graphical representations of the Profit Margin stratum (in Annex 4) suggest that assessing the Profit Margin is a straightforward objective process, on which expert economists would not differ. Such a conclusion would be incorrect. It is important at this stage to set out a number of judgmental questions that can affect the Profit Margin. In the course of the trial, these were referred to as "subjectivities" because they could affect the Profit Margin according to the individual judgment of the experts opining on the question by affecting the calculation of Product Unit Cost (and, to an extent, Product Unit Price):[223]

> …we have been talking about the computation of the gap between cost and profit, and we have identified at least five, possibly six, subjectivities, as I will call them, which affect the level of cost. Just to trip through them quickly: we have a subjectivity in relation to the allocation of fixed costs; we have a question of costs that are at an un-market rate; we have a question of unrelated costs; we have the effect of expectations of future costs; we have the question of how one computes a return on profit; and we may or may not have a question on volumes. In saying that these are subjectivities, I am saying that reasonable persons could differ, and differ quite markedly, in terms of what value they attributed to these subjectivities in terms of identifying what the costs stack would be, and it may depend on the individual case. But it is, I think, clear from the discussion that we have had this morning that the effect of these judgemental questions could be quite material.

148. The judgmental questions were discussed by the experts in the context of a stylised example which (in order to explain the references to it in the transcripts) we have set out at **Annex 5** hereto (the **Annex 5 Example**). These questions are as follows:

(1) *Excluding unrelated costs and localising common costs in the Focal Product.* All of the experts were agreed that Product Unit Cost (and, although the question is in this case far easier, Product Unit Price) were the relevant metrics for determining the Product Margin stratum. This meant that:

(i) Costs unrelated to the Focal Product needed to be excluded from the calculation of Product Unit Cost. In a multi-product firm,

[223] Transcript Day 8/pp.113 to 114 (concurrent expert evidence).

there will always be costs that are solely incurred in relation to products other than the Focal Product, and it may be that such costs are not recovered by the Enterprise in the sale of those other products. Whatever the position, these are **Extraneous Costs** that should not feature in the calculation of Product Unit Cost.

(ii) The Annex 5 Example referred to Extraneous Costs as "abortive costs": for example, the Dominant Coffee Shop's $500,000 expenditure and proposed expenditure on developing a new product is an Extraneous Cost unrelated to the Focal Product.

(iii) We are in no doubt, at least for purposes of the Excessive Limb (which is all we are presently concerned with) that such costs cannot and should not form a part of the Product Unit Cost. Somewhat inconsistently with their stance on the importance of focussing on Product Unit Costs, the experts did not agree in the case of the Annex 5 Example. We reject their evidence in this regard as untenable.[224]

More difficult is the question of common costs, which are costs incurred in part by reference to the Focal Product and in part by reference to other, non-Focal Products. These costs cannot simply be excluded but must appropriately be allocated to the Focal Product. An example of this is at Figure/Table 5. A concrete example of the issue in this case was whether costs solely attributable to the Capsules (four Focal Products) should be allocated according to volumes sold or revenue generated.[225] The point we make is this: apparently clear-cut questions of calculation hide significant judgmental questions that have a material bearing on the

[224] The experts disagreed: Dr De Coninck at Transcript Day 8/pp.99 to 101 (concurrent expert evidence); Mr Williams at Transcript Day 8/pp.101 to 102 (concurrent expert evidence); Dr Majumdar at Transcript Day 8/pp.102 to 103 (concurrent expert evidence); Mr Harman (more equivocally) at Transcript Day 8/pp.103 to 104 (concurrent expert evidence); and Ms Webster (also more equivocally) at Transcript Day 8/pp.105 to 106 (concurrent expert evidence). The question was whether costs that were nothing to do with the Focal Product should be included in the Product Unit Cost: Transcript Day 8/p.99 (concurrent expert evidence). We consider that all of the experts took their eye off the ball and looked instead at costs of something other than the Focal Product.

[225] See [71] to [73].

calculation of Product Unit Cost. It is important that these be articulated and resolved before seeking to answer the question of excess posed by the Excessive Limb.

(2) *The problem of anticipation.* Product Unit Costs are "snapshots" of an Enterprise's costs at a particular point in time. This can be misleading. In the present case, Annex 3 contains a distortion by reason of the fact that monthly sales of Capsules from Pfizer to Flynn were different to the monthly sales of Capsules from Flynn to the Pfizer/Flynn Customers. These fluctuations can be large, and (when considering a single supply chain, as here) potentially quite distortive. We compensate for these fluctuations by using averages over the Relevant Period, since it is a safe inference that over time Flynn will not have purchased more Capsules from Pfizer than Flynn needed for its commercial activities. Again, it is important to be aware of the problem.[226] Sometimes, the price charged by an Enterprise can be higher than justified by present costs because the Enterprise is (perfectly properly) anticipating a future increase in costs.[227] Mr Harman's evidence (paraphrased, with his agreement, by the President) was that the expectation of the Enterprise was a relevant factor:[228]

> "Let me try to capture what I think you are saying, Mr Harman. You can then tell me just how wrong I have it and then we will move on to the other experts to see what they say. I think what you are saying is that expectations are a relevant factor in terms of the cost-price interrelationship and in particular you ought to take into account the expectations of the undertaking in terms of their future costs in order to work out why they are pricing at a certain level, subject only to this qualification: you would only want to factor in reasonable expectations and you would want to exclude unreasonable expectations for whatever reasons…"

This suggests that an average across the allegedly infringing period ought always to be the starting point; but that one also ought to have

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[226] See the evidence of Dr Majumdar on this point at Transcript Day 8/pp.53 to 62 (expert concurrent evidence). Dr Majumdar favoured an average, but accepted that this was a judgmental question. Mr Harman's approach was different, but similarly based on the exercise of careful judgment involving a consideration of the expectations of the Enterprise. We would regard it as a matter for (in the case) the CMA to exercise that judgment, with which this Tribunal would be slow to interfere.
[227] Or *vice versa*.
[228] Transcript Day 8/pp.61 to 62 (expert concurrent evidence).

regard to factors outside this period, particularly if it is short. In this case, the Relevant Period is quite lengthy (over four years); and it is, therefore, a safe assumption that future anticipated costs and costs changes will be included in the averages over the entirety of the Relevant Period.

(3) *The problem of understated or overstated costs.* As to this:

(i) The Decision rightly records that "it is well established that any costs must be reasonably and efficiently incurred".[229] The reasons are obvious: by adjusting costs (either to inflate or deflate them) the Profit Margin stratum can be distorted. The problem lies in identifying whether costs actually paid are or are not reflective of true cost and – if they are not – how they need to be adjusted. In this case, the point matters because (on one view at least) Flynn's costs of Capsules were not reasonably and efficiently incurred. That is a point to which we will return: for the present we are exploring how this issue can objectively be approached.

(ii) The Annex 5 Example sought to provide instances of this for the experts to consider. The first is the rent paid by the Dominant Coffee Shop, which is in fact one tenth of the true commercial rent. Taking the rent as paid would thus result in a higher Profit Margin than using the true commercial rent (which is the precise converse of Flynn's position where, on the CMA's view, Flynn was overpaying for the Capsules it obtained from Pfizer). The second is similar: the Vanilla Shop pays no rent on its premises, its owners having inherited the shop and treating premises as a no cost item, and pricing accordingly low.[230]

(iii) The experts were agreed that current market value or current commercial value was preferable and that the Product Unit Cost

[229] Decision/[4.18].
[230] The two examples were considered with the experts at Transcript Day 8/pp.77*ff* (expert concurrent evidence).

ought to be adjusted accordingly, but again that this was a judgmental question.[231] The point was made clearly by Mr Doran when questioning Dr Majumdar:[232]

Q (Mr Doran)	So, if you are using the [Vanilla Shop] as a comparator, you would insert costs that they do not perceive so that you can compare properly?
A (Dr Majumdar)	No. Actually, I think, yes. It is a good question. I think what I might say is if I am comparing literally the price, I might take into account the fact that the [Vanilla Shop] does not perceive rent as a cost, if you like, and therefore it is probably pricing on the low side, so I do not think that means we then put rent into their accounts. I think what it means is, if we then compare their price with [the Dominant Coffee Shop] or with [the Robo-Shop], we might be mindful of the fact that their price is potentially a bit on the low side for the purpose of being a comparator and find possibly a sensible way of nudging it up or say, well, look, this is a good lower bound. I mean the bound approach can be quite useful. We know this is probably too much on the low side, but that is information in itself for just setting bounds.

We consider that Dr Majumdar's nuanced answer provides the solution as to how "inefficiently incurred costs" should be treated. The point is that what is an "inefficiently incurred cost" is itself a matter of judgment. When assessing the cost stack feeding into the determination of the Product Unit Cost of the Focal Product (or, where data exists, a comparator product) it is best to adopt a two-stage approach: (i) assess the "actual" cost, here the rent actually paid by the Dominant Coffee Shop, not the commercial rent at 10 times that rate or take the rent paid by the Vanilla Shop as zero, because that is how the Vanilla Shop saw its costs, and priced accordingly, but then (ii) consider explicitly how the Product Unit Cost (or perhaps Product Unit Price) ought

[231] Transcript Day 8/pp.79*ff* (expert concurrent evidence)
[232] Transcript Day 8/pp.82 to 83 (expert concurrent evidence).

to be adjusted to bring the cost into line with efficiently incurred costs. Such a two-stage approach ensures that the manner in which the Enterprise actually saw its costs (which will have affected price) is taken into account, but also ensures that any adjustment to reflect efficiently incurred costs (which is a judgmental question) is also explicitly stated.

(iv) This is the approach that we consider should have been taken (but was not taken) in regard to the cost to Flynn of the Capsules acquired from Pfizer. In other words, the process ought to identify the price actually charged by Pfizer to Flynn, but then (if necessary and explaining why) should adjust those figures so that costs reflect efficiently incurred costs. In this case, as we have described, the Focal Product Spreadsheets simply took the price paid by Flynn to Pfizer as a cost to Flynn, but made the broadbrush allegations of collusion or joint dominance that we have described.[233]

(v) Mr Harman's approach to this question was less easy to understand:[234]

A (Mr Harman)	Let me start with the [Vanilla Shop] because I think that is slightly easier, but you will tell me otherwise, I am sure. I mean in general when we think about cost plus and its link to [Real World Competition], we are thinking about almost the price at what entrants to the market would price if it was competitive, you know, at a set of prices. So we would normally think about the assets that a business has as being the replacement cost of those assets today, and that has two dimensions. Either that is the cost that somebody could enter the market and compete at the prices you are setting or it is the value that the owner of that business has in their hand. And here, assuming that [the Vanilla Shop] is a shop and not a kind of

[233] See [133].
[234] Transcript Day 8/pp.84*ff* (concurrent expert evidence). Emphasis added.

	stand outside somebody's house and they are selling coffee on the road, there is invested capital and that capital has value and any reasonable person, business, is going to say: I am not going to work for free if my next opportunity is to sell this to somebody else and the person buying that would buy the store at its current value, you know, in the marketplace. Otherwise, you end up with a situation where you set prices so that you do not earn a return on the asset that you are sitting on which probably would compel you to earning returns that are far too low by reference to what you could do in the marketplace. So you know, generally speaking, you would need to replace their zero costs with a set of costs that you would expect to see in a competitive market. …
Q (The President)	Pausing there, before you go on to the [Dominant Coffee Shop], I think you would accept that if a large undertaking in the same market as small undertakings gets economies of scale in terms of the good it purchases, so that it gets them at 10% cheaper, that is something that you would not inflate by that 10% saving because it is a competitive advantage that the undertaking gets through its size.
A (Mr Harman)	Yes. I mean, I think it is an interesting point in terms of if I have scale advantages compared to the rest of the market, should I be able to adjust my costs stack to what I observe others in the marketplace have, and there is potentially an argument for that, if the market is acting competitively. It kinds of depends a little bit on how you got that scale in the first place, but in general I think that companies that have costs advantages, as long as they have not been gotten by illegitimate means, should be able to enjoy those cost advantages.
Q (The President)	Yes. I am just assuming that [the Dominant Coffee Shop] buys 10 times more coffee beans than the others, and they negotiate a volume discount. That is what I am hypothesising.
A (Mr Harman)	Yes. I think that is their cost advantage at the end of the day.

Although he did not accept this,[235] there is a clear difference between Mr Harman's treatment of the rent for the Vanilla Shop (which is Capital) and Mr Harman's treatment of the economies of scale derived from negotiating a better price for Land (as we would classify the coffee beans). In the case of one, he would adjust the cost, and in the case of the other, he would not. It will be necessary to return to this: what we consider this exchange demonstrates is that Mr Harman's focus was not on ascertaining the Product Unit Cost and comparing it with the Product Unit Price – which is the approach undertaken in the Decision, and which we have described extensively – but on the Enterprise as a whole. Ms Webster similarly focussed not so much on the construction of the cost stack making up the Product Unit Price as the position of the Enterprise in the market.[236]

(vi) Our point is that whilst such approaches based on the Enterprise and not the Focal Product might, in some cases, be correct, when considering whether the Product Unit Price of the Focal Product is excessive compared to the Focal Product's Product Unit Cost, focus on the Enterprise's costs is categorically wrong. We expand on this in relation to the next area for the exercise of judgment, namely the danger of ambiguity and the importance of definitional clarity.

(4) *Ambiguity of "Capital" and the importance of definitional clarity.* Many products can be produced at similar cost using different methods, including using different Factors of Production. Economists refer to this as a "production function". It is – or ought to be – trite that any judgment on excessiveness should not depend on the method of production chosen by the entrepreneur, unless it is manifestly inefficient (in which case, those costs will fall to be adjusted in the manner described at [149(3)]). This point has caused a high degree of confusion on the part of the

[235] Transcript Day 8/pp.87 to 88 (concurrent expert evidence).
[236] Transcript Day 8/pp.92 to 96 (concurrent expert evidence).

experts; and has led the CMA into a material error in the assessment of the amount of capital deployed in both the Pfizer and Flynn Enterprises, with the consequence that the Reasonable Rate of Return (calculated, in the case of Flynn, by reference to a ROCE) has been materially understated. Since this point of definitional clarity constitutes one of the reasons we consider that the Decision cannot stand, it is necessary for us to set out the point in detail:

(i) The Annex 5 Example was used to ensure that the point could be considered by the experts without the distraction of controverted facts. Thus, the Labour and Capital costs of the Vanilla Shop and the Robo Shop in the example total in each case $110,000, but the Labour costs and the Capital costs of production ($100,000 and $10,000) are inverted between the two.

(ii) The Robo Shop's costs of $100,000 are appropriately described as Physical Capital, using the term as we have defined it at [60]. Its Labour costs ($10,000) are equally clearly not Physical Capital. Yet it would, when considering the Reasonable Rate of Return be frankly absurd – quite simply nonsense – to leave Labour costs out of account. That would be to introduce a distinction without a difference between the two (hypothetical) Enterprises, because the Vanilla Shop's costs would (simply because it is Labour and not Capital intensive) be grossly understated for no rational reason.

(iii) Dr de Coninck saw the difficulty at once:[237]

> I suppose you certainly have a clear idea of why you designed those two examples. What I can infer from the description of those is that you have one which is the Vanilla Coffee Shop, which is labour intensive, does not have any clearly defined capital, at least to high levels used in it, which is making me think of, to some extent, Flynn. So there is capital in there somewhere, not necessarily well defined, difficult to control for, and a high reliance on labour.

[237] Transcript Day 8/pp.44 to 45 (expert concurrent evidence).

> Now, you can contrast that with the Robo Coffee Shop, which is one in which capital is much more important and labour much, much, less. You have measures of capital that are well-defined, and then to me it strikes me that the approach that one should take when looking at those two different coffee shops is quite different.
>
> If one tries to apply a notion of return on capital employed to determine what the Vanilla Coffee Shop can charge, then I think that is definitely not the right approach…

Dr de Coninck considered that this demonstrated that the ROCE approach adopted by the CMA was no use in "capital light" cases. Dr de Coninck, Flynn's expert, made Flynn's point that ROCE is a bad methodology for "capital light" Enterprises like Flynn. We do not think he is correct in this, for reasons we will come to. But if the ROCE test for a Reasonable Rate of Return were to differentiate between two equally efficient Enterprises that have simply deployed different Factors of Production differently, then we accept that the test is unusable for the purposes of the Excessive Limb.

(iv) Mr Harman was a staunch advocate of the ROCE approach to assessing the Reasonable Rate of Return. Unlike Dr de Coninck he was not prepared to suggest that it was deficient in "capital light" Enterprises. Mr Harman was, we consider, right in this view. But he was unable to explain how two, equally efficient, Enterprises, one Capital heavy and the other Capital light, should be similarly treated for purposes of the ROCE test. Mr Harman's answer was that the "capital employed" by the Vanilla Coffee shop was <u>less</u> than the "capital employed" by the Robo Shop, and so the return on capital would be numerically less for that reason. In short, Mr Harman's position was that (assuming a 10% return on capital) the return for the two Enterprises should be calculated as follows:

	Labour	Capital[238]	Total Cost of Focal Product	ROCE (10% on Capital Employed)
Vanilla Shop	$100,000	$10,000	$110,000	$1,000
Robo Shop	$10,000	$100,000	$110,000	$10,000

Figure/Table 9: ROCE applied to the Vanilla Coffee Shop and the Robo Shop

(v) We found Mr Harman's treatment of these hypothetical cases so troubling – and so important in terms of defending the Decision – that he was questioned on this at length on two occasions during the course of the hearing.[239] On each occasion, Mr Harman defended the distinction he was drawing. We are bound to say that we found his efforts both incomprehensible and indefensible in terms of the outcome that he reached.

(vi) We have considered the evidence of the experts on this point with care, given its importance. We consider that a ROCE approach is a perfectly proper way of assessing the Reasonable Rate of Return and that – for reasons we will come to – in this case the CMA was correct to deploy it. We thus reject Dr de Coninck's view that ROCE is unsuited to capital light Enterprises. On the other hand, although we agree with Mr Harman that ROCE is an appropriate measure, he made a basic and quite fundamental error in confusing Physical Capital with Capital in the sense used in ROCE. There is a difference between costs attributable to Physical Capital and costs attributable to Labour. That, however, is not a material difference when it comes to computing the Capital needed to produce the Focal Product.

[238] Of course, what is meant is Physical Capital, not Capital, as we have defined those terms, which is the source of the problem. But none of the experts nailed this ambiguity.
[239] Transcript Day 8/pp.135*ff* (concurrent expert evidence); Transcript Day 13/pp.91*ff* (cross-examination of Mr Harman).

(vii) The hypothetical costs in the Annex 5 Example and the actual costs in the Focal Product Spreadsheets represent the costs of producing the Focal Product or (to put the same point differently) the money required to acquire the inputs (the Factors of Production) needed to make the Focal Product. This is the definition of Capital set out above, to which Mr Harman subscribed. That definition does not differentiate between the different Factors of Product used to make the Focal Product, for reasons that are obvious. It is for the entrepreneur to find the most efficient "mix" and so keep costs down. The suggestion that a return on Capital should focus not on money required (Capital) but on different Factors of Products (specifically, Physical Capital) is a fundamental error that underlies the Decision and Mr Harman's defence of it.

(5) *The relevance of volumes of Focal Product sold.* Annex 3 records not merely the Product Unit Cost and Product Unit Prices of the Focal Products, but also the volumes of Focal Product sold. The experts were asked to comment on the significance of volumes sold when considering the Excessive Limb:[240]

> What I want to ask is, having ascertained, using cost, price and volume, the gap…between cost and price, do we need to worry any further about the volumes sold? I mean, does it matter, for instance, that one has a product that is very, very expensive, but sold in small quantities, versus a product that is much less expensive, and sold in a great many units?

Mr Williams expressed no view;[241] Dr Majumdar considered that volumes were not any further relevant;[242] Mr Harman considered that volumes were relevant, but based himself on the importance of an Enterprise recovering its costs of capital;[243] Ms Webster also considered that volumes were relevant, but making the point that if the Profit

[240] Transcript Day 8/pp.107 to 108 (concurrent expert evidence).
[241] Transcript Day 8/p.108 (concurrent expert evidence).
[242] Transcript Day 8/p.108 (concurrent expert evidence).
[243] Transcript Day 8/pp.109 to 110 (concurrent expert evidence). As before, Mr Harman focussed on cost at the Enterprise level. As we will come to describe, in particular when we come to assessing comparables, we consider that Mr Harman was right, but for the wrong reasons.

Margin was large but volumes small, a price might not be excessive, whereas if the Profit Margin was the same, but volumes very high, the Excessive Limb might be satisfied;[244] Dr de Coninck expressed the contrary view very clearly:[245]

> If I may, sir, I think that volumes are not an additional criteria that we should take into account when determining excessiveness beyond the calculation of the cost plus price comparison.

Dr De Coninck thus looked at the Focal Product alone, considering for purposes of the Excessive Limb the Profit Margin of the single unit without reference to volumes sold.

We consider that the volumes sold are relevant to the Reasonable Rate of Return, a point to which we will come. For the moment, we note that the experts did not speak with a single voice on this point.

(e) Assessment of capital employed

(i) Two questions

149. We turn to the Decision's assessment:

(1) Of the capital employed by Flynn (considered in this Section); and

(2) Of the appropriate return on that capital (considered in Section G(13)(f).

The Decision identifies these two distinct questions extremely clearly:[246]

> The first step in establishing a reasonable return for Flynn based on a ROCE methodology is to estimate the capital employed by Flynn in the production and supply of Flynn's Products. An estimate of the WACC is then applied to this capital employed balance to calculate the reasonable return.

[244] Transcript Day 8/pp.110 to 111 (concurrent expert evidence). We consider that there is a good deal of force in this point, for reasons that we will come to.
[245] Transcript Day 8/p.111 (concurrent expert evidence).
[246] Decision/[5.222].

(ii) The method of assessment used in the Decision

150. The Decision describes how the CMA calculated Flynn's capital employed in the distribution and sale of Capsules in the following terms:

> 5.231 Working capital is the amount of capital that is employed in financing short term assets, net of the capital provided by short term liabilities. Working capital is typically calculated by taking the value of stock and debtors less the value of creditors.
>
> 5.232 Flynn submitted that it set out to develop a safety stock holding policy in September 2012, to provide a buffer against supply interruptions. Flynn stated that it built stocks equivalent to two to three months' market requirements, amounting to approximately £4-5 million.
>
> 5.233 Flynn's submissions as regards its working capital requirements focus on its need to retain buffer stocks. The CMA agrees that it is legitimate for Flynn to earn a return on capital invested in holding an efficient level of stock as this is capital that could be invested elsewhere, and capital employed in the supply of Flynn's Products, on which Flynn is entitled to earn a return. In addition to Flynn's stock requirements, the CMA has included debtors and creditors in its analysis.
>
> 5.234 The CMA has calculated Flynn's working capital requirements based on Flynn's actual purchases and sales data during the Relevant Period (which can be used to estimate stock balances) and estimates of average debtors and average creditors days based on Flynn's contractual terms with Pfizer and UDG. On this basis, the CMA estimates net debtors of £0.7 million.
>
> 5.235 As regards Flynn's stock requirements, the CMA first calculated Flynn's average stock value during the Relevant Period, giving an average of £2.1 million. As this average stock value was below the £4-5 million estimate submitted by Flynn, the CMA reviewed Flynn's actual closing stock balances as at each of 31 March 2013 and 31 March 2014, as provided by Flynn. Flynn's actual phenytoin stock at 31 March 2013 was valued at approximately £2.7 million and approximately £2.8 million at 31 March 2014. The CMA has used a figure of £2.8 million as the value of Flynn's stock for the purposes of its Cost Plus assessment, based on the higher value of Flynn's observable closing stock balances. The CMA therefore estimates Flynn's annual total working capital requirements during the Relevant Period to have been £3.5 million.

151. The Decision considered various other forms of capital that Flynn suggested be taken into account (such as intangible human capital), but rejected these as not constituting capital for these purposes.[247] The Decision concluded:[248]

> Based on the above, the CMA has estimated the annual value of the capital employed by Flynn during the Relevant Period for the production and supply of Flynn's Products to have been £3.5 million (i.e. the value of its annual working capital requirements).

152. This sum was then apportioned across the four Capsule strengths as set out in Table 5.11 of the Decision, which we have set out (with commentary) at [105(4)].

(iii) Analysis

153. The Decision defines Capital in the manner used in this Judgment, namely as the money required to acquire certain inputs.[249] Our definition ("The money required to acquire the inputs (i.e. Factors of Production) needed to make the Focal Product") is of course specific to the exercise we have before us – application of the *United Brands* test – and the question is whether the CMA's definition is similarly apposite to meet the requirements of that test. The Decision's specific definition of Capital is:[250]

> *The money required to acquire an efficient level of buffer stock to provide against supply interruptions, adjusting for Flynn's debtors and creditors.*

This is the correct definition of Capital, albeit incorrectly applied. It is (to quote from Decision/[5.233]) "legitimate for Flynn to earn a return on capital invested in holding an efficient level of stock as this is capital that could be invested elsewhere". But that is not a Reasonable Rate of Return on the Product Unit Cost of the Focal Product. The Decision comprehensively asks the wrong question and the answer is unsurprisingly similarly incorrect.

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[247] Decision/[5.243] to [5.254]. It is not necessary to consider these, and other, arguments about whether Flynn's capital was greater than £3.5 million, because these arguments were rejected in the Decision, and the conclusion was that the capital employed was £3.5 million: see Decision/[5.258].
[248] Decision/[5.258].
[249] See [60(1)(iii)].
[250] See Decision/[5.232] to [5.234].

154. The money required to acquire an efficient level of buffer stock may well be a cost of running an Enterprise, but (unless "unitised" to constitute part of Product Unit Cost) it has nothing to do with the Product Unit Cost of the Capsules. As described in [100(4)], there is a confusion between the static and dynamic modelling of cost, price and profit. The Decision takes (in preference to the figures in its own static Focal Product Spreadsheets) a working capital figure derived from Walters 1/[40],[251] which is directed to a (relevant) cost that has nothing to do with Product Unit Cost at all. The relevant part of Mr Walter's statement, describing Flynn's efforts to ensure a reliable supply chain of Capsules, reads as follows:

> 39. …Flynn has a track record of acquiring tail-end products and developing their supply chain, including through the introduction of new API suppliers and new sources of secondary manufacture. This is an important part of the value added by Flynn. When it acquired Epanutin, Flynn knew that the supply chain had potential weaknesses and its priority was to improve this as soon as possible. In particular, Flynn experienced a supply issue almost as soon as it took over responsibility for supply of the product because Pfizer's API manufacturer in Kalamazoo suffered a batch failure…This immediately focussed our attention on steps which could be taken to strengthen the supply chain. Flynn was also aware that, prior to acquiring Epanutin, Pfizer had experienced at least four reported stock-outs of the drug. Following the supply issue in October 2012, Flynn took steps to build up a buffer stock and establish an alternative source of API.
>
> 40. As regards the buffer stock, in September 2012 Flynn set out to develop a safety stock holding policy to provide a buffer against supply interruptions. To this end, it built up stocks equivalent to two or three months' market requirements, with a consequential carrying cost of approximately £4 - £5 million. As a result of this safety stock policy, Flynn was able to avoid patients experiencing a later supply disruption in November 2015 for 25mg capsules, which arose as a result of supply issues with Pfizer. Similarly, in December 2015, Flynn learned that Pfizer had experienced a problem with the quality release for the 300mg capsule. This lead to a shipment of a large amount of outstanding stock being delayed until 19 February 2016. Flynn estimated that, but for its safety stock, this would have led to a six-week stock out of phenytoin capsules, resulting in approximately 17,210 prescriptions not being fulfilled in England alone.
>
> 41. As a further dimension to its supply chain strategy, Flynn took preliminary steps to identify a second API supplier as early as October 2012, when it experienced its first supply issues. As noted in Flynn's board minutes for that month, two potential suppliers had been identified by David Fakes of Flynn: Recordati and Katwijk…The

[251] See Decision/fn 871.

> purpose of identifying these new suppliers was both to strengthen the supply chain and, in the long-term, to reduce costs by replacing Pfizer as the API manufacturer entirely.
>
> 42. The CMA finds that there is no evidence that Flynn seriously considered incurring the costs of setting up a new API supplier…That is wrong: it was always Flynn's intention to source a new supplier…

155. This is nothing to do with the question posed by the Excessive Limb when assessed by reference to the Focal Product Spreadsheets. That is a consequence of the static way in which Product Unit Costs have been assessed by the CMA, divorced from the manner in which an Enterprise would in fact operate.

(1) An Enterprise would, as we have described, operate dynamically, and it may be that the Annex 3 data could have been compiled in this way. But it was not. A dynamic model would consider Flynn's Capital requirements by reference to its cash flow needs calculated by reference to costs incurred on some dates, and revenues received on other (typically later) dates. In other words, because of revenue coming in from the sale of Product, Flynn's Capital costs would be correspondingly less, and dependent upon the time gap between payment and receipt.

(2) These are factors that operate at the Enterprise level, but they were not taken into account by the CMA when assessing Flynn's Profit Margin. However, because Profit Margin is the difference between Product Unit Cost and Product Unit Price (which are assumed to be received at the same time) the Capital costs of acquisition of Product either need to be included at 100% because the revenue received on (instantaneous) sale is then immediately set off or that revenue needs to be discounted to account for the accelerated receipt.

(3) The latter exercise was not undertaken by the CMA. Nor was any meaningful discount (to take account of setting off the sale receipts) applied by the CMA to the Product Unit Cost. As a result, the CMA has adopted a cost of Capital that is unrelated to the Annex 3 data, risking misstatement of the infringer's Profit Margin.

(4) This case represents a particularly extreme example, because of the very high (Capital) Product Unit Cost of the Capsules. However, this very high cost was passed on by Flynn in its Product Unit Prices, which are set off when calculating Profit Margin against Product Unit Costs *with no temporal delay*.

156. We consider that the CMA's use of cost of Capital detached from the data in the Focal Product Spreadsheets requires close justification, which does not appear in the Decision. Such a justification is particularly important because the figure of £3.5 million can be seen as a gross understatement of the capital needed by Flynn in the distribution of Capsules. The Focal Product Spreadsheets put this cost at £74,156,575. We conclude that the Decision has erred in its assessment and determination of the capital employed in the production of the Capsules. Having correctly calculated the Product Unit Cost of the Focal Product in the Focal Product Spreadsheets, and so having ascertained the Product Unit Cost at just over £74 million, the CMA used a figure of £3.5 million bearing no relation to the Product Unit Costs, Product Unit Price and Profit Margin that the CMA had itself calculated.

(f) Assessment of the proper return on Capital

(i) <u>The approach in the Decision</u>

157. Mr Harman defended and explained the CMA's "cost of capital" approach in Section 5.2 of Harman 3. He set out the approach as follows:[252]

> The CMA stated that "to determine a reasonable rate of return following a ROCE approach, two inputs are required" (i.e. the capital employed and the cost of capital). The CMA explained that the cost of capital reflects the average percentage return that debt and equity investors expect in return for providing funds to a company, and that it is appropriate to use WACC as a measure of the cost of capital:
>
> > "where firms like Pfizer and Flynn fund their investments through a combination of debt and equity finance…the [WACC] represents the average rate of return sought by debt and equity investors, and therefore represents the average cost of capital which can be applied

[252] Harman 3/[5.2.1]. The criticisms made by Flynn are summarised in Harman 3/[5.2.2], but we do not set these out.

> to each Party's capital employed, in order to measure a reasonable rate of return."

158. The CMA's assessment of the capital employed was considered in Section G(13)(e). We are now concerned with the assessment of the proper return on the Capital employed. To calculate this, the Decision used the WACC.

159. The Decision considers the level of Flynn's WACC in Decision/[5.259]*ff*. The Decision noted that, in the statement of objections, a WACC of 9% was considered appropriate.[253] Flynn contended that this should be increased because Flynn was a small company, and that a "small company premium" should be included in Flynn's WACC.[254] The CMA rejected this contention.[255] Additionally, the CMA found support for its 9% figure in work carried out by an investment bank in relation to Flynn:[256]

> …the CMA has identified that an investment bank, Jefferies, carried out valuation analysis of Flynn in December 2012. This analysis included projections of Flynn's profitability and discounted Flynn's future cashflows using a WACC of 10%, with a sensitivity analysis using a range of 8-12% WACC.

160. Although Flynn contended that the Jefferies figure was unreliable,[257] the Decision used the analysis to move its provisional 9% up to 10%:[258]

> The inclusion of a 10% WACC in Jefferies' analysis therefore indicates that this level of return appropriately compensates investors for providing capital to Flynn, taking into account the relevant features of its business. The CMA notes that this is consistent with Pfizer's submissions on its own WACC and the WACC of various pharmaceutical companies, which according to publicly available data sits within a range of 8% to 12%. The CMA considers it appropriate to use the base case WACC of 10% (as adopted by Jefferies) in its ROCE calculations for Flynn for these reasons.

161. After further discussion, which we do not set out, the Decision concluded that a WACC of 10% was appropriate.[259]

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[253] Decision/[5.261].
[254] Decision/[5.264] to [5.265].
[255] Decision/[5.266].
[256] Decision/[5.267].
[257] Decision/[5.268].
[258] Decision/[5.271].
[259] Decision/[5.277].

(ii) Flynn's grounds of appeal

162. The Flynn grounds of appeal say this:

> 192. The CMA bases its reasonable rate of return of a 10% ROCE (equating to 2% ROS) on a single reference point: a 10% cost of capital figure mentioned in a presentation prepared by Jefferies bank in 2012. Flynn has explained in Ground 1 above why a ROCE benchmark is unsuitable for assessing excessiveness. In this section., Flynn explains why, in any event, the 10% ROCE benchmark used by the CMA is unjustified and, importantly, how that benchmark reflects a double-standard in the CMA's approach to comparators.
>
> 193. The 2012 Jefferies presentation was used by Jefferies investment bank as an opportunity to advertise its services in relation to a potential acquisition of Flynn. Slide 3, for example, describes Jefferies as the "largest healthcare investment banking team in the world". The presentation explores different ways in which Flynn's business could be sold and different methods of valuing it. The CMA has latched on to a small part of the presentation relating to a discounted cash flow ("DCF") valuation of the company, as follows:
>
> | **Discounted Cash Flow Analysis** |
> |---|
> | Terminal growth of 0.5% to 1.5% assumed. WACC of 10%. |
> | EBITDA exit multiples of 5x to 7x; WACC of 10%. |
>
> 194. The CMA's benchmark for Flynn's reasonable rate of return, i.e. a 10% WACC, is based entirely on this snippet of the presentation: Decision/[5.271], [5.277]. This is not, however, a suitable benchmark or comparator:
>
> (a) First, it does not purport to be an estimate of the real world returns earned on a product with the characteristics of phenytoin under normal competitive conditions. It is a cost of capital figure plucked from a document prepared for an unrelated purpose. The CMA's willingness to rely on this figure as a benchmark is in stark contrast to the counsel of perfection that it applies to Flynn's comparators, which are said not to be sufficiently similar to phenytoin to provide any meaningful evidence of normal returns in the industry. Yet the 10% WACC figure mentioned by Jefferies Bank has nothing to do with phenytoin capsules at all.
>
> (b) Secondly, the CMA's case appears to be that its chosen WACC figure is intended to be a proxy for "real returns earned, on average, across a range of markets exhibiting different degrees of competition". This highlights the fact that the CMA's 10% WACC figure has nothing to do with the characteristics of phenytoin at all: it is alleged to be an approximation of the average return on capital earned across a whole range of markets. If that were the correct question to consider, the CMA's 10% WACC could be applied to any

product (or at least any generic medicine). There is nothing to tie the benchmark to phenytoin capsules, or indeed any particular product, at all.

(c) Thirdly, the 10% WACC figure mentioned in Jefferies presentation is almost certainly not a reference to Flynn's cost of capital. It is a reference to the cost of capital of a hypothetical acquirer. This is a necessary input into any DCF analysis, as the acquirers WACC reflects its time cost of money and therefore the appropriate discount rate.

(d) Fourthly, the CMA's reliance on the 10% WACC figure lacks a solid factual foundation. As Williams 6 points out, for different valuation methods were considered in the Jefferies report and the report does not make clear what was the basis for the 10% WACC.

195. The 10% WACC figure referred to in the Jefferies presentation is therefore a wholly inappropriate comparator for assessing the normal competitive return for a product such a phenytoin, and it is certainly not a better comparator than those put forward by Flynn.

(iii) Analysis

163. Whilst we consider that the WACC, as assessed by the CMA, to be impossible to defend on appeal, we do not consider Flynn's specific criticisms (as opposed to the general point that the WACC used by the CMA is not capable of rational justification) to be particularly well-made. The CMA, as we have made clear, used the Jefferies presentation as upward confirmation of the 9% WACC that it had provisionally landed upon. The CMA quite properly also considered other points advanced by Flynn, suggesting a higher WACC, and rejected them. This consideration is not acknowledged in Flynn's grounds of appeal, and the criticism by Flynn is selective.

164. However, the point made at Flynn Grounds of Appeal/[194(a) and (d)] is fundamental. At [194(d)] is it said that the CMA's WACC "lacks a solid factual foundation". That is fair: the basis for the CMA's starting point of 9% is barely articulated in the Decision:

5.260 As set out in [5.170] and [5.171], Pfizer submitted that its WACC is around 9% and Flynn's own expert relied on an analysis by KPMG to demonstrate that the average cost of capital for pharmacological companies was between 7.7% and 8.2% between 2010 and 2014.

5.261 Based on this range of cost of capital estimates, the CMA considered in the SO that it was appropriate to use a WACC of 9% as the

> reasonable rate of return for the calculation of Cost Plus for Flynn's Products. This allowed Flynn to earn the same rate of return as Pfizer and a return which exceeded the estimated cost of capital relied on by Flynn's own expert on appeal before the CAT.

165. It is very difficult to understand the real basis for a Reasonable Rate of Return of 9%, beyond the bare assertion that the WACC is 9%. That is a conclusory finding which it is impossible to unpick further, and for that reason alone we would be minded to reject this finding in the Decision, and to allow the appeal on this ground.

166. The problem is, however, more fundamental. Just like the CMA's assessment of Flynn's employed capital, the CMA's WACC looks not to the Focal Product and the Product Unit Cost, but to the Enterprise. This is the point made – and in our judgment rightly made – at Flynn's grounds of appeal/[194(a)], which states:

> …it does not purport to be an estimate of the real world returns earned on a product with the characteristics of phenytoin under normal competitive conditions…

The Decision does not ask the two key questions: (i) what is the Reasonable Rate of Return to the entrepreneur for selling the Focal Product; and (ii) does the WACC constitute a good proxy or means of assessing the Reasonable Rate of Return? The Decision does not consider the first question at all. But it is clear –because the WACC is calibrated to the appropriate return to the Enterprise – that the WACC cannot, without more, determine what is the Reasonable Rate of Return to the entrepreneur for selling the Focal Product.

167. Expanding on this:

(1) We defined Normal Profit at [63] as the level of profit equal to the opportunity cost of Entrepreneurship or entrepreneurial effort. That opportunity cost can be assessed by considering the cost of obtaining the funds to finance Product Unit Cost or (to use the definition of Capital at [60(1)]) by assessing the cost of the money required to acquire the Factors of Production necessary to produce one unit of Focal Product.

(2) We know what money is needed to fund the production of the Focal Product because we have the data in the Focal Product Spreadsheets. The question we are here concerned with is the level of Normal Profit or what is the Reasonable Rate of Return (the return that will induce the production of the Focal Product). The Normal Profit will be calculated by reference to either (i) what the entrepreneur could have earned if otherwise invested their money, or (ii) what it would cost the entrepreneur to borrow that money. We consider the second measure (what it would cost the entrepreneur to borrow that money) to be the better, more reliable, measure.

(3) Thus, we define a Reasonable Rate of Return for these purposes as follows: it is the sum that the Seller would need to borrow (e.g. from a bank) to fund the Product Unit Cost. It is thus a unit based cost of capital (not a WACC but a **Per Unit Cost of Capital** or **PUCC**), and we consider that to be the appropriate measure of the Reasonable Rate of Return.

(4) It is at least the following:

(i) *The time value of money.* In short, the price of money over the period under consideration charged by a commercial lender to a commercial borrower (neither too big nor too small) needs to be ascertained.

(ii) *A risk loading.* Here the risk of the enterprise is taken into account: what upwards charge for borrowing is it reasonable for the lender to charge this Seller. In this context margins earned by similar undertakings may assist. These undertakings may not be very comparable: dominance prevents that. But for all that, "industry" returns constitute empirically extremely valuable data as to the business risks for the Enterprise in selling the Focal Product.

(iii) *Absolute or relative returns and volumes sold.* The volumes sold of the Product are relevant to the question of risk. Suppose a

> Seller (*A*) makes a return of £1 million by selling 1 million widgets (Profit/widget of £1), in contrast with a Seller (*B*) who makes a similar return by selling only 2 widgets (Profit/widget of £500,000). If the risk of not selling the marginal product is the same for each Seller, then *B*'s business is riskier than *A*'s, and one would expect the risk loading to be higher accordingly. While properly belonging to 'risk loading' described above, it seems to us sufficiently important to warrant separate consideration.

168. The Decision fails properly to address the manner in which the Reasonable Rate of Return should be calculated. The appropriateness of a WACC as a measure for this return is not considered. We consider the use of a WACC calculated by reference to the Enterprise to be *prima facie* inappropriate because it involves consideration of the return to the Enterprise, not as regards the production and sale of the Focal Product. We do not say that a WACC cannot be used: but doing so would require careful judgment, which the Decision does not undertake. Thus, whilst a cost of capital approach is appropriate, that cost needs to be localised in the Focal Product. We have termed this the PUCC, but recognise that this is not, in any way, a term of art.

169. The Reasonable Rate of Return used by the CMA to assess whether the Excessive Limb was or was not met was assessed and determined in a materially defective way.

(g) Conclusions as regards these grounds of appeal

170. This Section has considered the calculation of the Reasonable Rate of Return in the Decision. That calculation was done by reference to the ROCE-WACC, as we term it, and comprised two elements. First, an assessment of the Capital employed by Flynn; and secondly, an assessment of the appropriate return on that Capital employed, by reference to the WACC. In the case of both elements, the Decision errs materially. The determination of the level of Capital employed by Flynn in the Decision grossly understates the Capital employed. It follows that even if the return on Capital employed were defensible, it would have been

calculated by reference to the wrong figure. But, secondly, the return on Capital calculated by reference to the WACC does not set out a rational basis for the Rate of Return derived and, in any event, calculates the return by reference not to the Focal Product but to the Enterprise distributing it.

(14) The failure properly to consider comparables as part of the Excessive Limb

(a) Introduction

171. These grounds of appeal are summarised in [106(3)] and [106(5)]. Our approach to these issues is as follows:

(1) We set out the comparables Flynn relied upon.

(2) We describe the extent to which the Decision took these comparables into account, i.e. what consideration was given to them. As we will describe in greater detail, the Decision concluded that the comparables were of no assistance to the CMA and they were disregarded in the Decision.

(3) That leads us to our third area of consideration, namely the extent to which, given the comparators relied upon by Flynn, the CMA's discounting of those comparators was justified. This raises, in the first instance, the question of the purpose of comparators when considering the Excessive Limb.

(b) Comparators advanced by Flynn

(i) The comparators relied upon

172. The Flynn Grounds of Appeal identify the following comparables or comparators on which Flynn relied and which Flynn asserted had not properly been taken into account in the Decision:[260]

[260] They are listed in Flynn Grounds of Appeal/[153].

(1) The ROS of Flynn's other products.

(2) The ROS of comparator companies.[261]

(3) The margin earned by the Sellers of Tablets.

(4) The *Aspen* decision.

(ii) The ROS of Flynn's other products

173. Flynn's Grounds of Appeal note that "Flynn sells a range of products other than phenytoin capsules. Its return on those products are evidence of normal levels of return in the industry".[262] Those returns, calculated on a ROS basis, were set out in De Coninck 5, without however any statement of volumes sold. The table below sets out the ROS for the various products (the Capsules are highlighted in yellow), together with the volumes sold:[263]

	ROS (%)	Volumes sold
2013		
Barbiturates	88	7,237
Nizatidine	54	55,896
Axid	53	2,477
Thiopenthal	50	7,000
Phenytoin	35	595,180
Distaclor	29	398,882
Medikinet	14	392,128
Circadin	13	441,039
Cefuroxime	5	330,453
Vancocin	-3	659,175
Keflex	-10	737,605
Nebcin	-21	126,464
2014		
Barbiturates	91	6,305

[261] We consider the points pleaded at Flynn Grounds of Appeal/[153(b)], [153(c)] and [153(d)] together. They raise exactly the same points.
[262] Flynn's Grounds of Appeal/[157].
[263] See De Coninck 5/[36]. The data is also set out in Flynn's Notice of Appeal/[157]. The data for volumes sold appeared in graphical form in the record, but we were helpfully provided with the figures after the hearing ended. These figures were not controversial.

Collaguard	59	125
Thiopenthal	46	12,195
Phenytoin	33	798,438
Nizatidine	28	46,697
Axid	28	3,864
Circadin	23	674,793
Distaclor	22	270,804
Meikenet	12	415,347
Cefuroxime	7	179,775
Vancocin	-18	559,882
Keflex	-43	917,661
Nebcin	-69	152,82
2015		
Barbiturates	90	5,114
Thiopenthal	51	5,629
Axid	50	1,384
Collaguard	49	167
Vipertab	37	422
Phenytoin	36	712,650
Distaclor	33	243,538
Circadin	29	742,394
Medikinet	15	377,015
Cefuroxime	14	169,504
Nizatidine	4	39,563
Vancocin	-4	862,700
Keflex	-31	885,675
Nebcin	-36	202,564
2016		
Barbiturates	91	4,355
Axid	64	1,154
Thiopental	55	10,807
Distaclor	44	244,229
Vipertab	36	400
Phenytoin	35	657,366
Circadin	30	923,315
Collarguard	21	31
Medikinet	17	415,077
Cefuroxime	11*	288,154
Vancocin	9	657,639
Nebcin	-22	197,295

Nizatidine	-25	24,008
Keflex	-28	654,602

Figure/Table 10: ROS on Flynn products sold

As to this data:

(1) Flynn relied upon this data to show that the return on the Capsules was in line with the returns made on other products sold by Flynn.

(2) As we have described, Dr de Coninck did not consider the volumes of product sold to be relevant to the Excessive Limb.[264] We disagree with him on this point, although we entirely accept that it is and was a legitimate view for him to advance. For that reason, we have included the volumes sold in Figure/Table 10. The CMA made exactly the same point in the Decision:[265]

> When the level of sales volumes are properly taken into account, for example, the profitability of phenytoin is shown to be an outlier among Flynn's portfolio.

(3) The exclusion of volume data by Flynn, and its inclusion by the CMA and us, alters its value as evidence, but does not render it irrelevant. It is, therefore, necessary to ask what (if anything) the CMA did with this data. The short answer is that it was discounted entirely by the CMA:[266]

> …The returns of Flynn's other products thus fall some way short of meeting the criteria for relevant comparators.

(4) It seems to us that the notion of there being "criteria" for the consideration or non-consideration of comparators – suggesting a binary delta between inclusion (and presumably according them great weight) and exclusion (and presumably according them no weight) is undesirable given the nature of comparables.

[264] See [148(5)].
[265] Decision/[5.299].
[266] Decision/[5.309].

(5) For the present, it needs to be noted that Flynn relied upon this data in support of its ROS methodology, a methodology which the CMA rejected and which (to our consideration) constitutes a second best approach to a return on capital approach. The CMA's rejection of the comparables needs to be seen in this light. The CMA did not accept that the ROS approach was appropriate, a stance we agree with. The Decision explains why – even if ROS was the correct methodology – these comparators did not assist.[267] Given that we do not consider that ROS was the appropriate methodology, and that we are setting aside the Decision on other grounds, we consider it is pointless to evaluate the merits or demerits of failing to consider material in relation to a rightly rejected methodology.

(iii) The ROS of comparator companies

174. The Flynn Grounds of Appeal assert that "Flynn's returns on phenytoin are also consistent with the ROS rates earned by comparable companies in the industry, which average around 20-30%". Flynn's expert, Mr Williams, considered the ROS of nine comparable companies,[268] including the "ROS of two particular companies with a similar business profile to Flynn, Alliance Pharma plc and Martindale".[269] The Flynn Grounds of Appeal summarise the position as follows:

> 169. …In his second report Mr Williams analysed the ROS rates of nine comparable companies that operate in the generics industry, including two particularly close comparators, Alliance Pharma plc and Martindale (the trading name for McCarthy's Laboratories Ltd). Alliance is an especially close comparator because, like Flynn, it does not itself manufacture generic drugs and, also like Flynn, it specialises in acquiring and selling "tail" products from larger pharmaceutical companies. Martindale is also a close comparator, albeit less so than Alliance because it manufactures some of its own medicines in-house. The remaining seven companies are comparable to Flynn because they were, during the Relevant Period, "selling generics, branded generics or off-patent brands, the market dynamics of which in terms of pricing are similar [to phenytoin].

[267] The "other products" comparables are rejected for reasons set out in Decision/[5.295] to [5.310]. These paragraphs fall within that part of the Decision dealing with Flynn's representations on the appropriate ROS.
[268] Flynn's Grounds of Appeal/[169].
[269] Flynn's Grounds of Appeal/[153(b)].

170. Mr Williams' analysis showed that:

(a) Alliance Pharma had a ROS of 26%.

(b) Martindale had a ROS of 26%.

(c) The remaining seven companies…had a weighted average ROS of 21% for sales, marketing and distribution companies…which do not manufacture their own products and therefore "asset-light" like Flynn, and 22-25% for all seven companies.

175. We do not propose to go into the detail underlying Mr Williams' work, because that work was rejected in the Decision on altogether more general grounds. As the Flynn Grounds of Appeal record, "[t]he CMA has refused to give any weight to any of Mr Williams' proposed comparator companies, and has instead dismissed them on a binary basis".[270] The Decision records as follows:

5.329 The CMA has a duty to evaluate the arguments and evidence advanced by the undertakings fairly and impartially. However, the CMA does not have a duty actively to carry out additional investigative steps in every case or proactively seek additional evidence regarding the comparators put forward. The CMA has a margin of manoeuvre or discretion as to how it performs its duty of fair evaluation, including as to the depth and intensity of the inquiry and the extent of such duty on the CMA will be affected by the quality of the evidence adduced by the defendant undertakings, as there is an important evidential burden upon an undertaking being investigated.

5.330 Taking these principles into account, the CMA has fairly evaluated those profitability comparators put forward by Flynn and its experts during the Previous Investigation and during the Remittal and it has provided reasons as to why it considers none of these comparators provide a meaningful and reliable basis on which to establish a reasonable rate of return for Flynn's Products…All of these profitability comparators seek to compare the profitability of Capsules on the basis of percentage profit margins only (whether against Flynn's other products or against the margins earned by third parties). The CMA explained…that there are a number of significant conceptual problems in applying this type of approach to Flynn's Products. None of Flynn's comparator evidence engages with these overarching issues. Instead, Flynn advances only the simple computation of the profit margins of various other products and companies, without regard to how comparable these products and companies actually are to Capsules and without controlling for the distortion caused by Pfizer's high input price.

[270] Flynn Grounds of Appeal/[175].

176. Flynn's characterisation of the rejection of Flynn's evidence is accurate. Whether the CMA was right to do so is a question we will come to. At this stage, we make the following points:

(1) To the extent that the evidence was rejected by reason of "Pfizer's high input price", that was a materially irrelevant consideration, for the reasons we have given.[271]

(2) To the extent that this evidence was rejected because ROS was not a proper methodology for this case, we agree with the CMA's position.[272] However, we consider that rejecting the evidence on the basis that the comparators were not sufficiently comparable to be unfair to Flynn. As the CMA has found – necessarily, in order to establish a Chapter II jurisdiction – Flynn was dominant in the market, by reason of the characteristics of the Capsules (to which we will be coming).[273] In such circumstances, to require the production of comparables that closely compare to a product that is dominant because of its unique characteristics is unfair. Such evidence will be hard, if not impossible, to obtain. The better approach is to accept that the comparables are likely to be somewhat incomparable, but not to reject them out of hand for this reason. The extent to which comparables are truly comparable should go to weight. To this extent the CMA's binary rejection of Flynn's evidence leaves a great deal to be desired.

(iv) <u>The margin earned by the Sellers of Tablets</u>

177. Tablets are pharmacologically exactly the same as Capsules. The products are non-substitutable because of guidance issued by the MHRA, which advises general practitioners not (without very good reason) to switch patients between differently manufactured phenytoin sodium products. We have referred to this as the issue of Continuity of Supply.[274] It is time to consider this issue in greater detail:

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[271] See [134].
[272] For reasons we have described: see [116].
[273] See [54(2)].
[274] See [10].

(1) Phenytoin sodium is a third line AED targeting the most significant forms of epileptic seizure.[275] It will only be deployed where other forms of treatment have failed; and even then, there is no guarantee that this form of treatment will be effective:[276]

Q (Professor Waterson)	You have obviously talked about cases that have been beneficially treated with phenytoin. Do you also find that some of the people that you put on phenytoin, it does not work for them?
A (Professor Walker)	Yes, a very good question as well. So, when we get to third-line therapies, we are talking about probably only 5% of people becoming seizure-free regardless of what we try, so many of those patients will not respond to phenytoin, so they will go on to phenytoin for a short period of time. If it has been successful, they will remain on it; if not, they will come off. And indeed, I have had that recently, somebody where we were trying different drugs, we tried phenytoin and indeed it did not have a big effect on the seizures, and they came off that drug, so it is not invariably effective.

One of the advantages of phenytoin sodium is that its effectiveness can be tested for quite quickly, at least in patients that suffer from frequent seizures.[277]

(2) Medical views differ as to the efficacy of phenytoin sodium and when it should and when it should not be deployed.[278] This is a point where the

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[275] Evidence of Professor Walker: Transcript Day 5/p.182 (Professor Walker teach-in).

[276] Evidence of Professor Walker: Transcript Day 5/pp.182 to 183 (Professor Walker teach-in). But when it is effective, it is of huge benefit and value to the patient, because it means that seizures that were not capable of effective treatment by "first line" or "second line" AEDs are treated by this particular drug: Transcript Day 5/pp.201 to 205 (Professor Walker teach-in).

[277] Evidence of Professor Walker: Transcript Day 5/pp.183 to 184 (Professor Walker teach-in).

[278] Professor Walker was keener to prescribe phenytoin sodium than Professor Sander, whose position was (Transcript Day 6/p.7 (Professor Sander teach-in)) as follows:

> I do not prescribe phenytoin unless it is needed, there is nothing else available and I must say I have not prescribed phenytoin for a long time.

Professor Walker and Professor Sander differed in terms of the order in which they would try "third line" AEDs. For Professor Walker phenytoin ranked higher than it did for Professor Sander. The critical point is that neither expert considered the other's views to be anything but reasonable. In short, this was a case of divergent clinical approaches, both of them right. That point was expressly put to Professor Sander,

> nuanced views of the experts were inappropriately distorted by the efforts of their respective legal teams to put their case. Thus, Professor Walker was clearly being pressed to stress the value of phenytoin and Professor Sander to downplay its value. Such pressuring of experts is entirely inappropriate, and we have to say that the contrast between the nuanced, responsible and balanced evidence that both experts gave orally stood in unfortunate contrast to some parts of their written evidence, particularly that of Professor Sander. We do not blame the experts for this in any way: the litigation process is daunting to all, and experts can quite properly expect guidance from the lawyers whose clients are retaining them. These lawyers ought to reacquaint themselves with the guidance to experts issued by the courts. Lawyers tend to be very familiar with this guidance when it comes to cross-examining the other side's experts; it would helpful if a similar familiarity were deployed for the purposes of ensuring that their own expert is properly briefed when putting their name to an expert report.[279]

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who accepted this: Transcript Day 6/pp.11 to 13 (Professor Sander teach-in). Professor Sander's approach was significantly affected by his views on enzyme inducers. This is an area of medicine we do not need to trespass upon, and we do not do so, save that we entirely respect the Professor's views (as we do those of Professor Walker) as statements, reasonably and properly held, by experts in their fields.

[279] We will give one example of this, but it was a general problem in this case, and we want to make clear that this sort of approach simply does not assist the Tribunal. Thus, Professor Sander is remarkably dismissive of the benefits of phenytoin sodium and generally of those doctors who prescribe it in Sander 1/[14], [15] and [16(m) and (n)]. In Sander 1/[18], he says of Professor Walker specifically:

> Professor Walker states…that he remains of the view that phenytoin is a relevant and useful drug in the treatment of epilepsy, and states…that it should not be seen or characterised as a last resort drug. He continues to use phenytoin in his practice, even as a new prescription. This seems to suggest that Professor Walker is prescribing phenytoin to people with newly diagnosed epilepsy. However, it seems that he is also saying that he is starting this drug for the first time for some people with drug-resistant epilepsy who have failed previous drugs…It is indeed the case that occasionally phenytoin is tried once all other appropriate options have failed. This is the third-line drug or as often known, the drug of last resort, as suggested by NICE and other guidelines. Most clinicians treating epilepsy will do this, and my practice is no different. However, this is the exception rather than the rule and it would be misleading to suggest otherwise. Of course, Professor Walker is entitled to his views, but I'm afraid I have to disagree that phenytoin remains a relevant and helpful drug in the way he suggests.

Professor Walker commented on this as follows (Transcript Day 5/p.186 (Professor Walker teach-in):

> I know Professor Sander very well, and I do respect Professor Sander, and so having read his report I was slightly taken aback about the view he had taken, and I wanted to know from my own point of view whether that was, you know, a view which was shared generally amongst colleagues. So I have spoken to colleagues, I have spoken to a number of colleagues within my own department, and also outside, and asked them about their use of phenytoin, and I have found that it much more aligns with my use than it does with the complete abandonment of phenytoin as an anti-seizure medication.

The point also emerged at e.g. Transcript Day 5/pp.199 to 201 (Professor Walker teach-in).

(3) The true position is that expert physicians differ in their views as to when it is appropriate to deploy phenytoin sodium, but that it would be within the reasonable range of treatments to use phenytoin sodium as a third line AED and that it is, for those patients who respond to it, a hugely valuable form of treatment, in that it prevents or at least minimises distressing and damaging epileptic fits which may not be treatable in any other way.[280] The point was put to Professor Sander in the following terms:[281]

Q (The President)	…you have said on a number of occasions that you are entitled to a view, and let me be clear, I entirely accept that. But let me spin the question round, and again we are still talking about the new patient.[282] If you have a different physician, let us say Professor Walker, and you hear that they have explained the side effects of phenytoin differently to you,[283] with less emphasis, and have deployed phenytoin higher up the running order of third-line drugs, would you accept that they too are entitled to their view that that is a legitimate form of clinical judgement that they can exercise?
A (Professor Sander)	Yes, I think that is part of their clinical judgement.

(4) The next question is whether a patient responding to phenytoin sodium would be treated through the use of Capsules or Tablets. In this, both

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Of course, the report did not represent Professor Sanders' view, as he made extremely clear in his evidence. We ourselves want to be absolutely clear that whilst experts of course bear responsibility for their reports, this is a case where we consider that both experts acted to the highest standards despite, perhaps rather than because of, the efforts of the legal teams putting them forward.

[280] We say "may not" because there are a whole range of "third line" AEDs that can be deployed. The order in which they are deployed is a matter for clinical judgment. If phenytoin sodium is deployed early, ahead of other "third line" AEDs, and is effective, other "third line" AEDs will never be tested, but may themselves have been effective. This range of potential alternatives does nothing to diminish the value of phenytoin sodium as a form of treatment for epilepsy.

[281] Transcript Day 6/pp.231 to 232 (cross-examination of Professor Sander).

[282] The position as regards patients already taking phenytoin sodium is, of course, *a fortiori*. Professor Sander told us of a very sad incident where a patient's treatment regime was changed, with entirely unfortunate results. Where a regime including phenytoin sodium is used, there will be an entirely correct disinclination on the part of doctors to change that regime: Transcript Day 6/pp.232*ff* (cross-examination of Professor Sander).

[283] The question is badly put. What was meant was that the patient would be given a different explanation to that which would have been given by Professor Sander. We are satisfied that Professor Sander understood the question.

experts were indifferent as to the manner in which phenytoin sodium was administered. Professor Walker was asked the question directly:[284]

Q (Professor Waterson)	Do you have a suggestion as to why roughly of the 100mg drug which is available both as Tablets and as Capsules, around four times as many people have Capsules than Tablets?
A (Professor Walker)	No. I mean, I do not prescribe – so what I will start the prescription and then the prescription will be maintained in the community by the GP, and so I do not – I have some insights into what happens, but I do not – it is mainly anecdotal, I cannot tell you what the majority of GPs or pharmacists are doing, that is not my expertise. I see people, patients of mine, who are on a mixture of Tablets and Capsules, so I may have asked the GP to start them on phenytoin and they start them on the Tablets and then we have to increase the dose by 25mg, there is only the Capsules, so they will be on a mixture of Tablets and Capsules, so I see that not infrequently…

(5) In these circumstances, one can understand why Continuity of Supply in terms of continuity of treatment of phenytoin sodium would be highly desirable, even essential for proper treatment. But that is not what Continuity of Supply means in this context: Continuity of Supply refers to the maintenance of a patient on a particular manufacturer's phenytoin sodium product.[285] Given the evidence of Professor Walker that we have just set out, insistence on Continuity of Supply seems counter-intuitive and in need of justification. Given that it is Continuity of Supply that gives Capsules their dominant position, the point is of importance:

(i) Professor Walker identified the reason for Continuity of Supply as only indirectly medical. The reason for the policy was not that it was essential medically, but because it was psychologically

[284] Transcript Day 5/p.208 (Professor Walker teach-in). Also, to similar effect, Transcript Day 5/pp.213 to 214 (Professor Walker teach-in).
[285] See [10].

beneficial to patients, who wanted to be assured that they were getting the same drug and treatment over time:[286]

> …a lot of patients get very attached to their drug, you know, they like the same colour drug, the same drug in the same packaging, and if you are seizure-free and you are terrified of having seizures, the worst thing is that that could then change.

(ii) Accordingly, the **MHRA**[287] produced guidance on this point, beginning in 2004,[288] and culminating in the November 2013 **MHRA Guidance** (which we set out below).

(iii) It is fair to say that it is guidance that is honoured in the breach. But nevertheless, the policy is an important one, as Professor Walker noted:[289]

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[286] Transcript Day 5/pp.209 to 210 (Professor Walker teach-in).
[287] i.e. the Medicines and Healthcare products Regulatory Agency.
[288] Transcript Day 5/p.209 (Professor Walker teach-in).
[289] Transcript Day 5/pp.210*ff* (Professor Walker tech-in). Professor Sander took the view that the MHRA Guidance was perhaps too strident in tone: Transcript Day 6/pp.31*ff* (Professor Sander teach-in). As Professor Sander noted (Transcript Day 6/p.35 (Professor Sander teach-in)), "I would easily go to a desert island without taking this document".

…So the MHRA then produced its guidance for this, which was guidance, and they stated that there are these groups, group 1 is where phenytoin is. Ironically, levetiracetam, which was causing quite a lot of concern at the time was group 3, which said you could change willy-nilly. Group 2 was where you were supposed to discuss this with your doctor and get an agreement to change the prescription. So it came in specifically for that reason. In fact, we had a meeting with the MHRA shortly after or shortly just after the guidance came out, because of the unhappiness about the patient groups that drugs were going to be swapped.

Since that time, it has not been particularly noticeable to me that these rules have been obeyed, so again, I cannot speak for all pharmacists and all GPs; and I cannot speak around the country. I can only speak from my experience of my own patients, but, for example, lamotrigine would be a good example. People have been quite happily converted from one brand of lamotrigine to another. Often the brand that they were on depends on where – which one their local pharmacy has, and the GPs are certainly not prescribing, to my knowledge, by manufacturer.

With phenytoin, again, I have had patients who have changed from one manufacturer to another. Many of the patients I have on phenytoin would not even be able to tell you when manufacturer the phenytoin is. It is not something that they are particularly concerned or bothered with.

The MHRA guidance as well was important because there are concerns with those group 1 drugs that if you convert somebody from one to another that there could be either side effects or breakthrough seizures. Again, ironically, the MHRA – so, the MHRA and in fact, at the time, the European – the EMA and the FDA as well, have very strict rules to try to make sure that you have the same amount of drug in every generic, in generic versus branded, and they have certain criteria that they use, and for drugs with narrow therapeutic index such as phenytoin, for example, those criteria are much stricter, so they are even stricter, and in fact there is not a lot of evidence that if you give a single dose of phenytoin that, whether it is generic or branded or a different generic, that there is much difference in terms of the levels that you get in an individual person, and that is necessary for the generic to be licensed.

The thing with phenytoin that is different is that, because of this, slight differences in dose can make big differences, because people may be

> on it chronically, then there may be some indication that there may be some problems swapping from one to another. It has not been a big problem that I have encountered, and if people – people who are on phenytoin, their blood levels tend to vary quite markedly anyway for a variety of reasons, one of which is for example that about 20% or 30% of drugs are not taken, people forget their drugs regularly. Also, things like antacids can affect the levels, and the levels go up and down, and the effects of changing from one brand to another I do not think are quite as severe or quite as desperate as people make out, but it certainly has been my experience that people have been changed since that guidance has come in.

This is an important answer, with which Professor Sander did not disagree.

(iv) The evidence of both Professor Walker and Professor Sander was that: (i) phenytoin sodium was a drug where Continuity of Supply mattered, and the drug was appropriately in "group 1" of the MHRA guidance; but that (ii) even in the case of phenytoin sodium, the differences between differently manufactured Tablets and Capsules was likely to be extraordinarily slight, such that changing source of manufacturer might not, in the vast majority of cases, medically matter; however, (iii) psychologically, some patients might be attached to a particular product, and would – for entirely understandable reasons, given the seriousness of their condition – be concerned if their regime changed without very good reason,[290] even if this would make no difference in objective medical terms.

178. Turning, then, to the terms of the MHRA Guidance itself:[291]

> Antiepileptic drugs are drugs that are primarily used to control epileptic seizures, although they are used for other conditions as well. This section of the website provides information about switching between manufacturers' products of oral antiepileptic drugs, including switching between branded products and generic products, and between different generic products of a particular drug.

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[290] For instance, if there was a shortage of supply, any competent doctor would switch to another product and attempt to reassure the patient: Transcript Day 5/pp.217 to 219 (Professor Walker teach-in).
[291] We set out the terms of the MHRA Guidance so far as material. The document is rather longer than this.

Background

When a generic medicine is shown to be bioequivalent (has the same effect on the body) to the original ("reference") product, as defined by the relevant regulations and guidelines, these products can be considered to be clinically equivalent.

However, concerns about switching between different manufacturers' products of antiepileptic drugs (AEDs) have been raised by patients and prescribers. These include switching between branded original and generic products, and between different generic products of a particular drug.

Different AEDs vary considerably in their characteristics, which influence the risk of whether or not switching between different manufacturers' products of a particular drug may cause adverse effects or loss of seizure control.

Following a review of the available evidence, the UK Commission on Human Medicines (CHM) considered the characteristics of AEDs and advised that they could be classified into three categories, based on therapeutic index (a comparison of the amount of a therapeutic agent that causes the therapeutic effect to the amount that causes or toxicity [*sic*]), solubility and absorption, to help prescribers and patients decide whether it is necessary to keep using a supply of a specific manufacturer's product.

Category 1 – Phenytoin, carbamazepine, phenobarbital, primidone

For these drugs, doctors are advised to ensure that their patient is maintained on a specific manufacturer's product.

Category 2 – Valproate, lamotrigine, perampanel, retigabine, refinamide, clobazam, clonazepam, oxcarbazepine, eslicarbazepine, zonisamide, topiramate

For these drugs the need for continued supply of a particular manufacturer's product should be based on clinical judgement and consultation with patient and/or carer taking into account factors such as seizure frequency and treatment history.

Category 3 – Levetiracetam, lacosamide, tiagbine, gapapentim, pregabalin, ethosuximide, vigabatrin

For these drugs it is usually unnecessary to ensure that patients are maintained on a specific manufacturer's product unless there are specific concerns such a patient anxiety, and risk of confusion or dosing errors.

Notwithstanding the views expressed by Professor Walker regarding compliance with this regime, we consider that it would be a foolhardy general practitioner to disregard the MHRA Guidance and to vary a patient's treatment away from the Capsules absent very good reason. That is obvious from the allocation of phenytoin sodium to Category 1 and the terms in which Category 1 is described, in contradistinction to Categories 2 and 3.

179. Flynn's point in regard to Tablet prices was that the prices of the Tablets, and the margins earned by the Sellers of the Tablets, constituted strong evidence of what others were making, in terms of Profit Margin and/or Price, given that Capsules and Tablets were pharmacologically equivalent. The Flynn Grounds of Appeal state:

> 185. Flynn's profitability on phenytoin is considerably lower than that earned by the suppliers of phenytoin tablets. The margins earned by Teva, Wockhardt UK and Accord UK on phenytoin tablets are 72%, 72.3% and 40.5% respectively.
>
> 186. The CMA's response is that the margins (and prices) of phenytoin tablets are not suitable comparators, and are therefore to be rejected, because the tablet market is insufficiently competitive…

180. The Decision says this:

> 5.313 The CMA has carried out a detailed assessment of the level and extent of competition in the Tablets market…The CMA finds that a number of factors limited the effectiveness of competition in the Tablets market, including the exercise of market power by Teva, supply issues in the market price and regulatory Guidance recommending Continuity of Supply.
>
> 5.314 As a result of its findings on the lack of effective competition in the Tablets market, the CMA does not consider the margins earned by Wockhardt UK, Teva and Accord-UK provide suitable comparators for the purposes of estimating a reasonable rate of return for Flynn's Products. It is essential that selected comparators are not distorted by ineffective competition and…the CMA considers that this essential criteria is not met in the case of Tablet suppliers.

(v) The *Aspen* decision

181. The Flynn Grounds of Appeal plead that the findings in the *Aspen* decision assist Flynn on comparables:[292]

> The finding of the Commission in its *Aspen* decision that a reasonable rate of return for Aspen's off-patent cancer drugs was 10-20% above the median EBITDA of its competitors, which was 23%, resulting in an overall benchmark of 30-36%.

182. This is expanded upon in Flynn Grounds of Appeal/[187] to [189]. At [190], the reasons for the CMA's rejection of Flynn's point is stated as follows:

[292] Flynn's Grounds of Appeal/[153(f)].

> The CMA rejects any read-across with the *Aspen* decision on the basis that Aspen's products, unlike phenytoin, did not have a high input price. This is an invalid point of distinction…Similarly to Flynn, Aspen had outsourced the manufacture of its products to a third party, and Aspen (and the comparator companies considered by the Commission) supplied mainly off-patent drugs. Accordingly, not only does the Decision in *Aspen* provide a clear illustration of the correct methodology to be applied when determining excessiveness; the figures relied upon by the Commission are of relevance to the assessment of Flynn's prices and should have been taken into account, on a weighted basis, as part of a proper analysis of comparators.

(c) Analysis

183. The CMA rejected Flynn's comparators as part of its rejection of the ROS methodology. It is important to note that we have not accepted Flynn's primary contention that ROS is the appropriate methodology. More specifically:

(1) Viewed entirely in the abstract, a ROCE-based methodology is to be preferred over a ROS-based methodology, for the reasons we have given.[293]

(2) In this case, we consider that the CMA's decision to pivot away from a ROS-based methodology to a ROCE-based methodology to be defensible – and indeed right.[294]

(3) In these circumstances, the question of whether, had the CMA undertaken a ROS-based methodology (which it did not), it would have appropriately taken into account the Flynn comparators really does not arise, and we are disinclined to review in any detail the CMA's rejection of those comparators as part of the CMA's overall rejection of ROS. The question is really an academic one, with which we do not consider we should engage. The CMA's rejection or otherwise of comparators is therefore very little, if anything, to the point.

(4) More to the point is whether the comparators relied upon by Flynn should have been taken into account when considering ROCE. This point we do consider arises, and we deal with it below.

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[293] See [90].
[294] See [116].

184. We have concluded that whilst a ROCE methodology is the best way of ascertaining whether a Profit Margin or the Product Unit Price over Product Unit Cost is excessive when considering the Excessive Limb, the WACC based approach of the Decision errs in a material way because it fails to calculate the Reasonable Rate of Return in a transparent and objectively justifiable way. We have set out the components of how a Reasonable Rate of Return might be calculated. The CMA, rightly, stresses the importance of a judgmental approach and the need to consider the evidence in the round. The evidence should have been considered even though it was submitted in the context of a ROS analysis which the CMA rightly did not take forward. Moreover, where an Enterprise has been found to be dominant, comparators are never going to be close substitutes, so a binary approach – in/out – does not recommend itself. The CMA erred in taking such an approach. Overall, the CMA thereby deprived themselves of a consideration of potentially highly material evidence going to its ROCE analysis. What weight should have been attached to this material is a matter that the CMA should have considered; and the CMA comprehensively failed to do so. For these reasons, the CMA did not approach the Reasonable Rate of Return properly as it failed to take into account the comparables material that we have described. Accordingly, this ground of appeal succeeds.

(15) A failure to consider Producer Surplus when considering the Excessive Limb

(a) The point in issue

185. We have described the ground of appeal at [106(6)]. In *Phenytoin 1* (CAT), the Tribunal put the point as follows:[295]

> In this case, the CMA's almost total reliance on a reasonable rate of return approach is unconvincing. Quite apart from the criticism that may be made of how it arrived at a 6% ROS as a reasonable rate…it is clear that the CMA's approach owes more to a theoretical concept of idealised or near perfect competition, than to the real world (where normal, effective, competition is the most that should be expected). It has, on the whole, avoided making comparisons with other products or companies, and made little significant

[295] At [318].

attempt, other than by invoking Price Comparison over Time, to place Pfizer's and Flynn's prices in their commercial context during the Relevant Period.

186. It is important to note that some of these points – a failure to look at the "real world" in which the Focal Product was sold – feature in the grounds of appeal that we have already considered. We have concluded that:

(1) The approach to assessing the Capital employed by Flynn is wrong in that it fails properly to consider the Capital needed to produce a unit of the Focal Product.

(2) The approach to assessing the cost of that Capital was misconceived. The WACC considers costs at the Enterprise level, which is the wrong approach. As a result, the Decision fails to consider the real world, and in particular the comparators advanced by Flynn, which were directed to (or at least relevant to) this point.

187. In these circumstances, the Reasonable Rate of Return has been significantly understated and, in any event, wrongly calculated. In these circumstances, it cannot be said whether any Producer Surplus exists in Flynn's case. The Reasonable Rate of Return has not, reliably, been calculated. The question arising out of this ground of appeal is whether, on the assumption that a Reasonable Rate of Return can be correctly calculated (which, in this case, it was not, as we have found) the existence of a material amount of Producer Surplus is only consistent with there being an excessive price.

188. The question arising therefore is whether the CMA's approach is too much based on Perfect Competition (which has no Producer Surplus because of its assumptions) and not sufficiently based on Real World Competition which does in certain circumstances recognise Producer Surplus as a legitimate outcome of a competitive market. It will be necessary, at that stage, to consider the distinction between "legitimate" and "illegitimate" Producer Surplus. The question, for the present, is whether the CMA's approach is one that regards Producer Surplus as intrinsically an indicator of excessive pricing and is, for that reason, wrong.

(b) A framework for analysis

(i) Perfect competition

189. Perfect competition is not an ideal, but a model. Models exist in order to aid analysis and are only valuable to that extent. Under the assumptions of perfect competition, Sellers must sell at cost plus a profit that is no more than the Normal Profit. Defining Producer Surplus as any return to the Seller above the Normal Profit, perfect competition produces an outcome that involves no Producer Surplus at all, and which therefore maximises the Consumer Surplus. On the face of it, and given the assumptions underlying the model, this produces a very pro-consumer outcome, in that Consumer Surplus is maximised and Producer Surplus (as we have defined it) is reduced to nil, leaving the Seller receiving only the Normal Profit.

190. We turn to the model of perfect competition and explain why (in the world of perfect competition) the price will fall so as to eliminate the Producer Surplus and confine the Seller to the Normal Profit. The model of perfect competition contains the following assumptions:[296]

(1) There is no latency. Unlike in the real world, where changes occur dynamically over time, in the perfect competition model changes occur immediately, and have immediate effects.[297]

(2) The market contains only two protagonists: Buyers and Sellers. Each Buyer is an "ultimate consumer".[298] There are no supply chains: Sellers make or do everything themselves in order to create their Product.

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[296] The model is substantially that described in [318] of *Hydrocortisone 1*.

[297] The absence of latency is a necessary consequence of the assumption of a perfectly contestable market with no entry or exit costs. We accept, of course, that this is a simplifying assumption, but it is an essential part of the model. Otherwise, the costs of sellers in the market will vary according as to entry and exit costs, which undermines the whole point of the exercise. Dr Majumdar, in disagreeing with this (Transcript Day 10/pp.14 to 16 (concurrent expert evidence), sought to import rather more of the real world than is consistent with the model.

[298] Another simplifying assumption, but one that ensures the interests of the consumer are front-and-centre.

(3) Sellers (actual and potential) sell a single Product to a universe of (actual and potential) Buyers. Price is the sole determinant of (i) whether Sellers are willing to sell and (ii) whether Buyers are willing to buy. There is no product diversity.

(4) Aggregate demand (from Buyers) is limited, varying only by reference to price. In other words, the product and market demand curve is as it would be in the "real world", save that the "real world" contains a diversity of product (wholly absent from the model) that would inject a difficulty in generating the aggregate demand curve.[299]

(5) Aggregate supply (from Sellers) is potentially infinite, such that no Seller has market power. The market is perfectly contestable, in the sense that entry and exit is cost-free. This is an assumption completely at variance with the "real world": it is on the supply side that the model is only helpful if it is regarded as a model, and not as a true representation of how markets work in the real world.

(6) Price informs the buying and selling decisions of Buyers and Sellers differently. An individual Buyer will buy Product if the value that the Buyer attaches to the Product exceeds the Price. Value is subjective to the individual Buyer. Aggregating demand at any given price gives the shape of the demand curve.

(7) An individual Seller will sell Product if marginal revenue equals or exceeds marginal cost. Marginal revenue and marginal costs are the relevant measures for the Seller, particularly where the market is assumed to be perfectly contestable. Fixed costs of entry and exit do not act as constraints under perfect competition, because there are none. All costs are effectively variable. Marginal cost – for purposes of this assumption – must include a proper return to the Seller. If marginal cost excluded this, then the Seller would not be prepared to sell at the

[299] That is why it is not pointful to distinguish between product and market demand curves: there is only one product in play, and Buyers have only the choice to buy or not to buy. They cannot purchase an alternative Product.

marginal revenue price, because it would make more sense to spend the costs of production elsewhere, generating some form of return.

(8) Buyers have good market knowledge, such that their demand will move, immediately (there is no latency) to the Seller selling the Product at the lowest price. In effect, the perfect contestability that pertains on the supply side, is translated to the demand side. The consequence is that although market demand curve will be shaped normally, as in the "real world", each individual Seller will be faced with an individual demand curve that is perfectly elastic at the prevailing price.

191. On these assumptions, Sellers will have to price at cost plus Normal Profit:

(1) If the Seller is inefficient, then even if that Seller prices at that Seller's Cost plus a Reasonable Rate of Return, the Seller will have to leave the market because they will not be able to match the price of the most efficient Seller in the market. Demand, which is perfectly elastic in relation to that Seller, will move in its entirety to other Sellers who are able to sell Product for less. One of the assumptions that perfect competition does not make is that all Sellers are equally efficient. Sellers can be differently efficient, and inefficient Sellers are driven from the market.

(2) Sellers that are operating at maximum efficiency will be the only Sellers in the market. Because no Seller has market power and because of the elasticity of demand arising in these circumstances, every Seller in the market will have to price at Cost plus a Reasonable Rate of Return, which will be Normal Profit. Failure so to price will result in a total loss of demand to that Seller. Thus, all Sellers will have to price at the level of the most efficient Seller.

It follows from this that under conditions of perfect competition, Sellers cannot arrogate to themselves the Buyers' Consumer Surplus. Such a step would inevitably involve an increase in price that would result in a total loss of demand.

(ii) What is the point of the perfect competition model?

192. Perfect competition is a model. As a model, it does not represent reality, but provides a partial understanding of how aspects of the "real" world work. It is important to understand that the perfect competition model is unrealistic on the supply side (and so teaches very little). That is for the following reasons:

(1) Markets are not perfectly contestable. There is no uninhibited freedom to enter and leave the market at no cost. The ability to supply and the efficiencies of different Sellers vary according to factors that are beyond their control. Where aggregate demand exceeds the ability of the most efficient Seller to supply Product, there will be room in the market for inefficient Sellers to sell Product and stay in business in the long run. This, of course, gives the lie to any presumption that in Real World Competition the prices charged by a Seller track that Seller's costs.

(2) Markets do not involve the sale of a single Product, with no product differentiation and so no competition other than by way of price. In the real world, Sellers compete not just on price but on a whole range of other factors, which can be referred to as "product differentiation".

(3) Markets are dynamic and not static. Products, Buyers and Sellers are constantly in flux, whereas perfect competition is a static and not a dynamic model. That is a consequence of the assumption of no latency.

193. Although, as with all models, perfect competition is a flawed model, we do not mean to question its analytical utility, which we find to be great (provided the limits of the model are understood). In this case, the utility of the model arises because the model forces us to define exactly how the "real world" differs from the model, such that we can understand and describe the operation of economic forces in the real world more clearly. Whereas Producer Surplus cannot exist in the world of perfect competition, it can and does exists – and exist legitimately, without competition law infringement and to the benefit of consumers – in the "real world". The existence of Producer Surplus is not in all cases inimical to

competition. The perfect competition model enables us to understand why this is the case.

(iii) Producer Surplus and Real World Competition

194. The CMA's position, as articulated in the Decision and as defended by its experts was that CMA Cost Plus was, at least in the long run, the only competitive outcome in a state of Real World Competition. Prices sitting above CMA Cost Plus in the long run, and perhaps the medium term, were by definition excessive. That was the CMA's position. It was robustly attacked by Mr Brealey, KC (leading counsel for Pfizer) in closing. Before we consider the extent to which Producer Surplus can be regarded as consistent with Real World Competition, it is appropriate to set out the opposing positions of the CMA and the Appellants:

(1) It was the CMA's position that even under conditions of Real World Competition prices would trend to CMA Cost Plus. The concomitant is that Producer Surplus is not a competitively proper outcome. The point was put very forthrightly by Ms Webster when seeking to articulate a test for economic value:[300]

> …if competition is working well, my hypothesis is that in equilibrium, in the long term, prices will fall to a level that is reflective of costs, and that will be a good proxy. Also, it will include the value to consumers. So value will be consistent with cost plus, that will be a price that reflects the value to consumers when competition is working well…

This was an article of faith on the part of Ms Webster. When it was put to her that "you have an a priori view as to prices converging to cost in a case where there is normal and sufficient competition", her answer to that was an unequivocal "Yes".[301]

(2) Ms Webster's view reflected the CMA's line, which was that Real World Competition essentially reflected Perfect Competition, save with something of a time lag, so as to allow for latency. Thus, in view of the

[300] Transcript Day 8/p.154 (concurrent expert evidence). See also: Transcript Day 11/p. 81 (cross-examination of Ms Webster).
[301] Transcript Day 7/p.108 (Ms Webster teach-in).

CMA, the patent was something of a solitary and exceptional case, where (by virtue of the statutory monopoly conferred on the patent owner) a Producer Surplus might exist in the long run. The present case, not being a patent case, meant that the "patent anomaly" did not warrant consideration because it did not arise, the Capsules being decades out of patent. In the CMA's view, no other circumstances in which a Producer Surplus could be justified could exist in the medium or long run.

(3) The position of the CMA and its experts at trial was that Producer Surplus could only be a transient phenomenon, as in the **Face Mask Example** deployed in *Hydrocortisone 1*.[302] In that case, temporarily high prices in a contestable (i.e. Real World Competition) market creating Producer Surplus are explicable because of the inability of the market to service a spike in demand in the short run. Sellers in the market who are able to supply product at once can therefore increase their prices to reflect the excess of demand over supply. But the Producer Surplus thereby generated attracts new Sellers into the market, who compete and erode the Producer Surplus as soon as they can gear up production. Thus, the price trends back to CMA Cost Plus. Hence, Producer Surplus is only a short run phenomenon. Since the Relevant Period could not be described as short run, the CMA's fixed view appears to be that if Product Unit Prices contained a material element of Producer Surplus, they would be excessive for that reason alone.

(4) The CMA's view of the economic world was challenged by Mr Brealey, KC in closing.[303] Although a question of economic fact, not law, a number of cases concerned with price levels in competitive markets have stressed that Producer Surplus is not necessarily a transient phenomenon. Of course, it may be: but to elevate this proposition to an article of faith is to overstep the mark. The point was made most clearly by Mummery LJ in *Attheraces Ltd v. British Horseracing Board Ltd*.[304] The judgment of Mummery LJ is described in detail at *Hydrocortisone*

[302] At [152(4)] and [155(2)].
[303] Transcript Day 16/pp.3*ff* (closing of Mr Brealey, KC).
[304] [2007] EWCA Civ 38.

1, [327]. In particular, at [327(2)], the following passages in Mummery LJ's judgment were noted:

> As to the meaning of "economic value", Mummery LJ interpreted *United Brands* in the following way:
>
> "…the court did not say that the economic value of a product is always ascertained by reference to the cost of producing it plus a reasonable profit (cost +), or that a higher price than cost + is necessarily an excessive price and an abuse of a dominant position. The court was indicating that one possible way ("inter alia") of objectively determining whether the price is excessive and an abuse is to determine, if the calculation were possible, the profit margin by reference to the selling price and the cost of production."
>
> Finally, Mummery LJ gave the following warning:
>
> "…it has to be borne in mind that, as stated in *Oscar Bronner Gmbh & Co KG v. Mediaprint Zeitungs- und Zeitschriftenverlag GmbH & Co KG* (Case C-7/97) [1998] ECR I-7791, the law on abuse of dominant position is about distortion of competition and safeguarding the interests of consumers in the relevant market. It is not a law against suppliers making "excessive profits" by selling their products to other producers at prices yielding more than a reasonable return on the cost of production, i.e. at more than what the judge described as the "competitive price level". Still less is it a law under which the courts can regulate prices by fixing the fair price for a product on the application of the purchaser who complains that he is being overcharged for an essential facility by the sole supplier of it."

(5) Mr Brealey cited *Attheraces* and also the earlier decision of Laddie J in *BHB Enterprises Ltd v. Victor Chandler (International) Ltd*, which makes the point similarly:[305]

> 47. Mr Turner argues that, in effect, there is a per se rule. As he puts it, where a dominant undertaking charges prices greatly in excess of the cost of production, this is in principle an abuse of its dominant position. He says that the price charged by an undertaking enjoying a dominant position in a particular market must be compared with the price he would have been able to charge had there been competition. If he charges more than he would have charged in a competitive market, he is abusing his dominant position. He is obliged to behave in the same way as he would have had there been competition meaning, I assume, full-blooded, no-quarter-given, competition. He says that in a market where there is full competition, the price which a trader can charge will move towards that figure which will allow him to recoup his costs together with the cost to him of the capital he has used. In many cases, this will mean he will only be able to recover the capital he has expended together with interest at a

[305] [2005] EWHC 1074 (Ch). Emphasis added.

LIBOR type rate. Mr Turner does not admit to any exceptions to this approach…

48. Even before one considers the case law, it appears that this approach is based on a number of doubtful propositions. It assumes that in a competitive market prices end up covering only the cost of production plus the cost of capital. I am not convinced that that is so. Sometimes the price may be pushed much lower than this so that all traders are making a very small, if any, margin. Sometimes the desire of the customer for the product or service is so pressing that all suppliers, even if competing with one another, can charge prices which give them a much more handsome margin. In other words, even when there is competition, some markets are buyers' markets, some are sellers'. I do not see that there is any necessary correlation between the cost of production and the cost of capital and the price which can be achieved in the market place. Furthermore, the question is not whether the prices are large or small compared to some stable reference point, but whether they are fair.

49. In addition, this rule breaks down as soon as one applies it in the real world. What happens if there are only a few customers? Must the cost of production, including all research and development, be recovered from them? If so, does that mean that the price varies depending on the number of customers one has? Does it also mean that the price must go down once all the research and development costs have been recovered? Does it mean that traders cannot increase the price if they engage in successful advertising campaigns which whet the consumers' appetite? If Mr Turner's proposition were correct, it would mean that for most fashion products (clothes, cars, perfumes, cosmetics, electronics and so on) the prices charged would be deemed to be unfair. Indeed, it must follow that if the price of a product differed significantly in a single market or between markets in different locations, one must assume that, at best, one set of customers is getting the fair price and all the ones being charged more are being charged an unfair price. This would be so even though no trader occupies a dominant position.

195. We consider that a state of Real World Competition will not necessarily produce Prices that sit above cost or at the level of CMA Cost Plus, even in the long run. Even though CMA Cost Plus is a consistent theme throughout the Decision, the Decision fails to consider the limits of the proposition. The Decision says:[306]

> It is possible for an undertaking to price above Cost Plus without those prices being either excessive or unfair.

[306] Decision/[5.30].

But the circumstances in which prices above CMA Cost Plus might not be excessive or unfair are nowhere considered. Thus, the Decision accepts that a dominant Enterprise pricing at above Cost Plus does not commit a by object or *per se* infringement of competition law. Pricing at above CMA Cost Plus is not necessarily abusive. The problem is that neither the Decision, nor the CMA's experts, attempted to draw the line between legitimate and illegitimate Producer Surplus. In failing to do so, the CMA's adopted an *a priori* erroneous view of abusive pricing cases. It is not enough to say that this case was so clear cut a case of illegitimate Producer Surplus that further inquiry is unnecessary. That is just another way of presuming the very conclusion that the CMA was tasked to consider impartially and expertly. Since the line between pro-competitive Producer Surplus and anti-competitive Producer Surplus is key to understanding both the Excessive Limb and – as we shall see – the Unfair Limb, it is necessary to consider that line with some care.

(c) Different types of Producer Surplus

(i) Case 1

196. In *Hydrocortisone 1*, three cases were stated as to why Producer Surplus might exist.[307] The first case, (**Case 1**) (relative inefficiency amongst Sellers)[308] arises because in Real World Competition there are limits to the supply of Product (i.e. scarcity on the supply side) and (even where there is no scarcity) differences between the costs of different Sellers. Perfect competition assumes an infinite supply of Product, from an infinite number of Sellers, all of whom can enter and leave the market at will. Under such circumstances it follows that the costs of all Sellers will be the costs of the most efficient Seller. In the real world, there are inefficiencies between Sellers of the same Product. Where demand exceeds the supply of the most efficient Seller, then less efficient Sellers can remain in the market, and the most efficient Seller will gain an ability to price at a level above that of its Reasonable Rate of Return, such that a Producer Surplus is generated. Although such Producer Surpluses are more common in the short run, because markets adjust and more Sellers enter the market (as described in

[307] These cases were set out in brief in *Hydrocortisone 1* at [322].
[308] Described in *Hydrocortisone 1* at [322(1)].

the case of the Face Mask Example), this fact does not preclude the existence of Case 1 Producer Surplus over the medium or long term. To expand on this:

(1) As a general proposition a Seller will want to maximise Producer Surplus. A Seller will seek to pursue the inconsistent aims of increasing prices and increasing volumes sold (as well as reducing cost). The aims of increasing price and increasing volume are typically inconsistent because of the shape of the normal demand curve:[309] demand will fall, as prices increase, both in relation to the market (where there is a market-wide increase in price) and in relation to the individual Seller (where there is an individual, Seller-specific, increase in price). The approach that makes economic sense to the Seller depends upon:

(i) The Seller's costs and the Seller's ability to scale production (on the supply side); and

(ii) The absolute level of aggregate demand and the elasticity of that demand (on the demand side).

(2) By way of example, in the UK's electricity market, units of electricity are sold in half-hour trading periods at the price of the most expensive unit needed to meet demand. Thus:[310]

(i) In each half-hour trading period, each electricity generator bids the price it will accept to generate electricity. Naturally, those bids will be informed by the cost of that bidder's electricity production.

(ii) Bids are accepted in merit order – that is (given the electricity is fungible) the cheapest bids are accepted first, and the most expensive last, until demand is met.

[309] Where the demand curve is not normal, this outcome will not pertain: but generally speaking, the demand curve slopes down left to right for industries and individual sellers.
[310] Source: Stewart 2023, *Why is cheap renewable electricity so expensive on the wholesale market?*

(iii) However, the price of all units of electricity is set according to the bid price of the most expensive unit needed to meet aggregate demand. Paying the most efficient (i.e. the cheapest) producers the highest bid price promotes efficiency. Suppose each producer were paid on a CMA Cost Plus basis: efficient producers would not be rewarded by higher profit margins, and higher, not lower, bids would be incentivised (or at least lower bids would not be incentivised). The electricity market mechanism – which is explicitly not CMA Cost Plus – ensures that more efficient producers are not merely keen to supply (they will be bought from first) but also that they maximise Producer Surplus in a manner that will encourage other suppliers to become more efficient (because their Producer Surplus increases, whilst the price to the customer will go down).

(3) There is thus a detachment or disengagement between a Seller's costs and a Seller's price. Even in a competitive market, a Seller can generate Producer Surplus and competitively price at above cost, independently of that Seller's own costs. In fact, where demand exceeds the most efficient supply, the Seller's price will likely be determined by the costs of less efficient competitors, as illustrated in the example at **Annex 6**.

(ii) Case 2

197. The second case, **Case 2** (generation of distinctive value), concerns the fact that Sellers in the real world compete by product differentiation, not just price.[311] The perfect competition model assumes the sale of a single undifferentiated Product. It makes no provision for innovation or product differentiation, which is a key driver of the market economy: Sellers sell many products, and the way that they assist the public good through self-interest is by meeting demand not merely by competing on price, but by producing products that consumers want to buy. Again, this is a factor that – even leaving patents on one side – can exist for periods longer than the short run.

[311] Described in *Hydrocortisone 1* at [322(2)].

198. In each of Case 1 and Case 2, Producer Surplus results in prices that are not solely informed by a "cost plus" model (although that is an obvious driver of price, in that price will sit above cost-plus), but where price is also driven by demand. If that demand exists in circumstances of Real World Competition then a price at above CMA Cost Plus is clearly both possible and legitimate. If this can occur in instances of Real World Competition, then a dominant undertaking obtaining a similar Producer Surplus will not necessarily be pricing excessively.

(iii) Case 3

199. **Case 3** is the case where Producer Surplus is generated without added value to Buyers.[312] The distinction between Case 1 and Case 2 (on the one hand) and Case 3 (on the other hand) is by no means easy to draw. Indeed, there is no particular magic in these three cases. The point being made is that Producer Surplus is not necessarily a feature of markets with impaired competition. Such Producer Surplus can arise in properly functioning markets; and that is relevant to questions of unfair pricing where there is dominance.

(d) Should Producer Surplus be considered when considering the Excessive Limb

200. The distinction between "legitimate" (i.e. Case 1 and Case 2) and "illegitimate" (i.e. Case 3) Producer Surplus is most significant when the Unfair Limb falls for consideration. That is the subject of Section H. For present purposes, the question is whether the question of "legitimate" or "illegitimate" Producer Surplus must be considered as part of the Excessive Limb.

201. The Appellants contend that the approach used by the CMA is too much based on the perfect competition model, which does not recognise Producer Surplus as legitimate. If one starts with a pre-conception that perfect competition is a practical ideal (which it is not), then it is a small step to regarding any Producer Surplus as excessive. It is similarly a short step, when considering Real World Competition, to assume that the outcome of workably competitive markets

[312] Summarised in *Hydrocortisone 1* at [322(3)].

ought to be one where – at least over the medium or long term – prices track costs plus a Reasonable Rate of Return. In other words, where any form of entrenched Producer Surplus (i.e. materially present over the period under consideration) is an indicator of excess such that the Excessive Limb is engaged.

202. This was the position of Ms Webster, who expressed the view that Producer Surplus could only properly exist in the short run, and that entrenched Producer Surplus was excessive. On this basis the existence of Producer Surplus is, in and of itself, an indicator of an excessive price, because it constitutes a return above the Reasonable Rate of Return.

203. During the course of the original investigation, Pfizer's economic expert's acceptance that Pfizer was making above normal profit was taken as an admission of excess.[313] We have set out the relevant passages at [94].

204. The Decision appears to treat this as an admission that the Excessive Limb was met in the case of Pfizer. We certainly accept that the existence of Producer Surplus is an indicator of possible excess, and one that clearly needs to be taken into account. However, we do not consider that it can inexorably follow from the existence of a Producer Surplus that the Excessive Limb is satisfied, without at least some inquiry into the basis for the existence of that Producer Surplus:

(1) We recognise that the distinction between a Reasonable Rate of Return and Producer Surplus may be extremely difficult to draw. That needs to be borne in mind when assessing the Reasonable Rate of Return. However, any difference between the Reasonable Rate of Return and the Product Unit Profit will, by definition, constitute Producer Surplus.

(2) Where it is clear that a Producer Surplus does exist, it will be important to reach a view as to why it exists. The existence of Producer Surplus is, in our judgment, indicative of the Excessive Limb being satisfied. We do not consider that such a conclusion can be inflexibly drawn, but it is a matter that involves the application of judgment. Where it is clear that

[313] Decision/[5.53].

a Producer Surplus exists, and is clearly not Case 3, then some caution must be exercised.

(3) Where a Producer Surplus exists, then before the Excessive Limb can be regarded as passed, the question of whether the Producer Surplus might also exist in a market where the Enterprise said to be infringing is not dominant must at least be asked. The competition authority must be careful to avoid holding dominant undertakings to a higher standard than would apply in a case of Real World Competition (where there is no dominance). Where that Producer Surplus is clearly and distinctly (i) arising legitimately (i.e. is Case 1 or Case 2) and (ii) capable of justifying substantially all of the margin above the rate of return, then a finding of excess will need to be specifically justified.

205. For these reasons, we consider that the criticism of the Appellants that the Decision is too much wedded to a "cost plus" approach to have some substance. This question should have been asked explicitly. Instead, the Decision proceeds on the basis that anything above a Reasonable Rate of Return is *per se* excessive. In this, the Decision is, unfortunately, internally inconsistent. The Decision at Decision/[5.30] (which we have quoted at [195]) asserts that "[it] is possible for an undertaking to price above Cost Plus without those prices being either excessive or unfair". The Decision does not follow through on this. It concludes that the Product Unit Prices are above CMA Cost Plus, but it does not consider whether the Profit Margin above cost plus could have been defended in this case by "legitimate" Producer Surplus.

206. We stress that this is above all a question of judgment for the competition authority. It would be unfortunate if debates about the legitimacy of any Producer Surplus rendered consideration of the Excessive Limb unduly complex. On the other hand, treating every case of Producer Surplus as rendering Product Unit Price automatically excessive defeats the object of the Excessive Limb as a gateway to the Unfair Limb. As a general rule, provided that the Profit Margin and the Reasonable Rate of Return are appropriately calculated – as they have to be for the Excessive Limb to be considered fairly -

then the existence of Producer Surplus over the course of a reasonably lengthy "relevant period" is a good indicator of excess. More specifically:

(1) The Excessive Limb is, as we have described, a gateway condition that acts as a filter before the more nuanced Unfair Limb. As we shall come to describe, the Producer Surplus, and the reasons for its existence, occupy centre stage when considering whether a price is unfair. It would be extremely odd for the same factor – the existence of Producer Surplus – to be similarly material at both stages.

(2) The Excessive Limb is, as we have described, focussed on the Profit Margin, the difference between Product Unit Cost and Product Unit Price. It expressly leaves out of account the wider context. The Profit Margin is a static measure looking at the difference between price and cost at the Focal Product level, disregarding altogether the wider context. It is, again as we have described, an altogether unrealistic measure, in that it leaves out of account the way in which an Enterprise actually operates, with regard to overall cost and overall revenue, where output is determined not by specific price and cost but (on the theoretical plane at least) marginal cost and revenue.

(3) Clearly, the calculation of all of these parameters is no mechanistic exercise, but involves careful judgment. The distinction between a Reasonable Rate of Return and the Producer Surplus is to this extent fluid. But that fluidity should not obscure the essential difference between Producer Surplus and the Reasonable Rate of Return. Viewed, purely and simply, at the Product level, the only justification for treating the Producer Surplus as part of a non-excessive price is where such a Producer Surplus (including as to its extent) would plainly also exist under conditions of Real World Competition.

(16) Conclusions

207. For the reasons we have given, the finding of the Decision that Flynn's prices were excessive cannot be sustained. That finding is vitiated by a series of not

just material, but fundamental, errors. Findings of abusive conduct – and we appreciate that the finding in respect of the Excessive Limb is merely a gateway finding to the Unfair Limb – need to be objectively justified both in terms of methodology and the data used to inform that methodology. In this case:

(1) Although the CMA's approach to the question of excess was methodologically defensible,[314] in that (properly applied) the ROCE-WACC can determine a Reasonable Rate of Return, the application of that methodology was, in this case, flawed.

(2) Having properly calculated the Product Unit Cost for all of the Focal Products in question, and so a *prima facie* and defensible static measure of the Capital required to produce those Focal Products, the CMA then used a different (and far lower) figure for the Capital employed by Flynn in the distribution of the Focal Products.

(3) One of the reasons for this, we infer, was the fact the CMA did not want to include Flynn's costs of acquiring the Capsules from Pfizer in its assessment of Flynn's Capital employed. For reasons that we have given, the repeated tendency to regard Flynn's costs of Capsule acquisition as illegitimate and to be disregarded is, in and of itself, reason for concluding that Flynn's appeal against the finding of excess must succeed.[315]

(4) This view that Flynn's costs should not include the cost of the Capsules to Flynn appears to have lead the CMA (i) to have properly calculated Flynn's Product Unit Costs as <u>including</u> the cost of the Capsules, (ii) thereby to have assessed Flynn's Capital employed, but (iii) to have (for no reason) abandoned its own assessment in favour of an indefensible – and indefensibly low – alternative measure of the Capital employed.[316] Inevitably, therefore, the Reasonable Rate of Return was calculated by

[314] See [116].
[315] For the reasons why, see [134].
[316] See [155].

reference to a figure for Capital employed that was wrong. The finding of excess cannot stand for this reason, also.

(5) Furthermore, as we have described, the calculation of the Reasonable Rate of Return was materially wrong,[317] and the CMA failed to consider whether the existence of Producer Surplus on the part of Flynn was a matter that rendered Flynn's Product Unit Prices excessive or whether that Producer Surplus would likely have arisen anyway under conditions of Real World Competition.

208. It follows that the findings of infringement as against Flynn cannot stand. If the Excessive Limb is not demonstrably met (and it is not), then there is no point in proceeding to the Unfair Limb (at least so far as Flynn is concerned).

209. The finding of excess against Pfizer does stand, since it was not substantively challenged. We therefore proceed to consider the Unfair Limb. As a cautionary note, however, the interrelationship between Pfizer's prices for Capsules to Flynn, Flynn's costs, and the relationship between Pfizer's prices and the prices charged to Pfizer/Flynn Customers will need to be considered because Flynn and Pfizer are part of the same supply chain.

H. THE UNFAIR LIMB

(1) Approach in the Decision

(a) General

210. When considering the fairness or otherwise of Pfizer's and Flynn's prices, the CMA drew a clear distinction between the prices charged by Pfizer to Flynn and the prices charged by Flynn to Pfizer/Flynn Customers. In other words, Pfizer's prices to Flynn were unfair, as were Flynn's prices to the Pfizer/Flynn Customers. The Decision provides the following overview and summary of its findings in regard to the Unfairness Limb:

[317] See [168].

> 6.1 The CMA concludes that Pfizer's Prices for each of Pfizer's Products and Flynn's Prices for each of Flynn's Products throughout the Relevant Period were unfair by reference to the *United Brands* test as further articulated by the Court of Appeal.
>
> 6.2 First, the CMA finds that Pfizer's Prices and Flynn's Prices were unfair in themselves…
>
> 6.3 Second, the CMA finds that the comparators relied upon by the Parties do not demonstrate that Pfizer's Prices or Flynn's Prices were fair when compared to competing products or undermine the CMA's conclusion that the Parties' prices were unfair in themselves. In coming to this conclusion, the CMA has evaluated the relevant evidence and arguments advanced by Pfizer and Flynn and gathered and evaluated a large body of additional evidence…
>
> 6.4 The CMA has assessed factors relevant to the economic value of the Capsules as part of its assessment of whether the Parties' prices were excessive and unfair under the *United Brands* framework. Pursuant to the CMA's assessment, the CMA finds that demand side factors in this case do not result in an economic value beyond or additional to the economic value already reflected in the Parties' Cost Plus figures. Based on this, the CMA has concluded the Pfizer's Prices and Flynn's Prices bore no reasonable relationship to the economic value of their products during the Relevant Period…

211. According to *United Brands*, the Unfair Limb has two aspects:

(1) The price charged was unfair <u>in itself</u>; and/or

(2) The price charged was unfair when compared to competing products.

212. The Decision considered both these aspects, regarding them as alternative and not complementary tests:[318]

> The Unfair Limb is an alternative rather than a cumulative test. Accordingly, it is sufficient to demonstrate that one of the unfairness alternatives ("unfair in itself" or "unfair when compared to competing products") is satisfied to establish and infringement.

The existence of an unfair price can be established in many ways, as *United Brands* makes clear. One would expect the available and relevant evidence to point in one direction: in other words, whatever the formal legal position, complementarity is to be expected between different approaches to the assessment of "unfairness". Put another way: if a price, apparently unfair in

[318] Decision/[6.135].

itself, is justified as fair by a range of compelling comparables, that is a matter that needs to be considered in terms of the robustness of the "unfair in itself" conclusion. Although the competition authority does not have to seek out all possible forms of evidence, where relevant evidence is adduced, it must be taken into account. Where such evidence exists, the "unfair in itself" conclusion, where reached, would have to be able to stand in the face of the evidence going the other way.

213. Three elements were considered by the CMA in reaching the conclusion that Pfizer's prices and Flynn's prices were unfair:

(1) The comparables, which were adduced by Pfizer and Flynn.

(2) The question of whether Pfizer's and Flynn's prices were unfair in themselves.

(3) The "economic value" of the Capsules, and how this related to the other aspects of unfairness.

We describe the conclusions of the CMA under each of these three heads, before turning to the Appellants' appeals against the finding in the Decision that the Unfair Limb had been infringed.

(b) Comparables

214. The CMA concluded in regard to comparables:

> 6.136 Based on the assessment set out…above, the CMA has concluded that the Parties' prices during the Relevant Period were unfair in themselves. The CMA is not required to demonstrate that the Parties' prices during the Relevant Period were also unfair when compared to competing products.
>
> 6.137 However, the CMA has fairly evaluated relevant evidence put forward by the Parties in their defence, including any *prima facie* valid comparators. The Parties have advanced the following as being meaningful comparators for the purposes of assessing the fairness of their prices for Capsules during the Relevant Period:
>
> 6.137.1 Tablets; and

6.137.2 certain other AEDs.

6.138 The CMA has considered whether the evidence relating to these comparators undermines the CMA's conclusion that the Parties' prices were unfair in themselves during the Relevant Period.

6.139 …for the purposes of determining whether a price is unfair when compared to competing products, a comparator does not need to be identical or in the same relevant market, but it does need to be sufficiently similar to the product concerned to allow for a "meaningful" comparison based on objective, verifiable and appropriate criteria. This means that a comparison of the process must be made on a consistent basis and it must be ensured that the figures are really comparable.

6.140 Reflecting the view of the Court of Appeal that, "in broad terms a price will be unfair when the dominant undertaking has reaped trading benefits which it could not have obtained in conditions of "normal and sufficiently effective competition", the competitiveness of the market from which a comparator is taken is an important and relevant factor. Prices that are not set in conditions of effective competition are highly unlikely to be meaningful comparators. A comparator cannot be considered meaningful and reflective of economic value simply on the basis that the customer has accepted and is paying the price. Comparisons should also not be drawn with products the price of which may have been inflated by the exercise of significant market power.

6.141 Based on the totality of the evidence examined, the CMA has concluded that the comparator evidence does not undermine the CMA's conclusion that Pfizer's and Flynn's prices during the Relevant Period were unfair in themselves.

(c) Unfair in itself

215. We turn to the CMA's consideration of why Pfizer's prices and Flynn's prices were unfair in themselves. The CMA's consideration is set out in Decision/[6.5]*ff*. The conclusion that prices were unfair in themselves was based upon the following factors:

(1) The price increases imposed over time by both Flynn and Pfizer were significant, resulting in very high prices relative to costs, which "went well beyond the level that might have been required to ensure the drug was commercially viable or sustainable".[319]

[319] Decision/[6.6.1], [6.7] to [6.8] (generally), [6.9] to [6.16] (Pfizer's prices), [6.17] to [6.26] (Flynn's prices).

(2) The nature of the price increases was "selective":[320]

> It was only in the UK that Pfizer entered into arrangements of the type agreed with Flynn and significantly increased its prices well above the prices that Pfizer charged for identical Capsules in other European jurisdictions (Capsules supplied in EU Member States were all manufactured by Pfizer in the same German facility as the Capsules supplied to Flynn in the UK).

(3) Pfizer and Flynn illegitimately exploited their market power:[321]

> The Parties' prices reflected their substantial market power. Features of the relevant markets, including the absence of effective constraints and very high barriers to entry meant that those markets were incapable of functioning in a manner likely to produce a reasonable relationship between price and economic value. The Parties were aware of their market power and exploited this to impose significant overnight price increases on the NHS which they maintained for over four years. In doing so, the parties wilfully ignored customer concerns and did not engage constructively to resolve those concerns.

(4) The features of the Capsules provided no justification or legitimate reason for the Parties' prices:[322]

(a) Capsules had long been off-patent and in their third stage of the drug life cycle where competition is expected to drive the prices of generic drugs down and result in ongoing low prices even where they continue to deliver benefits for patients;

(b) there was no improvement to the products, or their production or distribution, or any innovation, investment or commercial risk-taking activity which might justify or provide a legitimate reason for the Parties' prices; and

(c) the CMA's qualitative assessment demonstrates that Capsules suffer from significant limitations and compare poorly to other AEDs. Reflecting this, Capsules were only recognised as a third-line treatment for patients during the Relevant Period and demand for the products was sustained predominantly by barriers to switching patients to other treatments, not because of the therapeutic benefits of Capsules relative to other AEDs.

(5) The Appellants (illegitimately) gamed the regulatory system in order to increase prices:[323]

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[320] Decision/[6.6.2]. See also Decision/[6.27] to [6.37].
[321] Decision/[6.6.3]. See also Decision/[6.38] to [6.72].
[322] Decision/[6.6.4]. See also Decision/[6.73] to [6.100].
[323] Decision/[6.6.5]. See also Decision/[6.101] to [6.117].

> The evidence on the commercial purpose of the arrangements entered into between the Parties and the approach of the Parties to them demonstrates that:
>
> (a) the commercial purpose of the Parties' arrangements was to remove Capsules from the constraints of the PPRS in order to increase prices significantly, thereby generating substantial profits for Pfizer and Flynn; and
>
> (b) a key reason for bringing Flynn into the supply chain was to provide reputational protection for Pfizer from the criticism that it would arise from the subsequent impact on the NHS, showing that the Parties appreciated the adverse impact of the price increases on the NHS.

(6) The Appellants' prices had significant and adverse effect on Pfizer/Flynn Customers and Pfizer/Flynn Patients.[324]

216. The CMA's conclusion, that the Appellants' prices were unfair in themselves is stated at Decision/[6.134].

(d) Economic value

217. The meaning of "economic value" and how it fits in determining the Excessive Limb is far from clear. The Decision considers "economic value" in Section 7. The Decision is frank about the fact that the CMA did not really know how to factor economic value into the *United Brands* test:

> 7.2 In *Phenytoin*, the Court of Appeal clarified that "economic value needs to be factored in and fairly evaluated, *somewhere*, but that it is properly a matter which falls to the judgment of the competition authority as to where in the analysis this occurs. As long as "it is properly factored into "Plus" or "unfairness" or into some other part of the test…there is no incremental obligation to take it into account again, as a discrete advantage or justification for a high price". Rather, when properly applied, the test should be capable of evaluating economic value.
>
> 7.3 For instance, the Court of Appeal noted that, "when evaluating patient benefit, it would be possible to measure its economic value in the Plus element of Cost Plus, or even in the fairness element. Equally, if there is evidence of the prices being charged in relevant, comparator markets which were effectively competitive then those prices could be capable of acting as proxy evidence of the economic value of patient benefit". As recognised by the CAT, determining the "economic value" of a product involves a considerable margin of appreciation with

[324] Decision/[6.6.6]. See also Decision/[6.118] to [6.133].

appropriate weight being given to factors on both the supply and demand side.

7.4 Consistent with this, given that there is no free-standing assessment of economic value outside of the assessments of excessiveness and unfairness, the CMA has evaluated economic value of the Parties' products as part of the application of the *United Brands* framework adopted and applied above…

Before we come to the Pfizer and Flynn Grounds of Appeal, some preliminary points need to be made:

(1) The fact that the courts in *Phenytoin 1* (both the Court of Appeal, and this Tribunal) have said, in clear terms, that this is a judgmental question for the CMA, increases and does not reduce the burden on the CMA to be clear as to how it has treated what is an obviously relevant factor: it is not good enough to say (as in effect Decision/[7.4] does) that an obviously relevant factor has been taken into account in a manner that cannot be articulated.

(2) The Decision could and should have said (i) what the CMA understood by "economic value" and (ii) how that factor had then been applied in the Excessive Limb, the Unfair Limb or both. Such an approach, clearly stated, would be entitled to significant weight as the exercise of regulatory judgment. As it is, however, the CMA's approach lacks the necessary clarity on these points and the issue of "economic value" floats uneasily in the Decision.

(3) Section 7, which deals explicitly with the question of economic value, does no more than re-tread the earlier parts of the Decision, finding that "economic value" cannot cause the finding of unfair in itself to change (Section 7A), and cannot cause the finding of unfair when considered by reference to the comparators adduced to be any different (Section 7B). The status of Section 7 is, in itself, something of a puzzle. As the Court of Appeal noted in *Phenytoin 1* (CoA) "economic value" is not a matter for separate consideration but falls to be considered <u>as part</u> of the Excessive and/or the Unfair Limbs. As it is, the Decision appears to create a <u>third route</u> by which unfairness can be established by way of a

re-run of the Excessive Limb. Thus, Section 7C states that "the very excessiveness of a price could be sufficient to establish that the price bears no reasonable relation to the economic value of the product/service being provided".[325] The Decision concludes that "demand side factors in this case – taken together – do not result in the economic value of the Parties' products being above the value already reflected in their Cost Plus figures".[326] Accordingly, the CMA concludes that neither Pfizer's prices nor Flynn's prices bore any reasonable relationship to the economic value of the Products they sold.[327] If this is no more than stating that the Excessive Limb is satisfied, because Product Unit Prices were excessive over Product Unit Cost, then these passages add nothing to the earlier analysis in the Decision, and their purpose is not understood. If, on the other hand, excessiveness can justify a conclusion that the Unfair Limb is itself satisfied, then this amounts to a re-writing of the *United Brands* test such that everything turns on whether there is an "excess" in terms of a price over and above cost plus a Reasonable Rate of Return. This effectively elides the two limbs of *United Brands* test, so as to deprive the Unfair Limb of significance and meaning.

(2) Pfizer and Flynn Grounds of Appeal

218. Both Pfizer and Flynn appealed the finding of unfairness in regard to the Unfair Limb. As Flynn took the lead in regard to the Excessive Limb, so Pfizer took the lead in regard to the Unfair Limb. We therefore begin with the Pfizer Grounds of Appeal but will make reference (where appropriate) to the Flynn Grounds of Appeal. As was the case with the Excessive Limb, the grounds of appeal are lengthy, and we set out their substance in as short a form as we can below:

(1) *The Decision pays insufficient regard to "real world comparator evidence" when considering whether the prices charged by Pfizer and*

[325] Decision/[7.23].
[326] Decision/[7.25].
[327] Decision/[7.26].

Flynn were unfair when compared to competing products.[328] The Appellants relied upon:[329]

(i) The £30 Drug Tariff Price for phenytoin sodium tablets.

(ii) The average sale prices for tablets and capsules.

(iii) The prices of other AEDs.

We have set out a number of these comparators already.[330] It will be necessary to return to them. Pfizer's Grounds of Appeal say this:[331]

> The CMA has consistently resisted Pfizer's reliance on real world comparator evidence. Real world comparators do not accord with the cost plus model that it relies upon to regulate the prices of generic pharmaceuticals. Where the CMA has demonstrated some openness to comparators – such as the tablet [average sale prices] – it has then reversed this position upon realising that the evidence did not support its case. It has failed to investigate and to disclose pertinent evidence relevant to, in particular, the tablet [Drug Tariff] price and the circumstances in which it was set.

Flynn made the same point in regard to the Excessive Limb, as we have described.[332]

(2) *The findings in the Decision as regards the patient benefit of and economic value of the Capsules are not sustainable*.[333] As we have described, the Decision attaches no value to patient benefit – or, to the extent different, economic value – to the Capsules beyond CMA Cost Plus.[334] In other words, what is said is that any Producer Surplus charged by either Pfizer or Flynn cannot be defended and is automatically unfair. This conclusion was at variance with the decision in *Phenytoin 1* (CAT),[335] and is criticised by the Appellants as both disregarding

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[328] See, generally, Pfizer Grounds of Appeal/[128]*ff*; and Flynn Grounds of Appeal/[150]*ff*.
[329] Pfizer Grounds of Appeal/[129].
[330] See [173].
[331] At [128].
[332] See [175].
[333] Pfizer Grounds of Appeal/[185]*ff*.
[334] See paragraph [246]; and Pfizer Grounds of Appeal/[185].
[335] CAT Decision/[412,417]; Pfizer Grounds of Appeal/[186].

economic value[336] and patient benefit.[337] In this regard, the Drug Tariff was relied upon as significant:[338]

> …the cost plus model ignores the reality of how pricing works in generic pharmaceutical markets. The CMA was well aware that it is standard practice in the generic pharmaceutical market to benchmark against the DT price…

(3) *The CMA Cost Plus Model is not fit for purpose*.[339] As we have seen, the CMA Cost Plus approach has been criticised in the context of the Excessive Limb, and this aspect of the appeals has already been dealt with.[340] Here, the question is whether the CMA Cost Plus approach is appropriate for purposes of determining the Unfair Limb, without considering the legitimacy (or otherwise) of any Producer Surplus sitting above the Reasonable Rate of Return. The Appellants criticised the CMA Cost Plus approach as a measure of unfairness for the following reasons:

(i) The primary criticism made by Pfizer is that CMA Cost Plus – even if, or particularly when – used for the purpose of the Excessive Limb is, for that reason, unsuited also to assess and determine the Unfair Limb:[341]

> The CMA's cost plus model dominates its Decision. Yet the Courts, and indeed the CMA's predecessor the OFT, have resisted the suggestion that cost plus is the default methodology for identifying unfair prices.

(ii) The point made by Pfizer is that on this approach, the Producer Surplus is effectively outlawed, in that any material excess of Product Unit Price over Product Unit Cost plus a Reasonable Rate of Return is not permitted to the dominant Enterprise.[342] This involves an assertion that an Enterprise may not recover

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[336] Pfizer Grounds of Appeal/[188]*ff*.
[337] Pfizer Grounds of Appeal/[205]*ff*.
[338] Pfizer Grounds of Appeal/[218].
[339] Pfizer Grounds of Appeal/[210]*ff*.
[340] See [195].
[341] Pfizer Grounds of Appeal/[108].
[342] Pfizer Grounds of Appeal/[111].

Extraneous Costs through the Producer Surplus, which begs the question of how a dominant Enterprise producing multiple products can recover for the loss-making product line.

(iii) Focus on CMA Cost Plus causes other factors to be ignored, notably "all evidence actually derived from real world pricing",[343] and is based on a theoretical model of perfect competition, where Producer Surplus cannot exist.[344] It disregards non-Product related Costs:[345]

> It is also relevant that pharmaceutical pricing typically occurs on a portfolio basis…, must account for research and development funding cycles, and is often impacted by non-price consumer concerns (e.g. supply chain integrity). These complexities explain why the legislator has crafted a multifaceted system of regulatory oversight, which seeks to maximise the benefits of mandatory price control, voluntary price control, and free competition, where each will be most effective. The stifling of multi-firm competition is contrary to a key element of this regime…The CMA's cost plus model, prone as it is to over-intervention, is liable to damage the generic pharmaceutical industry model…

(3) Approach

219. We consider the grounds of appeal as follows:

(1) Section H(4) considers whether the Decision is unduly focussed on "cost plus" when deciding the Unfair Limb. We have already considered the relationship between a Reasonable Rate of Return and the Producer Surplus as component parts of the Profit Margin. The point taken by the Appellants was simply this: when considering the Unfair Limb, the model that the CMA had in its mind was substantially derived from theory – a kind of dynamic perfect competition model – which accorded no legitimacy at all to the Producer Surplus, but rather regarded it as a

[343] Pfizer Grounds of Appeal/[212]*ff*.
[344] Pfizer Grounds of Appeal/[217]*ff*. It is noted that the Decision places enormous emphasis on the role of competition between generic pharmaceutical products: Decision/[2.80]*ff* and in particular [2.93] to [2.96].
[345] Pfizer Grounds of Appeal/[219].

badge not merely of excess, but of unfairness also. This is the issue which underlies a number of the Appellants' Grounds of Appeal.

(2) Section H(5) considers the finding made in the Decision that the Capsules have no "economic value" beyond CMA Cost Plus. This aspect will require consideration of what "economic value" is, before considering the extent to which such value was provided by the Capsules. It will be necessary to consider the Continuity of Supply issue, patient benefit as well as the Drug Tariff "price" for Tablets.

(3) Section H(6) considers the issue of comparables, and the extent to which the CMA properly took these into account. This Section also considers how the Unfair Limb operates when both the "unfair in itself" and the "comparator" aspects of this Limb are in issue.

(4) The "cost plus" model is not fit for purpose in the context of the Unfair Limb

(a) Cost plus and the Excessive Limb

220. We have cited Decision/[5.30] a number of times. Because of the importance of this paragraph, we do so again here:

> …For the avoidance of doubt, Cost Plus does not determine the maximum price for a product. It is possible for an undertaking to price above Cost Plus without those prices being either excessive or unfair.

This general point is nowhere further considered in the Decision. It does not feature in the CMA's analysis of the Excessive Limb, which proceeds on a CMA Cost Plus basis. For the reasons that we have given,[346] provided judgment is exercised, where Product Unit Cost and the Reasonable Rate of Return have been properly calculated, then the existence of a material Producer Surplus of the course of the period under consideration does *prima facie* signify satisfaction of the Excessive Limb. Going back to our test of "demonstrably immoderate" for the Excessive Limb, this is directed to a consideration of the

[346] See [83].

Producer Surplus. A Product Unit Price that entirely comprises Product Unit Cost plus a Reasonable Rate of Return is demonstrably moderate and not excessive. It is the Producer Surplus that renders it potentially demonstrably immoderate. The justifiability of the Producer Surplus is principally the province of the Unfair Limb, and the Producer Surplus should not assume undue importance nor take up too much time when the Excessive Limb is under consideration. The Excessive Limb is, after all, a gateway condition intended to act as a filter. It must neither be too fine-grained so as to exclude cases warranting consideration under the Unfair Limb, nor yet too coarse-grained so as to permit too many cases to proceed to the different considerations that arise under the Unfair Limb.

221. With this one judgmental qualification, the Excessive Limb is principally tested for on a cost plus basis. The CMA's approach (in this regard at least) was in principle correct, even if it went wrong in its implementation for the reasons that we have described. That, however, only underlines that:

(1) The legitimacy of any Producer Surplus found to exist at the stage of the Excessive Limb is central to the determination of the Unfair Limb; and

(2) A cost plus approach has little, if any, place when considering the Unfair Limb.

To the extent that the Decision determined the Unfair Limb by reference to CMA Cost Plus, it is likely to have fallen into error. Before we turn to that question, it is necessary to consider the Producer Surplus in the manufacture of pharmaceutical products like the Capsules.

(b) Producer Surplus and pharmaceutical products

222. In Decision/[2.55]*ff*, the "drug life cycle" is described. This life cycle can, no doubt, be described in various different ways. We adopt the CMA's three stage description, but in the course of summarising it, we add in other material points relevant to this Judgment.

223. The Decision records that "[m]ost drugs follow a common, relatively long, life cycle that has three distinct stages":[347]

(1) *The pre-launch period.* This is when research and development of new drugs takes place, and where regulatory approval for new drugs is sought.[348] The Decision records that "[d]uring this stage, competition between originators is R&D based with a race to be the first to successfully develop and register an invention".[349] The reward for winning this race is a patent. This constitutes the second stage of the life cycle to which we will come in a moment. Before we do so, it is worth pausing to consider the risks developers of new drugs undertake during this stage. These are not stated in the Decision, and may be described as follows:

(i) Research and development may involve significant costs to no discernible benefit. What was a promising area of research fails to deliver any benefits, and the costs are thrown away or are far higher than any benefit.

(ii) Even where research and development succeed in producing a tangible outcome in the form of a new pharmaceutical product, it may be that regulatory approval is not obtained. Again, the costs of the process (where the regulator in a given jurisdiction satisfies themselves that the product is safe and ought to be sold) are substantial, and there is no guarantee that regulatory approval will be obtained at all, obtained quickly, or in the terms sought.

(iii) Research and development may often be a race, where there can be only one winner if a patent is the prize.[350] It follows that the losers in the race will incur research and development costs that

[347] Decision/[2.58].
[348] Decision/[2.58.1].
[349] Decision/[2.58.1].
[350] Generally, as the Decision notes, that will be the case; but even without a patent, getting first to market is advantageous.

are thrown away not because the effort was wasted, but because someone else got there first.

The point we make is that these risks all involve costs that are "thrown away" and by definition will not fall within the Product Unit Cost of any Focal Product other than that of the winner of the race. In other words, for the losers, these costs thrown away will be what we have termed Extraneous Costs.

(2) *The market exclusivity period.* This is where the market exclusivity that is the reward for winning the race makes itself felt. As the Decision records, the conferring of a patent means that "the product benefits from market exclusivity and the commercialisation cycle begins".[351] Whilst this is true, there are factors which the Decision fails to recognise, notably:

(i) The outcome of a successful product development process may not be the grant of a patent. The mere fact that a product is developed and obtains regulatory approval does not mean that a patent will be granted. A monopoly is not assured.

(ii) Even if a patent is granted, and so a monopoly arises according to the applicable intellectual property law for that jurisdiction, there is no guarantee of demand. Many hundreds of patents are granted every year in the UK alone: not all of them – indeed, very few of them – enable the owner of the patent to charge at will for the product protected by the patent.

(3) *The post-exclusivity period.* The Decision describes the post-exclusivity period as "the period when generic competition is possible. Competition at this stage is primarily focussed on price because both the originator

[351] Decision/[2.58.2].

drug and competing generic drugs are effectively identical, making price the key differentiating factor".[352] The Decision goes on to say:[353]

> Products sold by originator companies are largely patent protected during the first two stages of the drug life cycle. The third stage of the life cycle commences when, following patent expiry, other pharmaceutical companies can enter the market with generic drugs. Generic drugs are typically sold at a substantially lower price than the originator drug was sold during the second stage of the drug life cycle…

The suggestion or implication is that the price of the drug during the third stage trends to cost plus.[354] However, the Decision also articulates a more nuanced analysis than this:

> 2.80 The final stage of the drug life cycle occurs when generic entry can begin. Usually, generic entry into the market is phased. During the stage, competition initially takes place between the originator and the first generic entrant(s), and subsequently between these companies and any further generic entrants. This process and, in particular, the development of competition between suppliers of generic medicines, is expected to lead to generic drug prices which are significantly below the historic originator price. Competition between generic suppliers is then typically expected to ensure that generic prices remain low.
>
> 2.81 Initially, there may be competition between generic entrants to be the first to enter. It is expected that the first generic entrant will obtain the highest profits as it only needs to price slightly below the incumbent.[355] Assuming that the incumbent does not compete on price straight away.[356] Price competition would typically be expected to be limited between the originator and the first generic entrant, due to incentives for the originator and the first entrant not to compete too strongly on price and maintain higher margins.
>
> 2.82 Other generic entrants might enter the market at a later stage, and it is typically with subsequent entry, and the initiation of price competition between multiple generic entrants, that price competition becomes fiercer.
>
> 2.83 Generic companies have different cost structures to originators given that they typically do not have to research as heavily (although the cost of research will depend on the complexity of the product) and therefore incur lower R&D costs. Generic companies also do not have to incur the high levels of marketing expenditure incurred by the originator in order to build brand value and the

[352] Decision/[2.58.3].
[353] Decision/[2.59].
[354] Decision/[2.59] fn 186, which makes this point.
[355] This is a phenomenon that is well-recognised. Generally speaking, the generic Seller first entering the market will (i) price at just below the incumbent and (ii) limit its own supply so as to avoid a price war.
[356] As we have noted (fn [358]), the first generic to enter the market will (without collusion) be inclined to avoid a price war, and limit the extent of the market that it contests.

market for the drug. This enables them to enter the market with lower prices than the originator and initiate competition.

2.84 Following entry of generic competition, the originator typically has three strategies it can employ to continue making profits:

2.84.1 Option one: choose to compete on price to protect its sales. The originator is likely to maintain larger sales volumes when generics enter if it lowers its price and competes with the generic manufacturers.

2.84.2 Option two: choose not to compete on price and instead maintain a higher price for its branded product. The originator would continue to receive a higher price for any patients who are on closed prescriptions (which specify a particular branded product[357]) whilst accepting that it is likely to lose patients on open prescriptions (which list the generic, non-proprietary, name of the medicine) to generic competitors charging a lower price.

2.84.3 Option three: choose not to complete on price and instead maintain a higher price for its branded product and introduce a generic version of the drug at a lower price. This would allow the originator to receive a higher price for any patients who are on a closed prescription but also allow it to protect some of its sales via the lower priced generic version.

2.85 The strategy adopted by the originator may vary over time depending on the pace and strength of generic entry. Irrespective of the strategy that the originator adopts, generic entry and subsequent competition would typically be expected to reduce the average prices due to encouragement of the use of open prescriptions in the UK.

2.86 If several suppliers enter the market, generic products usually become "commoditised", meaning that suppliers of generic medicines are not able to use brand value or product quality to differentiate themselves. This is the case even for life-saving medicines. The primary focus of competition for suppliers of generic medicines is then the price offered to wholesalers and pharmacies. This competition causes the average drug price to gradually fall towards the cost level.

2.87 In 2016, the Secretary of State for Health and Social Care…stated in Parliament:

> We rely on competition in the market to keep the prices of these drugs down. That generally works well and has, in combination with high levels of generic prescribing, led to significant savings.

[357] In the present case, this is a very important factor, given the Continuity of Supply issue that we have described. How this factor plays out is considered further below.

As the Decision itself makes clear, in the passages we have quoted, the Secretary of State's remark is probably accurate as a matter of theory, but less so in practice, particularly where (as here) there are Continuity of Supply issues.

224. Assuming, in the present case, a Profit Margin in relation to the Capsules comprising both a Reasonable Rate of Return and a material Producer Surplus,[358] we consider that a finding of excess and a conclusion that the Excessive Limb was satisfied would be entirely justified:

(1) Phenytoin sodium is an old drug, commercialised in 1938.[359] It is long out of patent, and has, for decades, been in the third stage of pharmaceutical product sales.

(2) Although there are complexities – which we address briefly in the next sub-paragraph – the Capsules have competition, in the form of Phenytoin Sodium NRIM Capsules[360] and in the form of Tablets,[361] both of which are pharmacologically identical. In these circumstances, one would expect the prices of the Capsules to trend to cost plus, because that is what happens in markets where there are multiple generic providers. The existence, therefore, of material Producer Surplus is *prima facie* surprising in this case.

(3) The complicating factor is the issue of Continuity of Supply, which causes what would otherwise be substitute products for Capsules not to be. Continuity of Supply is the reason the Capsules were found to be dominant and is the basis for the CMA's jurisdiction in this case. It might very well be, therefore, that any Producer Surplus could be justified by Continuity of Supply. We consider that the point is sufficiently unusual and esoteric for a regulator like the CMA properly to conclude that the filter of the Excessive Limb should not be used to prevent consideration of unfairness in the Unfair Limb.

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[358] There is, given our conclusions, no basis for such a conclusion as regards Flynn. Hence the assumption of Producer Surplus.
[359] See [8].
[360] See [18].
[361] See [18] and [177].

(4) Matters would be very different if the Capsules had been at the second stage of pharmaceutical development, protected by a patent. In such a case, the existence of some Producer Surplus would be expected, and we consider that the automatic reference of such cases to the Unfair Limb would be to misunderstand the true function of the Excessive Limb as a gateway or filter. That being said, it is perfectly possible for some Producer Surplus to be defensible, but not for the Producer Surplus to be so large in a given case as to be demonstrably immoderate or excessive. Put another way, it would be an error of judgment to proceed on the basis that the mere fact that a pharmaceutical product (or, for that matter, any product) is protected by a statutory monopoly like a patent renders the prices charged by the Seller inevitably not excessive

(c) Cost Plus and the Unfair Limb

225. We turn now from the gateway condition of the Excessive Limb to the Unfair Limb itself. The Excessive Limb is, as we have seen, concerned with the extent to which Product Unit Price exceeds Product Unit Cost plus a Reasonable Rate of Return. That excess is the Producer Surplus and – although the position is a little more nuanced than this, as we have described above – significant Producer Surplus is a *prima facie* indicator of excess. Put another way, the Excessive Limb is only peripherally concerned with the Producer Surplus. The focus is on establishing the Product Unit Cost and the Reasonable Rate of Return.

226. The Unfair Limb is predominantly concerned with the Producer Surplus and its justifiability. If the Producer Surplus, including in particular its extent, can be justified, then the Product Unit Price can properly be found to be fair, and the Unfair Limb accordingly left unsatisfied. Put another way, whereas the Excessive Limb is concerned with the existence of Producer Surplus, the Unfair Limb is concerned with its justifiability. From this it follows that a cost plus approach to the Unfair Limb is the wrong approach. The existence of Producer Surplus – and so the absence of a Product Unit Price trending towards CMA Cost Plus – is a given: the Excessive Limb has been satisfied. Focus on CMA Cost Plus – critical for the Excessive Limb – is at best an irrelevance and more like an immaterial factor to take into account in the case of the Unfair Limb.

227. This delineating of what goes to the Excessive Limb and what goes to the Unfair Limb is in accordance with *United Brands*. It would be irrational for the same factors that go to the gateway condition also go to the condition determinative of whether there is an infringement of the Chapter II prohibition. This sort of double-counting renders the gateway and a two-stage test pointless. The question we turn to is the extent to which the CMA paid regard to irrelevant and immaterial factors when considering the Unfair Limb.

(d) A focus on irrelevant factors?

228. We have set out at [215] the various factors on which the CMA based its conclusion that the Unfair Limb was satisfied. It is immediately apparent that the first three factors are points that go to the Excessive Limb and not to the Unfair Limb. Thus:

(1) The first factor (summarised at [215(1)]) is explicitly a CMA Cost Plus factor, with its emphasis on very high prices relative to costs. In other words, the factor identifies that Producer Surplus exists and presumes it to be unjustifiable and so unfair.

(2) The second factor (summarised at [215(2)] appears to be a comparative factor, contrasting the prices charged by Pfizer in the UK with the prices charged by it in other European jurisdictions. As to this point:

(i) It is difficult to see how this point can relate to Flynn at all. Flynn only sold in the UK and paid (as we have described) the high prices that it was charged by Pfizer, which will have informed its Product Unit Cost and so its Product Unit Price. We consider that the Decision could and should have considered the Unfair Limb separately as regards Pfizer and Flynn, for this factor has nothing to do with Flynn.

(ii) So far as Pfizer is concerned, this factor appears to be suggesting (i) that the price mechanisms in highly regulated pharmaceutical markets are the same, such that prices of pharmaceutical

products ought to be the same or similar across jurisdictions and (ii) that Pfizer was obliged to price similarly in all these markets. So far as (i) is concerned, we do not consider that the CMA has adduced any material to support this in the Decision; so far as (ii) is concerned, we do not consider that it is even a *prima facie* infringement of competition law for a dominant Enterprise to charge differentially from one jurisdiction to another.

(iii) This is another excessive pricing point, albeit based on trans-national comparators. What is being said is that the prices charged for the same product in other jurisdictions were lower than the prices charged for the same product in this jurisdiction. This is very clear from later paragraphs in the Decision regarding this factor, which it is appropriate to set out:[362]

> 6.27 During the Relevant Period, Pfizer sold Capsules in several other European jurisdictions under the *Epanutin* brand. The Capsules sold in other European jurisdictions were exactly the same drug as that sold in the UK, manufactured by the same company in the same German facility and with similar direct costs.
>
> 6.28 Despite these similarities and the fact that Pfizer stated that viability concerns were also relevant in other European jurisdictions, Pfizer has not sought to enter into any arrangements in any other European jurisdiction equivalent to those it entered into with Flynn in the UK or to implement price increases anywhere near the level of those implemented in the UK…
>
> 6.29 The CAT found it "a significant factor that Pfizer's capsule prices were only increased in the UK and only as a result of the arrangements reached between Pfizer and Flynn". Whilst the CAT recognised that some caution must be exercised in comparing prices between countries with differing regulatory regimes, the CMA considers that the selective nature of Pfizer's price increases supports the conclusion that Pfizer's Prices were unfair in themselves."

The point being made is this: (i) the Capsule Product Unit Costs for Pfizer were the same across Europe; but (ii) the prices were

[362] Emphasis added.

different, and higher in the UK; so that (iii) it therefore follows that the prices in the UK were not following cost. This last conclusion appears to us sound, however the other European prices were calculated: but the point we make is that this is again a CMA Cost Plus point.

(3) The third factor (summarised at [215(3)] is that the Appellants' prices "reflected their substantial market power". The CMA is saying that where a dominant Enterprise prices at anything other than CMA Cost Plus, its price is presumptively unfair. The issue of exploitation, as the CMA call it in the Decision – needs to be fairly determined by reference to the facts. The CMA have simply concluded that the Producer Surplus is illegitimate, with no supporting facts or reasoning to justify that conclusion. Thus, the Decision variously states:

> 6.38 It has been established that there were features of the relevant markets which provided Pfizer and Flynn with substantial market power during the Relevant Period. The evidence also demonstrates that the Parties were aware of their market power and exploited this by imposing significant price increases and sustaining these for over four years. The Parties' price increases forced the NHS to spend an additional £169 million on Capsules during the Relevant Period, without any additional benefits for patients.
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> …
>
> 6.46 Pfizer's and Flynn's dominance was not temporary, nor were their prices merely "temporarily high". In fact, the Parties continued to charge excessive prices for over four years until they were required to lower them to comply with the Directions issued with the 2016 Infringement Decision because the CAT refused Flynn's application for interim relief.
>
> 6.50 The evidence shows that the Parties were aware of their market power and exploited this to impose significant price increases on the NHS. They saw an opportunity and they took it.
>
> 6.51 The parties were aware that they did not face any effective constraint from competing suppliers. There were no other manufacturers of phenytoin sodium capsules at the time they began negotiating the arrangements and the parties were aware that different manufacturers' phenytoin sodium products (including capsules and Tablets) were not interchangeable to a significant degree.

This last point is the Continuity of Supply point, which operated as the source of the Appellants' market power, creating a monopoly position in the manner described at [224(3)]. We will come to the significance of this in due course: the point for the present is that the Decision is saying (without giving any reason) that increasing prices in the way the Appellants did was wrong (and so unfair). It may very well have been: but it is incumbent upon the regulator to articulate at least some reasoning in support of the conclusion it has asserted. The only discernible reasoning is that the prices charged exceeded CMA Cost Plus and so were not merely excessive but also (but for exactly the same reason) unfair.

229. Turning to the remaining factors that were relied upon in the Decision:

(1) As regards the fourth factor (summarised at [215(4)]):

(i) This in part another immaterial "excessive pricing" point. It is said that given the stage in product cycle at which the Capsules were (i.e. well into the third stage, where the products were out of patent, and had been so for a long time), there was no legitimate explanation for the prices that the Appellants charged. As the Decision notes, the "Capsules had long been off-patent and in their third stage of the drug life cycle where competition is expected to drive the prices of generic drugs down";[363] and there was "no improvement to the products, or their production or distribution, or any innovation, investment or commercial risk-taking activity which might justify or provide a legitimate reason for the Parties' prices".[364]

(ii) To the extent that this is a point about excessive pricing over cost, the point is bad (so far as the Unfair Limb is concerned) because it is immaterial for the reasons we have set out. But this

[363] Decision/[6.6.4(a)].
[364] Decision/[6.6.4(b)].

paragraph also contains an assertion that there was nothing in the provision of the Capsules to justify the Producer Surplus that (we assume) the Appellants were charging.[365] That is a point going to the Unfairness Limb, which we will consider in the context of the appeal in regard to the Decision's findings that the Capsules had no "economic value".[366]

(2) The fifth factor (summarised at [215(5)]) asserts that the Appellants illegitimately gamed the regulatory system in order to increase prices. This undoubtedly is a factor going to the Unfairness Limb, and we consider it in Section [H(5)].

(3) The sixth factor (summarised at [215(6)]) – that the prices charged had significant and adverse effects on the end customer and on patient welfare – similarly falls to be considered in Section [H(5)].

230. We conclude that this Ground of Appeal succeeds. The bases on which the Unfair Limb was determined on the face of the Decision are essentially factors relevant to the Excessive Limb and not to the Unfair Limb. The Unfair Limb has, therefore, been decided on the basis of immaterial and irrelevant factors and cannot be sustained. The Appellants are right to say that the mere fact that Product Unit Price is excessive over Product Unit Cost says nothing in relation to the Unfair Limb, although it is highly significant, and often determinative, as regards the Excessive Limb. To the extent that the Unfair Limb was decided by reference to factors that might be said not to be CMA Cost Plus related (those considered in [229]), they are not (for reasons we come to) in and of themselves sufficient to sustain a finding of unfairness; and, in any event, where the outcome of the Unfair Limb has been decided by reference to a series of factors that are not relevant but immaterial to that question, it is unsafe to do anything other than set the Decision aside. We conclude that the finding in the Decision that the Appellants' prices for the Capsules were unfair and in breach of the

[365] So far as Pfizer is concerned, we have not overturned the findings in the Decision that Pfizer's prices were excessive, and so the conclusion as regards Producer Surplus follows. Since no such conclusion is presently tenable as regards Flynn, we make the assumption (purely for the sake of argument) that there was excess and so Producer Surplus requiring of justification.
[366] i.e. in Section [H](5).

Unfair Limb to be indefensible in these appeals. The finding is – on its own terms – incapable of justification.

(e) What is relevant to the Unfair Limb?

(i) The question articulated

231. So far, a great deal has been said as to what is not relevant to the Unfair Limb, and why the various of the factors articulated by the CMA are immaterial to the question of unfairness, without stating what is relevant and what should be taken into account. It is incumbent upon us to do so, in order for the question of immateriality to be articulated as clearly as possible and to enable us to proceed to remake the Decision as we have indicated that we will seek to do.[367]

232. The Excessive Limb is concerned with the extent of the Producer Surplus, whereas the Unfair Limb is concerned with the reason why the Producer Surplus exists. Although the Producer Surplus cannot, given the assumptions that are made, exist in the case of perfect competition,[368] that does not mean, where it arises in the "real world", that is necessarily indefensible. Even in the case of Real World Competition, where there is no dominant Enterprise, it is possible for Producer Surplus to exist. Before reaching a conclusion that prices are unfair under the Unfair Limb, a competition authority must be satisfied that the Producer Surplus arises because of an infringement of competition law, and therefore it must be satisfied that the Producer Surplus that has been identified (including its extent) would not arise (or would not arise to that extent) in the case of Real World Competition.

(ii) Three complexities

233. There are, thus, three related questions to be considered: (i) the nature of the Producer Surplus in any given case; (ii) whether that Producer Surplus would arise in Real World Competition (i.e. where the pre-condition of dominance, that founds jurisdiction in Chapter II cases, does not exist); and (iii) where some

[367] See [52].
[368] See [190].

Producer Surplus would exist in a state of Real World Competition, whether the extent of the Producer Surplus in the case of dominance being considered is fair or unfair. These three matters are considered in turn.

(iii) The nature of the Producer Surplus

234. Producer Surplus can be classified into three Cases – Cases 1, 2 and 3.[369] Although there is something of a porous border between these Cases, they can be used to differentiate between illegitimate Producer Surplus and legitimate Producer Surplus. More specifically:

(1) Case 3 is the case where Producer Surplus is generated without added value to Buyers. Where Producer Surplus is solely attributable to Case 3, the Unfair Limb is satisfied without more. The decision in *Hydrocortisone 1* is a case in point. There the Tribunal found that the prices charged for hydrocortisone could not be defended under the Unfair Limb because the Producer Surplus paid by Buyers fell entirely within Case 3.

(2) Cases 1 and 2 are more difficult. In those Cases, the existence of some Producer Surplus is justifiable. But these cases are not a "blank cheque": they cannot justify the charging of any price no matter how high. Take, for example, the most extreme instance, that of a "blockbuster drug" protected by a patent monopoly. This is, *par excellence*, an instance of Case 2, where an *ex hypothesi* distinctive product, unique in the market because of its inventiveness, generates demand enabling the Seller to name their own price, thereby generating Producer Surplus. Assuming that the prices charged are so high that the Excessive Limb is passed,[370] prices found to be excessive under the Excessive Limb may very well not be unfair under the Unfair Limb. That, too, is a question of judgment

[369] See [196] to [199].
[370] This would be a case where judgment would have to be exercised in relation to the Excessive Limb. Some Producer Surplus would be expected, and it would be irresponsible to regard each and every case as involving excessive prices under the Excessive Limb. That said, there will be prices that are so high that even a Case 2 Producer Surplus ought to be considered under the Unfair Limb, and so be regarded as excessive under the Excessive Limb.

informed by factors that we will come to. What is clear, however, is that no dominant Seller can price unconstrainedly. There will always come a point where even the Seller of a "blockbuster drug", protected by a patent monopoly, prices not only excessively but also unfairly. In short, whilst falling within Case 2 provides the Seller with the right as well as the ability to charge in excess of CMA Cost Plus even in the long run, that right has limits under competition law.

235. Ms Webster suggested that the "blockbuster drug" protected by a patent monopoly was a *sui generis* case where a Producer Surplus could be maintained over the long run. Otherwise, her view was that in a case of Real World Competition (which, of course, the patent case is not) Producer Surplus could not be maintained in this way. For reasons that we have given,[371] even in the case of Real World Competition a legitimate (Case 1 or Case 2) Producer Surplus can be maintained in the long run. Of course, in many cases, competitive forces ought to reduce Producer Surplus so that the market reaches a CMA Cost Plus outcome: one of the effects of the Producer Surplus is to attract new Sellers into the market, because all a Seller needs to remain in the market is to earn Normal Profit. Anything over and above Normal Profit ought to attract new entrants. The point is that in Case 1 and Case 2, even under conditions of Real World Competition, the market conditions are such that new entrants cannot compete either on price (Case 1) or on other product differentiators (Case 2), such that Producer Surplus can be maintained, potentially indefinitely. To this extent, therefore, we do not accept the evidence of Ms Webster. It is the role of competition law to differentiate between legitimate cases and illegitimate cases of Producer Surplus, including (to be clear) as to the extent of that Producer Surplus, not merely its existence. The point of the Unfair Limb is to police the extent of the Producer Surplus. Put another way: it is wrong to proceed on the basis that where there is dominance and a Producer Surplus, the prices of the dominant Enterprise are *ipso facto* unfair.

[371] See [236].

(iv) Legitimate producer surplus in the case of Real World Competition

236. Although it is obviously easier to generate and maintain a Producer Surplus where the Enterprise is dominant in a market – because there are a lack of substitutes – Case 1 Producer Surplus is the norm in Real World Competition provided only that demand exceeds the ability of the most efficient Seller to supply that demand. Since (i) relative inefficiencies are the norm, and not the exception, because (ii) Sellers are heterogenous not uniform, and (iii) the most efficient Seller is unlikely in all cases to be able to supply the whole market, most markets will exhibit some Producer Surplus.

(v) The difficulty in assessing the fairness of the extent of the Producer Surplus

237. Abuse of dominance through pricing too high constitutes one of the most difficult areas of competition law infringement. That is because price is an inherently market-driven outcome derived through the interaction of aggregate supply and aggregate demand. Where the market is reasonably competitive – i.e. in a case of Real World Competition – courts ought to be slow to question the price that is the outcome.

238. A market in which a dominant Enterprise participates is not, for that reason alone, infected by abusive conduct. A finding of dominance means that certain conduct permitted to a non-dominant Enterprise is not permitted to the dominant Enterprise. The range of abuses of a dominant position is wide and not closed, and one tried and tested means of assessing whether conduct by a dominant undertaking is abusive is the use of the counterfactual. In other words, the question of abuse can be elucidated by asking:

What would be the case in the counterfactual world, i.e. if the abusive conduct were removed from consideration?

Often – although not always – the extent to which the conduct in question can be assessed to be abusive turns on whether the price (express or implied) of the

relevant product would go down or up in the counterfactual world,[372] when compared to the real world. In answering this question, a great deal turns on the theory of harm that is articulated, for the theory of harm defines the extent to which the counterfactual world is different from the real world and the manner in which the differences between the real world and the counterfactual world are evaluated.

239. This approach is not possible where the abuse in question is one of unfair pricing. It cannot, sensibly, be asked what the effect of the harm – the price – would be in the counterfactual world, because that assumes the abuse. If the abuse is presumed to be a price that is too high, then the counterfactual world (without the abuse) would be the same world, but with a lower price. The inquiry verges on the circular and is in danger of presuming that which it is testing for, namely an abuse of a dominant position. That is one of the main reasons why abuse of dominance in the form of excessive pricing represents a difficult emanation of competition law. The use of labels like "excessive" and "unfair" – unless embedded in a proper economic context – tend to the subjective.[373] Obviously, such subjectivity needs to be avoided.

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[372] Although one might assume that a higher price in the counterfactual world would render the existence of an abuse more likely, that does not follow: take, for instance, the margin squeeze referred to in paragraph [75(2)] above. In that case, the counterfactual price would be higher than the actual price. This serves to indicate that the theory of harm underlying the articulation of abuse is a matter of enormous importance.

[373] An early edition of O'Donoghue and Padilla, *The Law and Economics of Article 102 TFEU*, 2nd ed (2013) says this at 733:

> There is no generally accepted definition in economics of what an unfair or excessive price is. For Marxist economists, the "fair" price of a product would be equal to the value of labour involved in its production. Classical economists would also endorse a cost-based theory of value. For neo-classical economists, the "fair" value of a good or service would be given by its "competitive" market price, which is the equilibrium price that would result from the free interaction of demand and supply in a competitive market. This was also the interpretation given to the notion of "fair" prices by scholastic economic thought, and is also the interpretation used by the ordoliberal school of economic thought, which had a major impact on the development of EC competition policy. For the ordoliberals, a price is "fair" when it is the result of "free and honest" competition; in other words, dominant firms should set "competitive" prices, i.e. they should act "as if" they operated in competitive markets. Modern industrial organisation theorists would define excessive prices as those which are set *significantly* and *persistently* above the competitive level as a result of the exercise of market power. All these definitions, including the last, are however ambiguous and somewhat circular.

(f) An approach to assessing the Unfair Limb

(i) The relevant test

240. The Unfair Limb is concerned with whether the Product Unit Price line over the period of the (alleged) Chapter II infringement is too high such that it may properly be termed "unfair". Figure/Table 8 (at [145(2)]) shows a stack of different values, where Product Unit Cost, the Reasonable Rate of Return and the Producer Surplus sit below the price line, with Average Consumer Surplus sitting above it. The Unfair Limb is concerned with the binary question of whether the "correct" location of that price line is the price charged – the Product Unit Price – or somewhere below the Product Unit Price.

241. The Unfair Limb is not concerned to ascertain the "true" or "fair" price. The Court of Appeal made clear in *Phenytoin 1* (CoA) that the court should not seek to benchmark or ascertain the price that would pertain under circumstances of Real World Competition.[374] Rather, the question is whether the Product Unit Prices charged by the dominant Enterprise over the period of the (alleged) infringement are too high. The starting point for this inquiry is the Product Unit Price actually charged by the dominant Enterprise. Ms Webster did not accept this: she contended that the correct starting point was CMA Cost Plus. This, however, is another manifestation of the CMA Cost Plus fallacy that we have described. Put another way, it is wrong to presume (even in a case of dominance) that the Producer Surplus is illegitimate or abusive, even as to its extent. The test is therefore:

Is the price line (i.e. Product Unit Price over the period of the (alleged) infringement set at an unfairly high level, such that a fair price would be materially lower than the Product Unit Price in fact charged?

There is, as the Court of Appeal has emphasised, no need to specify what the "fair" price should have been. What matters is the identification and weighing of the factors – and they may point in different directions – that inform the binary outcome of the test we have framed. The Unfair Limb involves a

[374] *Hydrocortisone 1* [247] to [254].

weighing of multiple factors: precisely the sort of multi-factorial approach that courts are very used to undertaking in other contexts.

(ii) Relevant factors

242. In any case where the Excessive Limb is satisfied, factors relevant to the Unfairness Limb need to be identified and weighed. What follows is a list of potential factors for any given case. The list is obviously not a closed one:

(1) *Classification of the Producer Surplus: Cases 1, 2 and 3.* Case 3 is the instance where no part of the Producer Surplus is defensible. Where the Producer Surplus can be classified in this way, questions regarding the extent of the Producer Surplus do not arise. Cases 1 and 2 are harder cases, because the Producer Surplus is obtained or can be obtained in conditions of Real World Competition as well as in cases where there is dominance. In order to understand whether the Producer Surplus is excessive, it is necessary to understand why it has arisen. Producer Surplus has to be earned by the dominant Enterprise, not forcibly extracted from an unwilling market.

(2) *Case 1: relative inefficiency amongst Sellers.* Where a Producer Surplus can be explained as an instance of Case 1, the Unfairness Limb ought to be relatively easy to determine. Suppose a situation like the electricity generation market described at [196], where the dominant Enterprise is also the most efficient (selling electricity at the lowest prices). If demand exceeds the supply of that Enterprise, then it will receive a price that is higher than what it was offering, which will almost by definition be Producer Surplus. It might be said that the dominant Enterprises prices were excessive, but it could not be said that they were unfair.[375]

(3) *Case 2: generation of distinctive value.* In Case 2, the demand for the dominant Enterprise's product arises out of the non-price differentiation

[375] It would be a different matter if the dominant Enterprise deliberately withheld efficient capacity so as to increase its aggregate Profit Margin. This would not be an instance of Case 1, which proceeds on the basis that the most efficient (dominant) Seller is selling to efficient capacity.

of the Focal Product. In other words, the differentiating feature is something other than price, but which enables a higher price to be charged, because the differentiating feature itself attracts demand. Case 2 is intrinsically more subjective than Case 1. A number of secondary questions arise that may be relevant to justifying the Producer Surplus in Case 2:

(i) To what extent is the Focal Product truly distinctive in terms of the value it offers to Buyers?

(ii) To what extent is that distinctiveness incapable of replication by other Sellers, and why are other Sellers not entering the market (as would ordinarily be the case)?

(iii) To what extent is the demand from Buyers "voluntary"? Is the demand driven by need or desire? A banana is not substitutable by other fruit; and it may be that a dominant position in the banana market can – because of an absence of substitutes – be used by the dominant Enterprise to generate a SSNIP (which is one way in which dominance can be tested for). If the price of bananas rises beyond a SSNIP, the demand curve for bananas is unlikely to be as inelastic as that of a pharmaceutical product needed for a serious medical condition. At some point above the SSNIP used for market definition, a price rise will cause demand for bananas to default to other fruit, even if they are not (in competition law terms) substitutes. This is because the demand for bananas arises out of desire, not need.[376] Where demand is need based, significant price increases may have little or no effect on demand, precisely because the demand for the Focal Product is need- and not desire-based.

[376] This is the basis for the "cellophane fallacy": there is a failure to spot an abuse of dominance through unfair pricing because prices are so high, application of a SSNIP results in a falling away of demand, such that the price increase is not worth the Seller's while. The SSNIP test is not helpful here, because the price is already abusive. In cases of unfair pricing, great care is needed in deploying the SSNIP, for this reason.

(4) *To what extent is the Producer Surplus being used to recover legitimate Extraneous Costs?* The life cycle for pharmaceutical products was considered at [223]. Whilst the Enterprise that successfully obtains the grant of a patent to a blockbuster drug may well be able to charge a price containing significant Producer Surplus, many pharmaceutical firms incur Extraneous Costs in failed product development. The Appellants made the point that successful drugs fund unsuccessful drugs. A CMA Cost Plus price does not enable the Enterprise to recover Extraneous Costs, because the Product Unit Price is no more than the Product Unit Cost plus the Reasonable Rate of Return for the risks involved in selling the Focal Product only. There is, in such a price, no room for recovering Extraneous Costs; yet the circumstances may be such that the business model of the Enterprise – viewed as a whole – requires some form of Producer Surplus to be charged in the case of successful products. As we have described, the Excessive Limb explicitly does not take account of the wider costs of the Enterprise.[377] The question of excess is measured by reference to the Profit Margin; and the Profit Margin is simply the difference between Product Unit Cost and Product Unit Price. Extraneous Costs of the Enterprise do not feature.

(5) *Cost savings caused by the sale of the Focal Product exceeding the level of the Producer Surplus.* It will be necessary to consider this factor in greater detail, for Mr Brealey, KC placed considerable emphasis on it on behalf of Pfizer. In the context of the Capsules, he made two points:

(i) The price of Capsules was less than the human cost of epileptic seizures avoided. Because these human costs are difficult to quantify in monetary terms, Mr Brealey, KC placed less emphasis on this point than on his next point. Nevertheless, this is a factor that needs to be borne in mind. The Capsules deliver an unquantifiable – but obviously positive – benefit to those patients to whom they are prescribed, which might serve to justify significant Producer Surplus. (We do not say that this is

[377] See [62].

necessarily the case: all we are doing is identifying potentially relevant factors.)

(ii) The price of Capsules was less than the economic cost of the epileptic seizures that would otherwise have occurred. Thus, there is the cost to the NHS of treatment of the aftermath of epileptic seizure – which we accept is likely to be far higher than the cost of the Capsules that would (on this hypothesis) have caused the seizure to be avoided. Similarly, the wider costs of a sufferer of epilepsy being off work, etc would be avoided.

It is uncomfortable to speak in such cold terms of the benefits arising out of the prescription of Capsules: the point is, however, a valid one, and it needs to be taken into account.

(6) *The extent of any Consumer Surplus.* Aggregate Consumer Surplus sits above the price line.[378] The extent to which the difference between Product Unit Price and CMA Cost Plus is divided between the Seller (in the form of Producer Surplus) and the Buyer (in the form of Consumer Surplus) is a relevant factor on which the Appellants relied. We agree that it is a relevant factor: although we would stress that its weight must depend upon <u>why</u> the Consumer Surplus arises.

(5) The Capsules and their "economic value"

(a) What is "economic value"?

243. The meaning of economic value was considered in *Phenytoin 1* (CoA). Green LJ observed that the term was undefined in *United Brands*,[379] going on to say:[380]

> The concept of economic value is not defined. In broad terms the economic value of a good or service is what a consumer is willing to pay for it. But this cannot serve as an adequate definition in an abuse case since otherwise true value would be defined as anything that an exploitative and abusive dominant

[378] See Figure/Table 1 at [65(3)].
[379] At [65].
[380] At [154].

> undertaking could get away with. It would equate proper value with an unfair price. That is a well-known conundrum in international competition law. The same point was made by the Court of Appeal in *Attheraces*…at [205]. The issue was first identified in US antitrust and arose from criticisms of the judgment of the Supreme Court in *US v. Du Pont*, 351 US377 (1956) when it attracted the soubriquet "the cellophane fallacy". To overcome this in *United Brands* in [250], the Court held that there must be a reasonable relationship between price and economic value.

Economic value is closely related to the concepts of Consumer Surplus and Producer Surplus that have already been considered. The factors that we have outlined as going to the Unfair Limb are all about the relationship between economic value and price. It is helpful, however, to frame these difficult judgmental questions in different ways, because there is no "brightline" test for the Unfair Limb. This is a multi-factorial test, where it is incumbent on the competition authority to set out, describe and weigh the relevant factors with careful, objective, clarity.

244. We make the following points by way of expansion:

(1) Where there is Real World Competition, the price that is agreed between the Buyer and the Seller represents the economic value derived by both the Buyer (in the form of the product purchased) and the Seller (in the form of the consideration – money – received). From the Buyer's point of view – and we will focus on the Buyer, because it is the fairness of the price charged to the Buyer that we are concerned with – value is <u>not</u> the price paid, but the Consumer Surplus derived. Where – as one generally is – talking about a group of Buyers (Buyers in the aggregate), we are looking at the Average Consumer Surplus.

(2) Average Consumer Surplus can only be assessed by reference to a price that is paid: without a price paid, it cannot be said what higher price the Buyer or Buyers would have been prepared to pay. The function of the market in the case of Real World competition is to enable a proper – by which we mean <u>fair</u> – allocation of Producer and Consumer Surplus as between Buyers and Sellers. The price is the outcome, on the Buyer's side, of (i) willingness to pay and (ii) ability to pay. It is important not to focus just on willingness to pay. Many people may be willing to pay

for something – because they want it – but actually cannot manifest that willingness because they do not have sufficient resources to pay.

(3) In the case of Real World Competition, there is no compulsion to purchase, because the existence of other products, even if not substitutes in the competition law sense, means that there is some element of competition. Real World Competition is not perfect competition, so some Producer Surplus can, and probably will, exist. But the Buyer's Consumer Surplus is protected through competition. Real World Competition stands in contrast to perfect competition (which is a model only) and what we can call **Impaired Competition** (where, for example, there is a dominant undertaking abusing its position). The problem with Impaired Competition is that one does not know – cannot know – the price. All one can say is:

(i) The price actually charged can, at best, be treated as presumptively right. But it may not be the outcome of Real World Competition, and so cannot be regarded as anything other than a starting point.

(ii) CMA Cost Plus is useful as a test of how high the price is – how great the Producer Surplus is – but to assert that the fair price is a cost plus price is to impose an outcome that is quite possibly more extreme than the outcome that would pertain in Real World Competition.

(4) One is driven back to the question of a reasonable relationship between Product Unit Price and "economic value", where the latter value is (in Real World Competition) the same as Product Unit Price, but in non-Real World Competition differs or may differ from it in a manner that cannot be ascertained by reference to market forces. The problem – as Green LJ rightly pointed out – is that in a case of dominance, where there is no workable competition, economic value cannot equate to price paid. That is because the existence of abuse cannot be tested for. The price may be fine – dominance does not equate to abuse – but there is no

workably competitive state that would enable the price in such a case properly to be equated with economic value. To do so would, in those circumstances, be to render economic value the equivalent of an abusive price, which is absurd.

(5) However, that conclusion cannot be allowed to redefine economic value as CMA Cost Plus. Economic value involves both appropriate Producer Surplus and appropriate Consumer Surplus.

245. Accordingly, the proper approach – in the case of abuse of dominance by way of unfair prices – is to see economic value as lying somewhere between CMA Cost Plus and the Product Unit Price actually charged. Where the line is drawn turns on the factors that we have already described at [242].

(b) The findings of the Decision in regard to the Capsules

246. The Decision makes various findings in regard to the benefits or value of the Capsules. We focus here not on the conclusion drawn by the CMA – namely, that the Capsules were worth no more than CMA Cost Plus – but on the underlying reasoning as to the Capsules' economic value (seen as an aspect of the Unfair Limb). As to this:

(1) *The Capsules were in the "third stage" of drug life.* The Decision finds:[381]

> Capsules had long been off-patent and in the third stage of the drug life cycle where competition is expected to drive the prices of generic drugs down and result in on-going low prices even where they continue to deliver benefits for patients.

On the face of it, this is an unexceptionable finding, save for the failure to refer to Continuity of Supply:

[381] Decision/[6.6.4(a)].

(i) Continuity of Supply is not a condition imposed or created by Pfizer (still less by Flynn), but by the UK medical establishment for the benefit of patients.[382]

(ii) The MHRA Guidance[383] created a state of dominance in that Capsules and Tablets became non-substitutable; and specifically manufactured Capsules themselves became non-substitutable *inter se*. We cannot go so far as to say that these products were never substitutes for one another. In cases of shortage of one form of supply, another would typically be used. But there was, as is unsurprising given the terms of the MHRA Guidance, a high degree of non-substitutability.

(iii) This is the only basis upon which a finding of dominance could properly have been made, and (having made that finding) the CMA should also have taken account of the consequences. The fact is that the MHRA Guidance renders products that would otherwise be substitutes (because they are pharmacologically the same) non-substitutable.

(iv) It is irrelevant that the experts we heard from considered that the MHRA Guidance might have gone too far and/or was more honoured in the breach. There is no inconsistency in finding dominance alongside limited substitutability. It is clear, for instance, that if there was a scarcity of Capsules, Tablets would be prescribed, and *vice versa*. Equally, we have seen that Capsules and Tablets might be mixed in terms of prescription.

The point we make is that this was not a typical "third stage" case. In asserting that it was, the CMA made a significant error, which inclined it erroneously towards a CMA Cost Plus approach when assessing economic value. In effect, the CMA failed to understand the basis upon

[382] See [177] to [178].
[383] Which is set out at [178].

which its finding of dominance (made in the Phenytoin 1 Decision) rested.

(2) *The product had not improved over time.* The Decision finds:[384]

> …there was no improvement to the products, or their production or distribution, or any innovation, investment or commercial risk-taking activity which might justify or provide a legitimate reason for the Parties' prices…

There is nothing factually wrong here, but the paragraph is telling in terms of the CMA's *ex ante* mindset on the question of the Unfair Limb. Any price above CMA Cost Plus needed – on this approach – to be justified. The approach presumes unfairness where the Excessive Limb is satisfied, thus reversing the burden of proof.

(3) *The Capsules suffered from "significant limitation".* The Decision finds:[385]

> …the CMA's qualitative assessment demonstrates that Capsules suffer from significant limitations and compare poorly to other AEDs. Reflecting this, Capsules were only recognised as a third line treatment for patients during the Relevant Period and demand for the products was sustained predominantly by barriers to switching patients to other treatments, not because of the therapeutic benefits of Capsules relative to other AEDs…

This finding is incorrect in a number of important respects:

(i) The reference to "barriers to switching" is presumably a reference to the MHRA Guidance and to Continuity of Supply. The paragraph suggests that the barriers were imposed by the Seller (not correct) and were imposed for reasons other than patient benefit (also not correct).

(ii) The suggestion that Capsules were not medically beneficial in the appropriate case is a fundamentally incorrect statement containing an implied criticism of conscientious doctors treating

[384] Decision/[6.6.4(b)].
[385] Decision/[6.6.4(c)].

epileptic patients. The evidence of the medical experts – Professors Walker and Sanders – made clear the difficult questions of judgment that arise when treating sufferers of epilepsy. Professors Walker and Sanders came from opposite ends of the spectrum in terms of their appreciation of the benefits of phenytoin sodium, but each had respect for the other's views when they gave evidence orally. The short point is that the prescription of phenytoin sodium is a medical judgment call; and when it is made, it is done to minimise or eliminate seizures in circumstances where there is (as a matter of clinical judgment) no other better treatment. Of course, phenytoin sodium is used only as a third line drug: but that says more about its utility than anything else. Phenytoin sodium is deployed, when other drugs do not work and, in appropriate cases can be very effective.

The CMA's "qualitative assessment" of the benefits of phenytoin sodium is somewhat divorced from reality. Further, underlying the thinking in the Decision is that the Product Unit Price must be justified as fair (by the Seller) rather than shown to be unfair (by the CMA).

247. The finding in the Decision that there was no economic value or patient benefit beyond CMA Cost Plus is not sustainable:

(1) The medical benefits of the Capsules are given insufficient weight. It is obvious that the Capsules bring with them significant patient benefit. That much is obvious from the medical evidence that we heard.

(2) The extent to which the Appellants were entitled to price at above CMA Cost Plus is not a point that receives separate consideration in the Decision. It is simply asserted that the economic value of the Capsules sits at CMA Cost Plus, without considering any of the factors that might or might not justify a Producer Surplus.[386] Without such consideration,

[386] See [218].

a conclusion that the economic value of the Capsules sat at CMA Cost Plus was a finding that was not open to the CMA.

248. The Appellants relied on the Drug Tariff in reinforcement of this part of their appeal. It is considered next.

(c) The Drug Tariff

(i) The position of the Appellants

249. We describe the Drug Tariff in general terms at [123]. A Drug Tariff was published for Tablets, which was used by Pfizer and by Flynn as a proxy for the pricing of Capsules. For reasons that we will come to, we regard the Drug Tariff as qualitatively different to the other comparators advanced by Pfizer and by Flynn. We deal with the Drug Tariff here because, as a "price" set by DHSC, it is in essence different to the other comparators relied upon, not least because it can be argued (as the Appellants did) that the Drug Tariff says something about the economic value to be attributed to phenytoin sodium (at least in Tablet form) that is not said by the other comparators.[387]

250. The Pfizer Grounds of Appeal state:

> 130. Pfizer benchmarked its Supply Price to Flynn for the phenytoin sodium capsule by reference to the tablet [Drug Tariff] price. It acted reasonably when it did so for the following reasons.
>
> 131. The phenytoin sodium tablet is a valid product comparator because:
>
> (a) The [Drug Tariff] is the price set by the [DHSC] and paid to pharmacies for the phenytoin sodium tablet, which is bioequivalent to the phenytoin sodium capsule.
>
> (b) …there is compelling evidence in the case file and elsewhere that it is standard for pharmaceutical companies to benchmark their prices for generic drugs by reference to a discount off the [Drug Tariff]; and

[387] We leave out of account the fact that the Drug Tariff is, in many cases, informed by the prices charged by the Sellers of the pharmaceutical product in question. That is not because we consider such matters to be irrelevant, but because there are insufficient material before us to make any informed determination on the point. Neither the CMA nor the Appellants made anything of the precise manner in which the Drug Tariff was calculated. In this case, as we will come to, the Drug Tariff rate for Tablets was specifically agreed at a rate of £30. That is a matter that we will come to consider.

(c) The £30 [Drug Tariff] price was set by the [DHSC] in 2007 and remained at the same level for almost a decade thereafter. It reflected a price agreed between the [DHSC] with Teva after it had threatened to use its statutory powers to force a reduction in the tablet price in order to achieve value for the NHS…

(d) Pfizer's Supply Price was set at 50% discount off the DT price for the tablet.

251. Dr Fakes, who gave evidence for Flynn, said this[388]:

> 81. When considering the pricing of individual medicines, Flynn generally adopts a market-based approach. This can be based on one of or a combination of the following factors.
>
> *Drug Tariff price of comparators*
>
> 82. Typically, if Flynn is launching a new product and there is a similar product or products already available, Flynn considers its launch prices by using the current Drug Tariff price for that other product(s) as a guide or reference point and applies a discount to that price. I say as a reference point because the Drug Tariff price is the amount the pharmacist is reimbursed for dispensing the product. Accordingly, it is necessary to discount from this to reflect the margins made by other parties in the supply chain between the supplier and the pharmacist. This approach is typically adopted where Flynn is launching as a second, third or subsequent supplier and where there is a need for Flynn to achieve a price advantage in order to achieve a meaningful share of supply. The Drug Tariff is a good source of data because, whilst it records the reimbursement price, the Drug Tariff reflects the actual price paid by the NHS/DH for the drug and is publicly available. I therefore see the information contained therein as a reliable source of actual product prices. I am aware that other suppliers take the Drug Tariff price into account when determining launch prices.
>
> *Gross margins*
>
> 83. Flynn looks at gross margins based on percentages and absolute value. In relation to absolute value, this is not looked at in isolation and is always compared in relative terms including against the percentage gross margin. The reason for this is that if a product has a high cost and is sold at a low percentage gross margin, but the market conditions subsequently move against Flynn or Flynn had to absorb a significant financial cost in relation to the product, this could quickly render the product unprofitable for Flynn. This would be even more so if Flynn's costs in relation to the product were significant. Furthermore, on launch, Flynn is unaware of how competition will develop and the volume that it would lose over time as a result of additional generic entry. In the case of phenytoin capsules. Flynn lost significant volume as a result of the entry of NRIM. At launch, Flynn also anticipated

[388] Fakes 1.

> further generic entry which is believed was likely to materialise. These factors impact the launch price of the product.

252. The position of the Appellants in regard to the Drug Tariff was that:

(1) The Drug Tariff was a public statement by the state as to the value that it placed on the effective dispensation of phenytoin sodium Tablets. It is necessary to be very clear what we understand the Appellants to be saying. The Drug Tariff is not the price of the drug. It is the rate at which a pharmacy is reimbursed for dispensing a particular drug, the price of which is determined by negotiation as between the pharmacy (the Buyer) and the drug producer or wholesaler (the Seller). As the Appellants acknowledge, the Drug Tariff represents an indication of the maximum that a Seller of a pharmaceutical product can obtain. The Seller will have to sell at below the Drug Tariff so as to allow the pharmacy some margin. Competition between Sellers of the same or similar pharmaceutical products may create further downward pressures on price.

(2) The Appellants priced by reference to the Drug Tariff. They do not go so far as to say that it was the only factor in pricing, but their evidence, which we accept, is that it was a material factor.

(3) The point of controversy – to which we will be returning – is the extent to which the level of the Drug Tariff provides an input into the Unfairness Limb. In other words, where a Seller prices by reference to the relevant rate in the Drug Tariff, is that suggestive (to put it no higher than that) of (i) fairness or (to put the same point differently) (ii) a reasonable relationship between economic value and price?

(ii) The CMA's position as stated in the Decision

253. The CMA did not regard the Drug Tariff rate as relevant or material to the Unfairness Limb. The CMA's position was that the "£30 Drug Tariff Price of

Tablets is not a meaningful comparator".[389] Before we come to the reasons why the CMA reached this conclusion, we should say something about the manner in which the conclusion is framed. We appreciate that the Appellants advanced the Drug Tariff explicitly (in their legal arguments) as a comparator, and the CMA is entitled to some latitude in adopting those terms and in rejecting the argument on those terms. But it is necessary to grapple with the fundamentals of the case made by the Appellants. It is – as the Pfizer Grounds of Appeal and Dr Fakes' evidence make clear – plain that the Drug Tariff is not, in and of itself, a comparator price. It constitutes a ceiling within which Sellers of pharmaceutical products engage, because it is the rate at which pharmacies are reimbursed.[390] Since – for any drug – pharmacies' costs will extend beyond the mere purchase of the drug, it follows that the price "ceiling" is actually lower than the Drug Tariff rate.[391] Accordingly, to reject the Drug Tariff on grounds that it is not a meaningful comparator is actually to misunderstand its significance.

254. We turn to the reasons deployed by the CMA for rejecting the Drug Tariff rate as a "comparator":

(1) *The Drug Tariff is not a like-for-like comparator.*[392] The Decision records that:

> …the Drug Tariff price was not a like-for-like comparison with the Parties' prices, which were at different levels of the supply chain. Critically, the £30 Drug Tariff price was significantly above the upstream selling prices charged by Tablets suppliers during the Relevant Period (which would be the like-for-like comparison with Flynn's Prices). This makes any

[389] Decision/[6.192].
[390] There are many such controls in what is a complex and highly regulated environment. We heard a great deal of evidence from Mr Hawkins, Dr Skedgel and Professor McGuire about such constraints, including in particular the manner in which NICE evaluated the cost-benefit of drugs. We will explain why – although extremely interesting and important – we ultimately did not regard this evidence as helpful to these appeals in due course. For the present we simply stress that this is a highly regulated market and unusual market. Another point, to which we will come, is the fact that there is no easily identifiable Buyer for pharmaceutical products, which renders competition law analysis harder.
[391] The point is obvious, but perhaps ought to be stated expressly: (i) all pharmacies, whatever their nature or size, will incur costs over and above the cost of the drug in dispensing it. There are the Labour costs of dispensers and other staff, and the Capital costs of premises and equipment. These are all matters that are (in whole or in part) reimbursed by the Drug Tariff; (ii) pharmacies differ in size and structure, and their costs base is remarkably different. The Drug Tariff contains within it a policy element enabling small pharmacies to stay in business.
[392] Decision/[6.192.1].

> comparison between the £30 Drug Tariff price and Flynn's upstream supply prices inconsistent and not meaningful…

As to this:

(i) This paragraph makes precisely the point we have made above: the Drug Tariff is not a comparator. We observe in passing that the suggestion in this paragraph that the true comparator is the price of the Tablets was not followed through by the CMA: Tablets were rejected as comparators, for reasons that we will consider in due course.

(ii) The fact that the Drug Tariff is not a comparator does not mean that it can properly be left out of account. The Decision does not consider what the significance of the Drug Tariff might be. As we have described, the Drug Tariff could be seen as (i) a form of price ceiling, but (ii) (and much more significantly) as an indication of the economic value to be attributed to the service of a pharmacy dispensing Capsules. That economic value (£30) is greater than merely the provision of the drug to the pharmacy; but it provides some indication of the value to be attributed to the cost of the drug forming a component part of that service.

(iii) This is reflected in the evidence of Dr Fakes: neither Flynn nor Pfizer priced at the Drug Tariff rate. Rather, they used that rate as a guide.

(2) *The Drug Tariff was not a price set in conditions of effective competition.*[393] The CMA appears to have concluded that the Drug Tariff was itself the outcome of a competition law infringement by Teva. The Decision records:[394]

[393] Decision/[6.192.2].
[394] Decision/[6/192.2].

> …the £30 Drug Tariff was not a price set in conditions of effective competition and the evidence shows that the price continued to reflect Teva's substantial market power and significant price increases:
>
> (a) At the time of the meeting with the DHSC in 2007, at which the £30 Drug Tariff price was agreed, Teva was the monopoly supplier of Tablets. The DHSC had no alternative sources of supply and, due to the nature of the product, patients could not be switched to alternative treatments.
>
> (b) Reflecting Teva's market power, the £30 Drug Tariff was substantially higher than it had been prior to a series of significant price increases imposed by Teva between 2005 and 2007. The Drug Tariff price of £30 was almost eight times higher than the Drug Tariff price of £3.87 (paid by the DHSC in April 2005 at the beginning of scheme M) and almost 18 times higher than the Drug Tariff price of £1.70 (paid by DHSC in March 2005).

We do not accept the CMA's reasoning in this regard:

(i) The nature of the Drug Tariff is mischaracterised, as we have described. The Drug Tariff is not a price at which the Seller of a pharmaceutical product sells. It is, as we have said, a ceiling informed by factors going well-beyond simply the Product Unit Price of the drug in question.

(ii) Given the policy aspects of the Drug Tariff level – both generally and in regard to specific drugs – as a means of reimbursing pharmacies, it would be wrong to say that where the Drug Tariff for Tablets (as a proxy for Capsules) did not align with CMA Cost Plus, the Drug Tariff was for that reason too high. This is, again, a reflection of the CMA's presumption that a price sitting at above CMA Cost Plus is an illegitimate price. Thus, the increase in price from £3.87 to a price "almost eight times higher than the Drug Tariff price of £3.87" is regarded by the CMA as conclusory in favour of an infringement of competition law. Given that unfair pricing is the very matter under decision, all the point does is betray a predisposition on the part of the CMA to regard any price out of line with CMA Cost Plus as failing the Unfair Limb.

(iii) We are not satisfied that it can properly be said that the DHSC was induced to agree a Drug Tariff rate that was inconsistent with its public law responsibilities, which is the implication of the Decision: that the DHSC was pressured by Teva into agreeing a rate it would not otherwise have agreed. We did not hear from DHSC. Given the price control powers that vest in the state,[395] and given that these powers were threatened in this case,[396] we do not consider the conclusion of the CMA to be warranted by the evidence.

(iv) We do not consider that it is relevant to make findings as to what occurred between Teva and DHSC or how the Drug Tariff in the case of Tablets came to be agreed. The fact is that the Drug Tariff was agreed at this rate, and third parties to that rate – i.e. pharmacies and suppliers to pharmacies, including the Appellants – were entitled to rely upon it, the former for reimbursement and the latter for pricing information.

(3) *Flynn was told by DHSC and others that a price by reference to the Drug Tariff was too high.*[397] The Decision states:[398]

> …the Parties' justification for increasing their prices by reference to the Drug Tariff price of Tablets is based on the contention that £30 reflected what DHSC had accepted to be the value of the Tablets and was willing to pay. However, there was a significant body of contemporaneous evidence (which the parties were aware of when imposing and maintaining their prices) which explicitly contradicts this view…

We can deal with this point briefly. We observe, in passing, that the Drug Tariff is not a price for or a value of the Tablets *per se*. More specifically, we entirely accept that "push-back" against Pfizer's and Flynn's prices is likely to be a factor relevant to the Unfair Limb. It should be taken into account as a factor indicating that the Product Unit Price was unfairly too high. But the fact that such a factor exists cannot (or cannot

[395] *Hydrocortisone 1* [99] to [107].
[396] They have never been used: and this is the only time that even a threat has been articulated.
[397] Decision/[6.192.3].
[398] Decision/[6.192.3].

properly) be used to exclude from all consideration an independent factor (i.e. the Drug Tariff) that points the other way.

(d) Conclusion

255. We conclude that whilst the Drug Tariff is not a price comparator, it is a relevant factor that could and should have been considered by the CMA when determining the Unfair Limb. We also conclude that there is no basis for holding that the economic value of the Capsules stood at CMA Cost Plus and no higher. For these reasons, these Grounds of Appeal succeed.

(6) Comparables

(a) Approach generally

256. We make the following points at this juncture:

(1) The basic test is whether the Product Unit Price of the Focal Product is "unfair". A price will be unfair when the dominant undertaking has reaped trading benefits which it could not have obtained in conditions of Real World Competition.[399]

(2) We have articulated what we mean by Real World Competition and Impaired Competition above.[400]

(3) We do not consider that it is appropriate at any stage lightly to infer Impaired Competition. Obviously, that goes for the infringement that is actually being investigated. But equally, potentially relevant evidence should not be discounted without more because of a concern that it may represent the outcome of Impaired Competition. Rather than viewing comparables in binary as either having great weight or no weight, evidence should be looked at in the round, and its weight assessed. As Green LJ stressed in *Phenytoin 1* (CoA):

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[399] *United Brands* at [249].
[400] See [79(3)] and [244(3)].

(i) Depending upon the facts and circumstances of the case, a competition authority might use one or more of the alternative economic tests which are available. There is, however, no rule of law requiring competition authorities to use more than one test or method in all cases.[401]

(ii) 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 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.[402]

(iii) If a competition authority chooses one method and one body of evidence, and the defendant undertaking does not adduce other methods or evidence, the competition authority may proceed to a conclusion upon the basis of that method and evidence alone.[403]

(iv) 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.[404]

257. In this case, the CMA has (as we have described[405]) considered both the unfair in itself method and the comparables method when addressing the Unfair Limb. However, consideration of the comparables method was in large part forced upon the CMA by the points taken by the Appellants, which the CMA has been obliged for that reason to consider. In other words, the CMA's approach has been to consider the comparables advanced by the Appellants, and to dismiss them, leaving the unfair in itself conclusion to prevail untrammelled.

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[401] At [97(iv)].
[402] At [97(vi)].
[403] At [97(vii)].
[404] At [97(viii)].
[405] See [212].

258. We have found this conclusion not to be sustainable. For this reason, the comparables adduced by the Appellants are little to the point, since they have been deployed to gainsay a conclusion in regard to the Unfairness Limb that we do not consider to be safe and which, in any event, we have overturned.[406] Nevertheless, the CMA was obliged "fairly" to consider them, and it is appropriate to review the CMA's approach in this regard.

(b) Approach to comparables

259. We consider that a competition authority should be slow to dismiss comparables out of hand. Comparables are inevitably going to be difficult to find where the Focal Product said to be unfairly priced is, *ex hypothesi*, dominant in its market. There are, by definition, going to be limited substitutes. Comparables, in short, are not going to be very comparable.

260. Often, the comparables will be sold in different markets. The competition authority cannot be expected to conduct a full investigation of other markets, as well as the market in which the Focal Product is sold. That, inevitably, must affect the weight that can be given to comparables, but cannot justify their exclusion from all consideration. The authority cannot properly use the chimera of Impaired Competition to preclude consideration of comparables altogether. A finding of Impaired Competition is a serious one, not to be undertaken lightly: it is far better to speak of concerns and risks in the nature of the comparables going to their weight, than to exclude them altogether.

(c) The comparables in the present case

(i) <u>The comparables in question</u>

261. We turn to the comparables in the present case:

[406] See [277].

(1) The Drug Tariff price is not, in our judgment, a comparable, but it is relevant. We have already considered it.[407]

(2) The average sale prices of other phenytoin sodium products, including in particular the Tablets.[408]

(3) The prices of other AEDs[409] and other (Flynn sold) pharmaceutical products.[410]

262. Apart from the Drug Tariff, which we have already considered, we deal these comparables below.

(ii) Other phenytoin sodium products

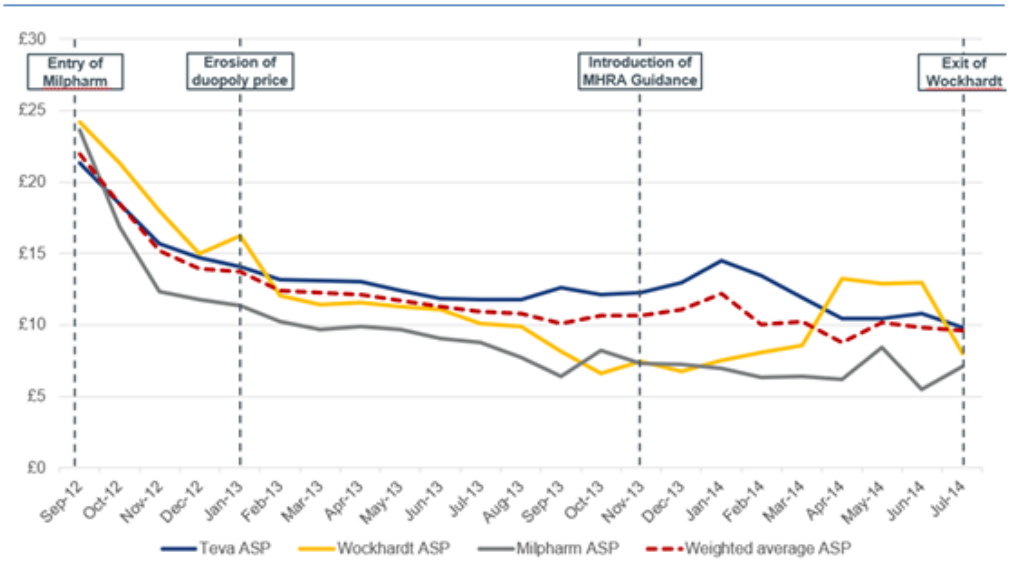
263. These products – the Phenytoin Sodium NRIM Capsules and the Tablets – are pharmacologically the same as the Capsules, and in the ordinary case would not only be key comparables, but actual substitutes for the Capsules. The fact that they are not is because of the MHRA Guidance, which renders them liable to be differentiated because of the need to preserve Continuity of Supply.

264. As we have described, the substitutability between Capsules and between Capsules and Tables was not absolutely watertight, and it may be that in practice significant substitutability existed. Nevertheless, we consider that at the pharmacy level, a manufacturer-specific (even if unbranded) phenytoin sodium product would be dispensed and that it would be a brave GP who would depart from the existing treatment regime for no reason at all. This we consider underlies the CMA's finding of dominance in regard to the Capsules, and similar considerations must arise in relation to the other phenytoin sodium products. In these circumstances, it would be right to treat the prices of these products with a high degree of care: on the one hand, these are pharmacologically identical products, and so good comparators; on the other

[407] See [254]. The Drug Tariff is relied upon by Flynn (see [251]) and Pfizer (Pfizer Grounds of Appeal/[129(a)]).
[408] See [179] for Flynn's position on this and Pfizer Grounds of Appeal/[129(b)].
[409] Pfizer Grounds of Appeal/[129(c)].
[410] See [173].

hand, because of the need for Continuity of Supply, they are not good comparators at all.

265. Pfizer's Grounds of Appeal contain a graph setting out a comparison of Tablet Average Selling Prices (ASPs), which we reproduce below:[411]



Source: RBB analysis; PRC00636 (Teva's response of 2 October 2020 to the CMA's s.26 Notice of 18 September 2020, Annex 1); PRC01516 (Teva's response of 12 February 2021 to the CMA's s.26 Notice of 25 January 2021, Annex 2); PRC00315 (Wockhardt's response of 20 July 2020 to the CMA's s.26 Notice of 29 June 2020, CMA Data Template WUK); PRC00326 (Milpharm's response dated 22 July 2020 to the CMA's s.26 Notice of 29 June 2020, Milpharm Data Sheet Final); PRE00274 (enclosed with Milpharm's response to the CMA's s.26 Notice of 18 September 2020, BK, CMA Case 50908-Annex 2 - Data Feb'17toAug'20-Compl. 2Oct'20); PRC01415 (Milpharm's response of 5 February 2021 to the CMA's s.26 Notice of 29 January 2021, Annex 2).

Figure/Table 11: Graph from the Pfizer Grounds of Appeal/[155]

266. The CMA rejected the Drug Tariff as a comparable because it sat above the price at which (i) Capsules were sold; and (ii) Tablets were sold.[412] This is what one would expect, and Figure/Table 11 above confirms this. Beyond that, it is difficult to make any further inferences. Before we turn to consider what can be said, we consider the reasons the CMA gave for taking no account of the Tablet prices. This was because the Tablets market did not demonstrate characteristics of Real World Competition, but rather (so it must be inferred) operated under conditions of Impaired Competition.[413] The CMA parsed the period of

[411] Pfizer Grounds of Appeal/[155].
[412] See [254]; see also Decision/[6.268.1].
[413] Decision/[6.307]*ff*.

competition between Tablets into four periods, analysing each of them closely, ultimately concluding:[414]

> …the Tablets market did not exhibit sufficiently effective competition during the period January 2005 to December 2021. Although there was a short period of more intense competition in Period 3, it was limited by several factors (as set out in the conclusion for Period 3). Therefore, at no stage do Tablets ASPs provide a meaningful comparator to establish whether the Parties' supply prices for Capsules were fair.

267. We do not consider that this data can so easily be dismissed:

(1) We are concerned at the introduction by the CMA of a new test of "sufficiently effective competition". We have defined Real World Competition above: if the CMA is saying that the comparators derive from a market with Impaired Competition so impaired as to be valueless, then the CMA should say so in terms.

(2) These comparators are informative, precisely because of the Continuity of Supply issue (which affected all of the products), which the CMA does not consider at all:

(i) If Continuity of Supply applied, as per the MHRA Guidance, then all of the Sellers of Tablets are dominant in their market. In such a case, one would expect incumbency to have significant effects in closing out the market to new arrivals. After all, if Tablet A is established in the market, Continuity of Supply ought to ensure that Tablet B, entering into the market and trying to contest it with Tablet A, will be at a significant disadvantage.

(ii) Yet what we see is something of a fall in prices on the entry of later Tablets, which suggests that Continuity of Supply (as the medical experts themselves suggested[415]) was more honoured in the breach.

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[414] Decision/[6.421]. Emphasis added.
[415] See [177].

(iii) If that is so, then there is some competition between Tablets, and something to be learned from the data. At the very least, we know that in the market for Tablets Continuity of Supply is not monolithic: it may be that either Product Unit Prices are driven down to cost plus or there is some element of Producer Surplus.[416]

(iv) It is certainly suggestive of something that Sellers in a similar position to Pfizer and Flynn are selling at similar prices. Whilst we know nothing about Product Unit Cost of these other Sellers, we do know Pfizer's and Flynn's Product Unit Costs, and can safely infer that a significant Producer Surplus is being earned. What one makes of this information is more difficult, but it is obviously relevant to the question of fairness and the Unfair Limb. We have no desire – it is not pointful – to parse the prices charged in any granularity, but there is a table of interest showing average sales prices over time, which clearly show other Sellers charging in a similar way to Pfizer/Flynn. The average sales prices are those of Pfizer, but the point is a general one applicable equally to Flynn:[417]

Time period	Teva ASP	Market-wide Tablet ASP	Non-Teva ASP	Adjusted Pfizer ASP
Sep 2012 to Jul 2014	£12.96	£12.01	£9.91	£13.28
Jan 2013 to Oct 2013	£12.56	£11.58	£9.63	£13.28

Figure/Table 12: Table of Tablet ASPs

[416] Data here is of course lacking: we know the Product Unit Price, but do not know the Product Unit Cost, nor do we have any data that is liable to shed light on the Reasonable Rate of Return.
[417] The figures are derived from Table 1 in Pfizer's Grounds of Appeal/[161]. We were presented with many data points, and the notion that we can do anything other than treat this data with a broad-brush is fanciful. The point is that no-one was pricing at cost plus, unless the plus was very oddly computed.

268. We consider that the CMA erred in disregarding this data. We cannot say at this stage whether it is supportive of a finding of unfairness or a contra-indicator. What we can say is that it is material that ought to have been taken into account, and it was a material error on the part of the CMA to disregard it.

(iii) Other AEDs and other pharmaceutical products

269. Pfizer, in our judgment rightly, placed rather less emphasis on the fact that the Sellers of other (non-phenytoin sodium AEDs) also sold at above cost plus. Pfizer's Notice of Appeal says this:

> 167. In addition to the evidence before the CMA in relation to the tablet, Pfizer also adduced considerable evidence at the CAT hearing concerning the prices of other AEDs. The Tribunal made the following findings in relation to that evidence (CAT Decision/[398]):
>
> > The argument for a meaningful comparison with other AEDs is considerably less compelling than for tablets, mainly because they differ widely as products even though they address the same medical condition, and there is no comparative economic data, particularly as to the cost structure of those AEDs. In our view their relevance as meaningful comparators is limited to showing what the buyer is prepared to pay for a treatment that addresses epilepsy for a given patient.
>
> 168. Table 4 and Figure 3 in the first expert report of Mr Derek Ridyard…attached at Annex 10A of this Notice of Appeal demonstrate that Pfizer's ASP was towards the mid to lower end of the price range for AEDs on the market at the relevant time. The second expert report of Mr Derek Ridyard…attached at Annex 10B focussed on five products: Topiramate, Lamotrigine, Levetiracetam, Ethosuximide and Oxcarbazepine. His core conclusion is that "several other compatible AEDs have reimbursement prices that exceed the supply prices charged by Pfizer"…That led him to conclude that Pfizer's Supply Price was not abnormally high. That conclusion is supported by the expert report of Dr Skedgel, at Annex 6, which concludes that, at the increased 2012 capsule DT price, phenytoin sodium represented value-for-money to the NHS relative to AEDs recommended by NICE in third line treatment at that time: "at a minimum, phenytoin sodium provides comparable value to other adjunct therapies at its increased 2012 price"…

270. The point that is being made is this:

(1) It must be accepted – and we do not understand Pfizer to dispute this – that these are nothing like as close comparators as the Tablets. Phenytoin sodium is used in very specific circumstances as a third line treatment,

and we have not considered how these "comparator" AEDs served patient interests.

(2) Equally, we have no real understanding of the Product Unit Cost of these AEDs, the Reasonable Rate of Return or (therefore) the extent of the Producer Surplus.

(3) The value of these comparators is best described as "impressionistic", and we consider that a competition authority would be well within their rights (exercising their judgment) to treat this material with caution and (for that reason) accord it limited weight.

(4) But this material is informative to this extent:

(i) These are products subject to the Drugs Tariff regime.

(ii) Given that the Capsule prices do not appear to be out of line with these products, unless the Product Unit Costs of these products is unusually and improbably high, which we discount, two (mutually exclusive) points suggest themselves. Either: (i) the Reasonable Rate of Return for pharmaceutical products is high (in which case, this is a matter to consider as part of the Excessive Limb); or (ii) there is a material level of Producer Surplus in the market (to be considered in the assessment of the Unfair Limb).

271. As we have described,[418] Flynn relied upon other, non-AED, products sold by it. We have more information here as regards Product Unit Cost and Profit Margin (as well as volumes sold), but the point is essentially the same: that the prices of these products was indicative either of a higher Reasonable Rate of Return than the CMA was prepared to give credit for or of "legitimate" Producer Surplus.

[418] See [173].

272. The CMA rejected this evidence as being immaterial either to the Excessive Limb or to the Unfair Limb:[419]

> The CMA's view is that the differences between Capsules and the Comparator AEDs described above means that, from a product perspective, these AEDs are not sufficiently similar to Capsules to allow for a meaningful comparison.

273. We disagree with this conclusion. The question is what the CMA understands by a "meaningful comparison". We consider the comparison to be material in providing insight into what might be a Reasonable Rate of Return for pharmaceutical products and/or in showing what Producer Surplus is prevalent in these markets. Unless Real World Competition is nowhere present this is obviously material to both of the *United Brands* limbs. The exclusion of this evidence is irrational and not defensible. If the question was "precisely what level should the Reasonable Rate of Return be set at?" or "what level of Producer Surplus is legitimate?", then the CMA might have a point. But that is not the value or importance of this data. The importance of the data is that it suggests that the entire market for AEDs and for the distribution of pharmaceutical products does not operate as the CMA thinks, namely on a Product Unit Cost Plus WACC or ROS return. That fact is fundamental to this inquiry, and the evidence cannot be left out of account.

274. Of course, these prices prevailed in a highly regulated market. It is at this point that we should say something about the evidence of the health economists, Dr Skedgel and Professor McGuire. We should also add – although technically a witness of fact, really an expert – Mr Hawkins. All gave interesting and helpful background evidence into how the UK's regulatory system sought to value medicines that were clearly beneficial to patients but cost a lot of money. We heard a great deal about the operations of **NICE** (the National Institute for Health and Care Excellence), the use of QALYs (the Quality Adjusted Life Year) and the cognate concept of VSL (the Value of a Statistical Life). This evidence all went to aspects of cost – benefit analysis, which is undoubtedly related to the Unfairness Limb: self-evidently, if the "benefit" exceeds the "price" charged (a cost to the paying party, here the NHS), then the argument in

[419] Decision/[6.482].

favour of fairness is strong. The problem is that computing the "benefit" involves a qualitative assessment which is coloured by the process in which the question is asked. It seems to us that we can draw nothing from the fact that phenytoin sodium has been approved for prescription. NICE's evaluation is that phenytoin sodium ought to be part of the physician's armoury, although NICE says nothing about the price that should be paid for Capsules or Tablets.

275. The evidence that we heard on this point was helpful in that it assisted in understanding the intractable nature of the questions posed by the Unfair Limb. But it would be wrong to import the public health processes that govern the availability of drugs in the UK into what is a competition law assessment of whether a price is unfair within the Chapter II prohibition. Doubtless the same factors – cost of production, price, benefit to patient – will pertain. But how they are weighed must be undertaken separately according to context. Here the context is one of competition law infringement. Accordingly, we derive nothing from the fact that phenytoin sodium was approved by NICE; nor indeed do we derive anything from the marginal – even qualified – nature of that approval.

276. We are grateful to the parties for making these experts available to us, and to the experts themselves, including Mr Hawkins. They undoubtedly assisted us in our consideration, but very much in terms of the deep background. For the reasons we have given, we do not consider that their evidence can be material in the decisions we have to make in this judgment, and it is for that reason that we mention their evidence only in passing.

(7) Conclusion

277. The approach in the Decision to the Unfair Limb discloses a number of errors that are sufficiently material to oblige us to overturn the findings of unfairness in the Decision both as regards Pfizer and as regards Flynn. In particular, the factors driving the conclusion that the Unfair Limb is met set out in the Decision are factors that do not justify that conclusion. The factors taken into account are, in large part, immaterial to the Unfair Limb.[420] These errors are compounded

[420] See [228] to [230].

by a failure properly to consider the comparables relied upon by the Appellants.[421]

I. PROCEDURAL UNFAIRNESS

278. This ground of appeal was advanced by Pfizer alone as Ground 4.[422] The Pfizer Grounds of Appeal plead as follows:[423]

> …This appeal should be allowed because the CMA's conduct of this investigation has been sufficiently unfair and unbalanced that the Tribunal cannot have confidence in the process by which the CMA gather and disclosed evidence, the objectivity of the CMA's analysis and ultimately the Decision itself.

279. Ground 4 is particularised in a number of respects, and most of these we have no hesitation in rejecting. Thus, points are made in regard to the CMA's disclosure of material,[424] the CMA' changes of position in response to Pfizer's probing,[425] and the dilatory nature of the investigation.[426] We do not consider that these are fair criticisms of a decision-making process that clearly has been conducted conscientiously and with every effort being made to achieve due process.

280. However, the fourth particular requires further consideration, and seems to us to be well made:[427]

> The public statements of the CMA, and its approach to the evidence as a whole, displays a clear case of confirmation bias. The CMA's conduct of this investigation has been characterised throughout by a single-minded desire to bring the case home. That is not consistent with its role as a competition authority.

281. Ground 4 is made out in this regard for the following reasons, which we have already identified in this Decision. We state them out briefly now:

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[421] See [184].
[422] Pfizer Grounds of Appeal/[221]*ff*.
[423] At [221].
[424] Pfizer Grounds of Appeal/[221(a)].
[425] Pfizer Grounds of Appeal/[221(b)].
[426] Pfizer Grounds of Appeal/[221(c)].
[427] Pfizer Grounds of Appeal/[221(d)].

(1) The CMA has been over-influenced by the arrangements between Pfizer and Flynn, which resulted in the dramatic increases in the prices for the Capsules. Without labelling those arrangements as competition law infringements, the CMA has treated them as such, thereby disregarding the presumption of innocence and reversing the burden of proof. These are fundamental failings.[428]

(2) The fact that price increases – of a dramatic nature – occurred practically overnight is a factor impossible to disregard, and one that should not be disregarded. As the Chancellor put it in *Phenytoin 1* (CoA):[429]

> …It was quite easy to lose sight of a stark reality, which was that, literally overnight, Pfizer and Flynn increased their prices for phenytoin sodium capsules by factors of between 7 and 27, when they were in a dominant position in each of their markets. That did not, of course, abrogate the need for a rigorous reasoned approach to the legal and factual questions before the CAT, but it was important to keep in mind.

This was a criticism levelled at the decision in *Phenytoin 1* (CAT). It can equally well be made of the Decision itself. The price increases in the Capsules are significant, but no-one has ever said that de-branding products that were (as branded products) subject to the PPRS price controls was illegitimate. Following debranding, Flynn and Pfizer priced to the Tablet price levels, which themselves were informed by the Drug Tariff rate which was (we find) properly set by DHSC. The fact that prices increased is therefore not, of itself, particularly surprising. It was expected that generic competition would subsequently keep prices under control. That did not happen and it may be that this absence of generic competition is an indicator of competition law infringement, in the way that (substantial) price increases are not. It was incumbent upon the CMA to consider the reasons behind the fact that this market was not working and – in light of a true and fair examination of that market – understand and articulate the nature of the abuses that may or may not have been taking place.

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[428] See [134].
[429] At [243]. Emphasis added.

(3) Dramatic increases in price by dominant Enterprises very likely means pricing at above CMA Cost Plus. That is almost inevitably going to be the case where prices are increasing by factors of over seven. The CMA, as the Decision makes clear, only ever saw this as a CMA Cost Plus case. Whereas this approach may be defensible when considering the Excessive Limb,[430] it is not so far as the Unfair Limb is concerned. The notion that there could be such a thing a legitimate Producer Surplus was mentioned, once, in the Decision but never seriously considered.

(4) Equally, the circumstances pertaining in the real world – the comparators we have described, and the Drug Tariff – were essentially disregarded. The fact that comparable pharmaceuticals were being priced at similar levels to those of the Capsules during the Relevant Period is not determinative, but it is material and it did fall to be considered.

282. We consider that this ground of appeal – which builds on failings in the Decision that we have already identified – also succeeds.

J. CONCLUSION AS REGARDS THE DECISION; AND THE TRIBUNAL'S JURISDICTION TO RE-MAKE

283. There are sufficient and sufficiently material errors in the Decision such that the outcome of the Decision cannot stand on the basis of the stated reasoning. We find that the reasoning on the Unfairness Limb is bad as against both Pfizer and Flynn. As regards the Excessive Limb, we find that the reasoning as against Flynn cannot stand. We also find that the Decision, in its entirety, was procedurally unfair.

284. As we shall come to describe, although these were not the subject of appeal by Pfizer, we have concerns about the approach that the CMA adopted in regard to the Excessive Limb even as regards Pfizer. That is because of the fact that Pfizer and Flynn were both present in series within the same supply chain (i.e. one was

[430] Although even here some nuance is required: see [83].

selling the same product to the other), and there is therefore a particular necessity to ensure that the Excessive Limb and the Unfairness Limb are consistently applied to Pfizer and to Flynn.

285. Since the Decision cannot stand as against either Pfizer or Flynn, the question is whether we should exercise our power to re-make the Decision. The Appellants appeal the Decision pursuant to section 46(1) of the Competition Act 1998. Paragraph 3 of Schedule 8 of that Act sets out the Tribunal's jurisdiction on appeals made pursuant to section 46. According to these provisions:

(1) The Tribunal must determine the appeal on the merits by reference to the grounds of appeal set out in the notice(s) of appeal.

(2) When determining the appeal on this basis, the Tribunal may confirm or set aside the decision (or any part of it) and may (i) remit the matter to the CMA, (ii) impose or revoke or vary the amount of a penalty, (iii) give such directions or take such other steps or make any other decision as the CMA could have made.

(3) If the Tribunal confirms the CMA's decision, the Tribunal may nevertheless set aside any finding of fact on which the decision was based.

286. The Tribunal's approach to appeals of this kind was considered in *Compare The Market* and summarised (following *Compare The Market*) in *Hydrocortisone 1*. We do not propose to set out these passages in this Judgment but will follow the approach set out in *Compare The Market* and *Hydrocortisone 1*.

287. The Tribunal has the power to make any decision that the CMA could have made – or it can remit the decision to the CMA. Given the time since the infringements; the fact that there has already been one remission; and the very careful consideration and setting of out the facts by the CMA in the Decision, we consider that it is appropriate that we seek to remake the decision. We stress that, in this, we will err on the side of caution. Specifically, where a point arises on which the Appellants did not adduce evidence, then we must approach

matters on the basis most favourable to the Appellants. If we identify a material lacuna in the evidence that cannot be resolved in this way, then we will either remit or bring this story to a close by allowing the appeals without further remission to the CMA.

K. THE DECISION RE-MADE

(1) Introduction

288. Eight infringements were found in the Decision, four against Pfizer and four against Flynn. All relate to different dosages of the same Capsules. We need to consider the four alleged infringements against Pfizer separately from the four alleged infringements against Flynn. There are enough material differences between Pfizer and Flynn to warrant such separate consideration, even though there are also clearly a number of common matters. We will consider the four Pfizer infringements and the four Flynn infringements together: although Annex 3 shows that the prices charged and the costs incurred in the production of different Capsule dosages varied, we can take such variations into account when considering the Pfizer infringements and the Flynn infringements collectively. There is no need for an infringement-by-infringement consideration. In each case, our assessment is framed by the two limbs of the *United Brands* test – the Excessive Limb and the Unfairness Limb.

289. Although we propose to consider the allegations against Pfizer and Flynn separately, Pfizer and Flynn were part of the same supply chain, and the implications of this need to be recognised. We consider this in Section K(2). Pfizer and Flynn sold/bought from each other in the same supply chain, but did not do so collusively and did not do so infringing any aspect of competition law. The Decision makes no finding of Chapter I prohibition infringements, and we must proceed on the basis that the arrangements between Pfizer and Flynn were legitimate and not infringing of competition law. Put another way, we are dealing with two sets of separate infringement allegations, four levelled against Pfizer and four levelled against Flynn.

290. Secondly, when considering the Unfairness Limb it is necessary to have some sense of who the "ultimate consumer" is. We appreciate that there is trend to regard competition law infringements as capable of being founded on *intra*-supply chain facts, and nothing in this Judgment should be seen as questioning this approach. But, in a case of pass-on (and, as is clear from Annex 3, this is a case of pass-on) the intermediate buyer who pays an unfairly high price but then passes it on to the ultimate consumer is hardly paying an unfair price themselves. In other words, simply focussing on the intermediate buyer might be said to be asking the wrong question, and it may be that the focus needs to be on the ultimate consumer even as regards the allegations against Pfizer, which sold only to Flynn. If that is right, then the identity of the ultimate consumer is a difficult question in this highly regulated market both as regards Pfizer and as regards Flynn. We consider these questions in Section K(3).

291. Section K(4) then considers, in general terms, what the data in Annex 3 teaches, before we proceed to consider the question of Chapter II infringement as against Flynn (Section K(5)) and then Pfizer (Section K(6)).

(2) The significance of the supply chain

292. The Excessive Limb obliges consideration of the difference between Product Unit Cost and Product Unit Price, that difference being the Profit Margin. Matters become more complex when two unfair pricing cases are advanced in relation to two Sellers in the same supply chain, which is the case here:

(1) As regards Flynn, provided Flynn's Product Unit Cost includes the cost to Flynn in acquiring Capsules from Pfizer, the approach to the Excessive Limb is straightforward: we know, from Annex 3, both the Product Unit Cost and the Product Unit Price. The questions which follow are:

(i) Is the price paid by Flynn to Pfizer for the Capsules a "reasonably and efficiently incurred cost"? As we have described ([148(3)]), the issue of understated or overstated costs is a question of judgment requiring of consideration when Product Unit Costs

are determined. The question here will be whether the price charged by Pfizer to Flynn can be regarded as a "reasonably and efficiently incurred cost" to Flynn; and whether that assessment depends on whether Pfizer was – in its price to Flynn – infringing the Chapter II prohibition.

(ii) Having calculated the Profit Margin, what is the Reasonable Rate of Return and to what extent does the Profit Margin contain a Producer Surplus accruing to Flynn. If a Producer Surplus does accrue to Flynn, then it must be asked whether there are factors that suggest that, even where a Producer Surplus exists, the Excessive Limb is not satisfied.

(2) Turning to Pfizer, when considering the Excessive Limb, the relevant metrics are Pfizer's Product Unit Cost and Pfizer's Product Unit Price (i.e. the Capsule price as charged to Flynn). Matters are more difficult when considering the Unfair Limb. Is it right to say that unfairness should be judged, in the case of Pfizer, by reference to the price charged by Pfizer to Flynn, when the unfairness – because the price to Flynn is passed on as a cost by Flynn to Pfizer/Flynn Customers – actually manifests itself in the unfairness to the ultimate consumer (whoever that may be), not to Flynn. The point can be stated in this way:

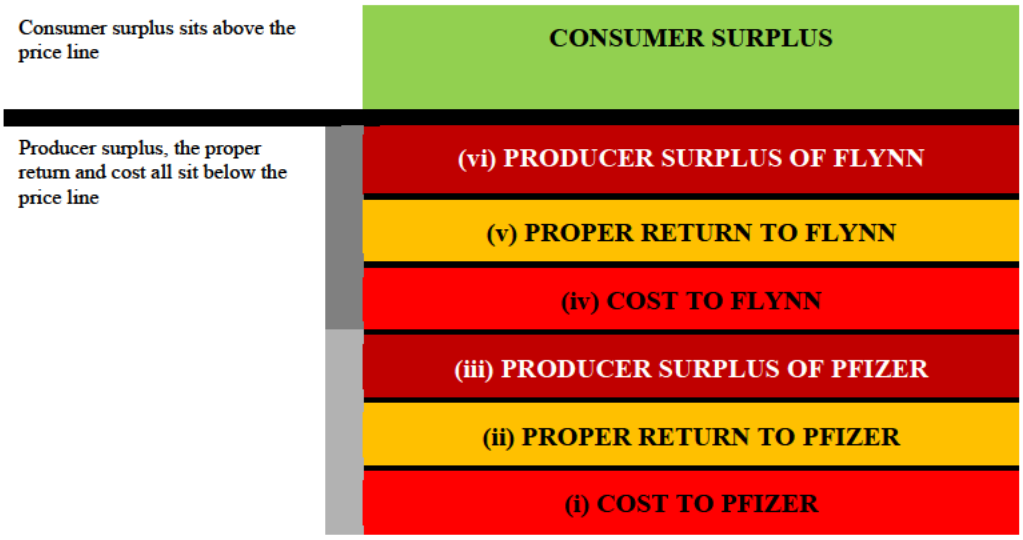
(i) If the Unfair Limb is to be assessed by reference to the prices charged by Pfizer to Flynn, then a range of different factors come into play than if the question is whether the Unfair Limb is to be assessed by reference to the prices charged by Flynn to the ultimate consumer.

(ii) In the latter case, what is relevant is the unfairness or otherwise to the ultimate consumer, even in the case of Pfizer, which does not directly sell to the ultimate consumer. That is because Pfizer's prices to Flynn directly affect the prices to the ultimate consumer because Flynn was able to pass all of the cost of the Capsules on to the ultimate consumer and also make a profit.

That is the unequivocal evidence derived from Annex 3, which was not disputed.

The problem is how to reconcile an assessment of Pfizer's Profit Margin calculated by reference Pfizer's charges to Flynn, with an unfair price that is the price charged by Flynn to the ultimate consumer. The question is how to assess the Unfairness Limb in regard to Pfizer where the outcome of the Excessive Limb has been determined by reference to Pfizer's Product Unit Costs and Pfizer's Product Unit Prices.

293. It seems to us that in a chain such as this, the layers of cost and return subsisting below the price charged to the ultimate consumer should be considered in the following way:



Figure/Table 13: The approach to considering the Unfairness Limb in the case of multiple Sellers in the same supply chain

(1) The Consumer Surplus (that of the ultimate consumer) sits above the price charged to that consumer, represented by the thick black "price" line.

(2) Below the price line are two sets of costs and returns, those of Pfizer and those of Flynn. Starting at the bottom of the stack, these are:

(i) Pfizer's Product Unit Costs;

(ii) The Reasonable Rate of Return to Pfizer;

(iii) The Producer Surplus to Pfizer (if any);

(iv) Flynn's Product Unit Costs;

(v) The Reasonable Rate of Return to Flynn;

(vi) Flynn's Producer Surplus (if any).

(3) Excess is a question of whether the Producer Surplus (iii) accruing to Pfizer is excessive and whether the Producer Surplus (vi) to Flynn is excessive. Unfairness involves asking in each case:

(i) Whether the Producer Surplus (iii) to Pfizer is unfair given the Product Unit Price charged by Flynn (as opposed to Pfizer's Product Unit Price).

(ii) Whether the Producer Surplus (vi) to Flynn is unfair given the Product Unit Price charged by Flynn.

We will approach the Excessive Limb and the Unfair Limb in this way.

(3) The ultimate consumer

294. In most markets, the ultimate consumer is the Buyer who purchases the Product for consumption, and who does not buy either to on-sell the product or incorporate it into another product that will be on-sold. In the case of medicines, the Buyer is far harder to identify. The person benefitting from the drug is the patient, but in our system, the patient does not pay for the drug, but pays a means-tested prescription charge that bears no necessary relationship to the cost or price of the medicine itself. The party who pays, via the pharmacy and the

Drug Tariff, is the CCG.[431] Neither the patient nor the CCG has any particular agency in what product is prescribed: that is a matter for the clinical judgment of the doctor treating the patient.

295. The question therefore arises as whose interests are relevant when considering the question of fairness. The ultimate consumer is a triptych combining the characteristics of doctor, CCG (referred to here as the Pfizer/Flynn Customer[432]) and patient (referred to here as the Pfizer/Flynn Patient[433]). This problem of the ultimate consumer's characteristics being drawn from different persons was addressed – in the context of the Buyer's reaction to a SSNIP done for the purposes of market definition – in *Hydrocortisone 1*. In that case, the Tribunal made the following point in regard to the demand for medicinal products like the Capsules (although in that case, the Product in issue was hydrocortisone tablets):[434]

> …this is a market where consumer choice is remarkably elusive and difficult to capture. The ultimate consumer – the patient – actually has very limited choice, but does provide the demand for the product (in the shape of the illness the patient suffers from). The patient does not, however, articulate that demand. That is principally done by the doctor and – to a subsidiary extent, to the extent permitted by the prescription regime we have described – the pharmacist. Demand is, therefore, informed by three different persons, interacting. This is far from the usual case, where it is the ultimate consumer who decides (informed by their "values", product price and their disposable income) what to buy and what not to buy.

In the context of market definition, this trifurcated concept of the consumer renders the application of the typical "SSNIP" test unworkable:[435]

> In this case, the "demand function" represented by the typical consumer is at least trifurcated between patient, doctor and pharmacy, as we have described. That makes application of the traditional SSNIP impossible. Ask a doctor what the reaction would be to a SSNIP on a medicinal product they were minded to prescribe to a patient, and the answer would be "I do not care! My job is to prescribe appropriately!" Ask the patient what the reaction would be to a SSNIP, and the answer would be "I do not care! I am exempt from paying for prescriptions or I pay a flat rate that does not differentiate between medicinal products." Ask a pharmacist, and the answer would be: "I care very much, and will try to maximise my profit, and switch, but I am professionally constrained

[431] The paying party may have changed over the years, but nothing turns on this. Everyone referred to as CCGs are bearing the economic cost of the Capsules.
[432] See [13].
[433] See [13].
[434] *Hydrocortisone 1* at [231(1)].
[435] At [243(5)].

> to fulfil the prescription written by the doctor." Ask a Clinical Commissioning Group and they would say "Under no account prescribe Plenadren, it is outrageously expensive, but use your clinical judgement." The short point is that no single group of persons can proxy consumer demand in this particular case.

296. Exactly the same problem arises in the context of the Unfair Limb, as it does with market definition. The factors going to unfairness – some of which we have described generally at [242] – can only sensibly be evaluated if a particular ultimate consumer is borne in mind. In the United Kingdom, a person in need of medical treatment is not deprived of treatment because they lack the means to pay. Instead, the cost of medicines – and other aspects of medical treatment – are borne or very considerably subsidised by the State. This is right, but it obscures the relationship between price and consumer that is the ultimate driver of competition law. The budget for pharmaceutical products in the United Kingdom runs to several billion pounds every year: how can it sensibly be said that the price of an individual course of treatment costing a tiny fraction of the total budget is or is not fair? We recognise that the State has evolved extremely sophisticated measures for assessing the value of medicines. Mr Hawkins, Dr Skedgel and Professor McGuire carefully educated us in these measures: but we consider the criteria by which medicines are admitted into the state system to be different to those that inform the Unfair Limb. The Chapter II prohibition provides a safeguard against overcharging in addition to the value for money criteria used by NICE. We see these different regimes as operating differently but to the same end; and we see no inconsistency in a pharmaceutical product being approved for use in the NHS whilst being sold at an unfair price, in just the same way as we do not regard the Drug Tariff as an indicator of either an excessive or an unfair price.[436]

297. That leaves open the problem of the operation of the Unfair Limb in this medicinal context. The doctor is not sensitive to price but prescribes according to patient need. The patient wants the most appropriate treatment, but does not have to pay market rates, and is in any event bound by the doctor's clinical

[436] As we have described, the Drug Tariff is not a price but a reimbursement rate to pharmacies which acts as a price ceiling under which competition takes place. The Drug Tariff thus says nothing about price: see [254].

judgment, taking into account patient preference as appropriate. The pharmacy wants to maximise the differential between the Drug Tariff rate and the cost of the drug in question but will be constrained by the fact that the doctor – in this case paying due regard to the MHRA Guidance – will typically prescribe not phenytoin sodium generally, but a specific manufacturer's phenytoin sodium: here, the Capsules. The CCGs will care very much about price: but have no agency.

298. We consider that the appropriate way in which to assess the question of unfairness for the purposes of the Unfair Limb is to hypothesise an ultimate consumer so as to lend focus to the criteria in play.[437] We consider that such a consumer/patient ought to have or be deemed to have the following characteristics:

(1) A diagnosis of epilepsy requiring treatment by way of a third line AED that is phenytoin sodium, in circumstances where Capsules are used to provide the phenytoin sodium.

(2) A level of understanding or knowledge about epilepsy, the various medicinal products available and the relevant guidance (including the MHRA Guidance) commensurate with that of a doctor, by which we mean a GP and not a specialist like the experts we heard from (Professors Walker and Sander).

(3) A responsible, but also reasonably robust, attitude towards dealing with that condition. In particular, the consumer/patient would understand that Continuity of Supply was intended for psychological comfort, and did not exist because of medical need.

(4) Have an income that is significantly above the average in the UK. Clearly, if we are to control for the fact that measuring unfairness by reference to state provision is insufficiently transparent to enable fairness to be assessed, the prescription charge regime needs to be

[437] See *Hydrocortisone 1* at [243(6)], where a similar approach was adopted in order to define the market.

abandoned in our hypothetical case. We are assuming a well-off, but not unlimitedly wealthy, patient as the best means for considering fairness of price.

(4) The data in Annex 3 generally

(a) Robustness of the data

299. We are satisfied that the data in Annex 3 is reliable. We have described that data at [14]. Annex 3 presents data regarding Flynn and Pfizer together, on a month-by-month, basis. For reasons that we have given,[438] "snapshots" – even over the period of a month – are to be avoided and averages over the entirety of the Relevant Period to be preferred. In this way, fluctuations in prices and cost are evened out.

300. There is, in this case, a further reason for adopting an average across the relevant period. Pfizer supplied different quantities of Capsules to Flynn in a month than Flynn sold in that same month to the Pfizer/Flynn Customers. These differences in volume are material:

(1) By way of example, in Relevant Period Month 1 (Sep 2012), the volumes of sales were as follows:

	Capsule Dosage			
	25mg	50mg	100mg	300mg
Volume sold by Pfizer to Flynn	10,992	21,254	34,418	13,800
Volume sold by Flynn to Pfizer/Flynn Customers	8,059	17,061	26,054	11,255

Figure/Table 14: Volume of sales differences in Relevant Period Month 1

[438] See [148(2)].

(2) Because the Focal Product Spreadsheets calculate Pfizer's and Flynn's Product Unit Cost and Product Unit Price at the aggregate level (i.e. total product cost and total product price) and then derive the per unit metric by dividing by the volumes sold, the differences in volumes sold in the supply chain produce anomalies.

(3) By way of example, in Relevant Period Month 1 (Sep 2012), for the 100mg Capsule dosage, Pfizer's Product Unit Price (the price to Flynn) was £42.50, whereas Flynn's Product Unit Cost (including the price paid to Pfizer) was lower at £39.17. This anomaly is because Pfizer's Product Unit Price was calculated by reference to Pfizer volumes, whereas Flynn's Profits Unit Cost was calculated by reference to Flynn volumes.

Such anomalies do not affect our view as to the reliability of the data we are using, but confirm the importance of the use of averages and the issues that need to be borne in mind when considering unfair pricing by two Enterprises in the same supply chain. Provided Flynn's metrics are based on Flynn's volumes, and Pfizer's metrics are based on Pfizer's volumes, there is no issue regarding the reliability of Product Unit Cost or Product Unit Price.

(b) Averages over the Relevant Period (as derived from Annex 3)

301. The table below sets out, in a form similar to that used in Annex 3, averages calculated across the whole of the Relevant Period:

Annex 3 values averaged over the Relevant Period	**Capsule Dosage**			
	25mg	50mg	100mg	300mg
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Volume sold by Pfizer to Flynn	10,282	20,780	18,991	12,746
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.68	£37.83	£36.67
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Average volume sold by Flynn	10,167	20,456	18,631	12,498
(f) Flynn Product Unit Price	£14.22	£14.43	£52.87	£55.02
	£1.23	£3.51	£33.42	£32.23
(g) Pfizer's Profit Margin	38%	111%	757%	726%
(h) Flynn's Profit Margin	£8.49	£6.50	£13.70	£16.94

	148%	82%	35%	44%

Figure/Table 15: Averaged Annex 3 values[439]

(5) Has Flynn infringed the Chapter II prohibition?

(a) Adjustment of the Flynn Product Unit Cost

302. Before we turn to consider the Excessive Limb and the Unfair Limb in the case of Flynn, it is necessary to consider whether the price paid to Flynn by Pfizer for the Capsules constitutes a "reasonably and efficiently incurred cost".[440] Put another way, should the price paid by Flynn be adjusted – and, if so, in what direction?

303. We are in no doubt that the price charged by Pfizer (the cost to Flynn) should not be adjusted. We reach this conclusion for the following reasons:

(1) We have concluded that there is no basis for us finding any Chapter I infringement in the relationship between Pfizer and Flynn, the CMA not having done so in the Decision. There is, therefore, no proper basis for suggesting that the price was not, as between Pfizer and Flynn, a proper competitive price.

(2) Does this conclusion change if we were to conclude that Pfizer's price to Flynn was unfair and a Chapter II prohibition? The first point to make is that this is not, in fact, a question before us. The second point is that if this question were before us, it would be quite difficult to conclude that the price charged by Pfizer was unfair to Flynn. That is because:

[439] Note that the average product unit cost and average unit price have been calculated after disregarding zero values, as these are months in which no relevant sales were recorded. Also note that average volumes are calculated by averaging total volumes sold across the 52 month relevant period to provide an average volume sold per month.
[440] The question posed at [292(1)(i)].

(i) Flynn passed on the cost of the Capsules to the Pfizer/Flynn Customers, together with a Profit Margin. This is clear from Annex 3 and Figure/Table 15 above.

(ii) Flynn was - and the CMA reached no other conclusion - buying the Capsules purely as a commercial proposition: Flynn had no need of the Capsules – save to further its commercial pursuits. If the price of the Capsules had been too high for Flynn to make a profit, then Flynn would doubtless have passed on the opportunity and not purchased any Capsules.

Assuming, nonetheless, that Pfizer's prices to Flynn were unfair, that is no reason to adjust Flynn's costs, either up or down. In the converse case – where one assumes that Pfizer's prices to Flynn were not unfair – again it is difficult to see why any adjustment (up or down) is needed. The fact is that given that there is no Chapter I infringement or abuse of collective dominance as between Pfizer and Flynn, the prices charged by Flynn are reasonably and efficiently incurred. No adjustment to Product Unit Cost is needed.

304. Flynn rightly laid stress on the risks inherent in Flynn's business, ranging from the costs of ensuring a reliable supply of product to risks of liability if sued (e.g., for product liability). We acknowledge that such costs are incidental to Flynn's business. They are, we consider, fully priced into Flynn's Product Unit Cost. The Relevant Period is a long period, spanning years not months, and it is safe to proceed on the basis that to the extent that such costs needed to be incurred in order to address such risks, they were incurred and are contained within the Annex 3 figures.

(b) The Excessive Limb

305. Flynn's average Profit Margin is the difference between average Product Unit Price and average Product Unit Cost, where all of these averages have been calculated across the entirety of the Relevant Period. Flynn's average Profit Margin is a profit per unit sold and has been calculated by reference to the four

different Focal Products whose prices are said to infringe the Chapter II prohibition:

Annex 3 values averaged over the Relevant Period	Capsule Dosage			
	25mg	50mg	100mg	300mg
Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
Average volume sold by Flynn	10,167	20,456	18,631	12,498
Flynn Product Unit Price	£14.22	£14.43	£52.87	£55.02
	£8.49	£6.50	£13.70	£16.94
Flynn's Profit Margin	148%	82%	35%	44%

Figure/Table 16: Flynn's Profit Margin averaged over the Relevant Period

306. The next question is what is the Reasonable Rate of Return? The approach to assessing the Reasonable Rate of Return was described, in general terms, at [240] to [242]. More specifically:

(1) The starting point is to assess the Capital employed by Flynn, using our variant on ROCE, the PUCC or Per Unit Cost of Capital. The Capital employed by Flynn in producing a single unit of the Focal Product is the funds required to cover the Product Unit Cost. The Product Unit Cost is as set out in Figure/Table 16 above and (when calculated as total) gives remarkably high levels of Capital employed by what was acknowledged to be a Capital "light" Enterprise. Thus:

	Capsule Dosage			
	25mg	50mg	100mg	300mg
Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
Total volume sold	10,167	20,456	18,631	12,498
Total Capital employed[441]	£58,257	£162,216	£729,776	£475,924
Product Unit Price charged by Flynn	£14.22	£14.43	£52.87	£55.02
Total revenue	£144,575	£295,180	£985,021	£687,640

Figure/Table 17: Flynn's Capital employed and total revenue generated

[441] Calculated by reference to the money needed to distribute the Focal Products, i.e. by reference to the Product Unit Cost.

(2) The reason the figure for Capital employed is high is because of the cost, to Flynn, of procuring the Capsules. We have already concluded that this cost should not be adjusted.[442] However, it must be recognised that this is a hugely generous measure of Capital to Flynn. Looking at Flynn's Capital needs on a non-static or dynamic, basis, it is obvious that the Capital Flynn would actually need will be far lower than the totals set out above. Viewed on a dynamic basis, the Capital Flynn would in fact need would depend upon factors such as the payment terms Flynn had with Pfizer and with Pfizer/Flynn Customers, and so on. The point is that Capital is normally assessed by considering an Enterprise as a going concern, which is precisely what Product Unit Cost does not do. As a very simple example, if Pfizer required payment at 7 days' notice, but the Pfizer/Flynn Customers paid a quarter in arrears, Flynn would need to fund 12 weeks' cost of the product.

(3) We have rejected Mr Harman's dynamic approach to the assessment of Capital as not the correct approach for the purposes of assessing cost. That remains our view, notwithstanding the very high Capital costs incurred by Flynn in this way. That is because we are calculating Profit Margin by deducting Product Unit Cost from Product Unit Price. This implies an immediate receipt of revenue as against Flynn's incurred Capital costs. We are not, therefore, persuaded that our Per Unit Cost of Capital Approach ought to be adjusted.

(4) We would have wanted to give the matter very considerable additional thought, given the figures in Figure/Table 17. However, we proceed on the basis of the Per Unit Cost of Capital Approach – notwithstanding our hesitation – for the following reasons:

(i) We do not have the data to assess these, essentially, cash-flow questions. As we have noted, a dynamic analysis could have been adopted; but it was not and we consider that such an

[442] See [303].

approach would have required a comprehensive re-working of the Annex 3 data.

(ii) If we had the data, then we would have to be persuaded that our Per Unit Cost of Capital approach ought to be adjusted downward. If we had the necessary information before us, and the benefit of the parties' submissions, we would of course want to consider the matter further, and it may be that adjustments would be appropriate.

(iii) As it is, we have neither the data nor the benefit of the parties' submissions. It is appropriate to proceed on the basis that the Capital employed is the Product Unit Cost without further adjustment, because this gives the benefit of the doubt (on an industrial scale) to Flynn, which is the appropriate course given the circumstances in which we are re-making the CMA's decision.

(5) We consider the best starting point for assessing a Reasonable Rate of Return to be the ROS figures set out in Figure/Table 10.[443] As to this:

(i) Figure/Table 10 sets out Flynn's ROS for Capsules and other pharmaceutical products distributed by Flynn. The average ROS per year, excluding the Capsules and also excluding (again, so as to give Flynn the benefit of the doubt) the ROS where the return was negative was:

- 38.25% (2013)

- 35.11% (2014)

- 37.2% (2015)

[443] At [173].

- 37.8% (2016)

(ii) We entirely recognise the fragility of these figures. They are fragile for a number of reasons. We know very little about the other products distributed by Flynn, in particular their Product Unit Costs and their Product Unit Price. We simply have the percentage ROS figure, from which these values cannot be inferred. The level of the percentage ROS figure varies according to volumes sold: the percentage ROS is significantly lower in the case of higher volume sales. That is unsurprising, given that a Seller will look to absolute revenue not percentage return. The Capsules, as can be seen from Figure/Table 10, are by volume one of Flynn's best sellers, and yet the ROS commanded is at around the average ROS rate, which is high.

(iii) Furthermore, the ROS measure does nothing to distinguish Reasonable Rate of Return from Producer Surplus. To assume no Producer Surplus at all in these figures would be unwarranted and – even giving Flynn the benefit of the doubt – there is no basis on which that could be assumed.

(6) We consider that a percentage Reasonable Rate of Return could not possibly exceed 30%, and even that is high, again giving Flynn the benefit of the doubt. It constitutes the absolute upper limit for the percentage assessment Reasonable Rate of Return.

(7) We also ask ourselves what return on the Capital employed (as set out in Figure/Table 17) would represent a Normal Profit to the Entrepreneur carrying on Flynn's business. The question here is what could the Capital be used for in order to generate an equal or better return to the Entrepreneur. Given that the Capital employed figures are, for the reasons we have given, significantly overstated, we consider that if an Entrepreneur's return was 15% of Capital (as we have stated it to be) that would constitute supra-Normal Profits. A figure of 15% is again

generous to Flynn, and serves as a strong confirmation that the 30% figure described above is, if anything, too high in favour of Flynn.

307. On this basis, we conclude that Flynn's Profit Margin is demonstrably immoderate. Taking a Reasonable Rate of Return at 30%, calculated by reference to Capital employed that is itself overstated by several multiples, it is clear from the figures at Figure/Table 16 that Flynn's Profit Margin exceeded these in themselves generous limits, in some cases by a considerable amount (148% in the case of 25mg Capsules and 82% in the case of 50mg Capsules). The margins are tighter in the case of 100mg Capsules (at 35%) and 300mg Capsules (at 44%) but we are completely satisfied that there is – even in these cases – a material amount of Producer Surplus in Flynn's Profit Margin.[444]

308. *Prima facie*, therefore, Flynn's Product Unit Prices are demonstrably immoderate and we should proceed to consider the Unfair Limb unless we consider that the Producer Surplus can, in the manner described in [242], clearly be justified as one that would pertain (including as to its extent) in the case of Real World Competition. We are not so satisfied, but we do not propose to spend very long considering this question, preferring to leave our consideration of the justifiability of Flynn's Producer Surplus to the Unfair Limb. Suffice it to say that it is difficult to see what value Flynn is providing so as to justify <u>any</u> Producer Surplus. Flynn is simply <u>distributing</u> products that it does not itself make, and it is only able to charge a premium in regard to the Capsules because of its exclusive supply arrangements with Pfizer, meaning that it is the only distributor of Capsules in the UK. These arrangements, whilst unimpeachable in competition law terms, are not sufficiently pro-consumer to enable an inquiry under the Unfair Limb to be avoided. To the contrary, such an inquiry is invited, and we consider that it would be an abuse of what is a gateway condition to halt the inquiry at the Excessive Limb stage. We therefore proceed to consider the Unfair Limb.

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[444] It is to be noted that Flynn's Profit Margin is low in these cases because its Product Unit Costs were extremely high. That is because Pfizer priced the different Capsule doses very differently, for reasons that we do not understand, as can be seen from Figure/Table 13. Consistently with our view that dealings between Pfizer and Flynn need to be regarded as arm's length, commercial, dealings, we do not take this differential pricing into account, although it undoubtedly looks odd.

(c) The Unfair Limb

309. The starting point is to classify the Producer Surplus.[445] We consider this to be an instance of Case 3, where no Producer Surplus is defensible and where, as a result, the prices charged by the Enterprise are unfair where they contain a material element of Producer Surplus. We reach this conclusion for the following reasons:

(1) This is not an instance of Case 1. Case 1 arises where demand exceeds the supply of the most efficient Seller, such that less efficient Sellers can generate a Normal Profit, enabling any more efficient Sellers to earn a Producer Surplus. Here, the Capsules are not substitutable,[446] Pfizer was the exclusive manufacturer and Flynn, Pfizer's exclusive distributor. If Flynn had competitors also distributing Capsules, and Flynn was the more efficient Seller, then Flynn's Producer Surplus would (to an extent at least) be justifiable. But that is not this case.

(2) Nor is this an instance of Case 2. Whilst it might be said that Pfizer is delivering value by continuing to manufacture Capsules so as to meet the very specific Continuity of Supply need of the Pfizer/Flynn Patients (a point we will come to), this cannot be said of Flynn. All Flynn is doing is distributing pharmaceutical products. That value is provided independently of the precise nature of the product being distributed. In short, the distinctive nature of the value provided by Flynn is the distribution of pharmaceutical products generally. There is no difference (in terms of value added) between the efficient distribution of Capsules and the efficient distribution of some other pharmaceutical product.

(3) Case 3 exists where Producer Surplus is generated without adding value to Buyers. Assuming Real World Competition, what is it that would enable Flynn to charge a Product Unit Price containing a material element of Producer Surplus? It is not possible to identify any feature of

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[445] The three "Cases" were set out in [196] to [199]. Their significance in terms of the Unfair Limb was considered at [234].
[446] This is the consequence of the CMA's definition of the market: see [246(1)(iii)].

the services offered by Flynn that would enable it to charge more than the Normal Profit in circumstances of Real World Competition.

(d) Conclusion

310. We conclude that the requirements of the Excessive Limb and of the Unfair Limb are met in this case in respect of the entirety of the Relevant Period and as regards all Capsule Strengths, and that Flynn has, in this way, infringed the Chapter II prohibition.

(6) Has Pfizer infringed the Chapter II prohibition?

(a) The Excessive Limb

311. Pfizer's Profit Margin was as follows:

Annex 3 values averaged over the Relevant Period	**Capsule Dosage**			
	25mg	50mg	100mg	300mg
Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
Average volume sold by Pfizer to Flynn	10,282	20,780	18,991	12,746
Pfizer Product Unit Price	£4.50	£6.68	£37.83	£36.67
	£1.23	£3.51	£33.42	£32.23
Pfizer's Profit Margin	38%	111%	757%	726%

Figure/Table 18: Pfizer's Profit Margin averaged over the Relevant Period

312. Before turning to the question of excess and determining the Excessive Limb, we make a number of preliminary points:

(1) The fact that Pfizer did not aggressively challenge, in its Grounds of Appeal, the finding of excess does not mean that we should not ourselves rigorously consider whether such a finding is justified. We have decided that the Decision cannot stand. If we are to decide the question of infringement for ourselves, as we have chosen to do, we must be satisfied to the requisite standard that all elements constituting an infringement on the part of Pfizer are met.

(2) In this, we are conscious that we have not received as detailed factual submissions on this point from Pfizer and the CMA as we would have done had the point truly been live before us. As with Flynn, our approach will be to give Pfizer the benefit of every doubt.

(3) We are conscious that the CMA placed considerable weight on the fact that Pfizer's prices for the Capsules were significantly lower prior to the arrangements between Pfizer and Flynn in 2012,[447] and that those prices significantly increased after those arrangements came into effect. In *Phenytoin 1* (CoA), the Court of Appeal commented on these increases, and they are clearly of interest as relevant background. But we do not consider that the mere fact that prices have increased – even dramatically – can assist very much in determining whether the increased prices are "demonstrably immoderate" or otherwise meeting the Excessive Limb. The fact is that Pfizer contended that its prices before its arrangements with Flynn were put in place were loss-making. Given the judgmental difficulties in ascertaining Product Unit Cost and Product Unit Price, competition authorities need to be confident that the evidence justifies the rejection of such a contention, and in this case, we are not. Similarly, whilst an ability to increase prices dramatically is certainly evidence of dominance, to regard it as evidence of abuse is to prejudge matters without considering the facts objectively.

We consider that we must proceed with caution when considering the Excessive Limb as regards Pfizer.

313. Nevertheless, despite this need for caution, and having considered all the evidence, we are satisfied, to the requisite standard, that the Excessive Limb is met in this case and that Pfizer's Profit Margin for the Capsules was excessive. We have reached this conclusion for the following reasons:

(1) Although the Profit Margin for each of the Capsule dosages has been calculated to a high degree of reliability given the Focal Product

[447] See [13] to [14].

Spreadsheets, the key question is how much of that Profit Margin constitutes a Reasonable Rate of Return and how much (if any) constitutes Producer Surplus.

(2) Our starting point is to consider the Capital required to produce each Capsule dosage and to reach a preliminary – and very much broadbrush – assessment of what might be an appropriate return on this Capital. The relevant factors going to such a preliminary assessment were set out at [167(4)] and comprise compensation for the time value of money, adjusted for risk, taking account of the fact that the volume of Product sold is a factor very relevant to risk.[448]

(3) Taking the time value of money for a risk-free enterprise at a generous 5%, we consider that a risk loading of 10% on top (i.e. a return on Capital of 15%) to be reasonable. The risk loading is generous to Pfizer because:

(i) The Capsules were an established Product, having been sold in the market for many years. The risks of product liability litigation and other kinds of risk emanating from sale were at all material times low.

(ii) The market for the Capsules was well-established and demand inelastic for those patients to whom it was appropriate to prescribe phenytoin sodium. We accept that the use medical practitioners make of phenytoin sodium has diminished over time, and that phenytoin sodium is a third-line AED. Whilst one would expect demand for the product to decline over time, that decline is and will continue to be gradual and over the long run. For those patients to whom phenytoin sodium is prescribed, it is a critical part of their treatment and the demand for the Product (from this cohort of Buyers) will be highly inelastic in a case where the need for the Product will be lifelong or at least

[448] The greater the volumes sold, the less the Seller's profit turns on the marginal sale: very low volumes of sales justify a higher return on Capital employed.

spanning many years. Pfizer could, therefore, assume that existing demand for phenytoin sodium would not change even if prices increased dramatically.

(iii) The importance attached to Continuity of Supply in the MHRA Guidance meant that not only was the demand for phenytoin sodium inelastic, the demand for the Capsules themselves was also inelastic. Although we accept the evidence of Professors Sander and Walker that switching between differently manufactured forms of phenytoin sodium was not medically problematic (and would be positively indicated if there was a shortness of supply of one particular product), both Professors stressed the psychological importance to some patients of Continuity of Supply. Given the seriousness of the condition, such patient concerns are easy to appreciate and the reason why the MHRA Guidance exists. For Pfizer, this meant an assurance that demand for the Capsules they produced would be inelastic. That, of course, is commercially immensely significant: it is not a great overstatement to say that Pfizer was operating in conditions where the demand for its products, the Capsules, was guaranteed in the long run.

(4) We therefore consider that the Reasonable Rate of Return on Capital to be 15%. We stress that we are only calculating the level of return that describes that level of Normal Profit that will persuade the entrepreneur not to leave the market. We are not seeking to calculate a return that will encourage new entry; nor are we seeking to calculate a return that will cover Extraneous Costs. These are functions of the Producer Surplus, which sits above the Reasonable Rate of Return.

(5) On this basis, the Profit Margin earned by Pfizer on all Capsule dosages – including the 25mg Capsule dosage – is excessive. The difference in Profit Margin between 25mg Capsules on the one hand and the other Capsule dosages on the other hand should, however, be noted. It is striking, both in relative and absolute terms. The percentage Profit

Margin for 25mg Capsules is 38%, whereas it exceeds 100% in the case of 50mg Capsules and 700% in the case of 100mg and 300mg Capsules. Turning to the absolute Profit Margin, it is appropriate here to consider the total Profit Margin accruing to Pfizer. Re-stating Figure/Table 18 to include such calculations, we see:

Annex 3 values averaged over the Relevant Period	**Capsule Dosage**			
	25mg	50mg	100mg	300mg
Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
Average volume sold by Pfizer to Flynn	10,282	20,780	18,991	12,746
Pfizer Product Unit Price	£4.50	£6.68	£37.83	£36.67
Pfizer's Profit Margin	£1.23	£3.51	£33.42	£32.23
Total monthly Profit Margin	**£12,647**	**£72,938**	**£634,679**	**£410,803.60**

Figure/Table 19: Total monthly Profit Margin to Pfizer

Given the volumes sold, one would expect the Profit Margin per Unit sold to fall, not increase, and certainly not increase as dramatically as it does. Although the 25mg Capsules will, by definition, contain less active ingredient than higher dosage Capsules, and whilst that will make a tiny difference to cost, this is not enough to explain the far higher Profit Margins accruing to Pfizer for 50mg, 100mg and 300mg Capsules.

(6) Whilst we consider the price of 25mg Capsules to be excessive in satisfaction of the Excessive Limb, for the reasons we have given, this case is clearly more marginal than in the case of the other Capsule dosages. The level of Producer Surplus accruing to Pfizer is obviously far less. We therefore consider that the 25mg Capsule can be seen not merely as a Focal Product potentially infringing the Chapter II prohibition, but also as a comparator Product, particularly when we come to consider the reasonableness or fairness of the Producer Surplus accruing generally to Pfizer. Using the 25mg Capsule dosage as a comparator assists because the price of this Product reflects Pfizer's own assessment of risk and appropriate pricing in regard to a Product that ought, if anything, to be priced relatively higher than the three other, stronger dosage, Capsules (because of the volumes sold). Thus:

(i) We are confident that even the Profit Margin for 25mg Capsules contains a material element of Producer Surplus, and so is *prima facie* excessive.

(ii) The position is *a fortiori* as regards the remaining Capsule dosages. Not only is the Profit Margin and so the Product Unit Price for the remaining Capsule dosages far higher but (using the 25mg Capsules as a comparator) it is impossible to reach any conclusion other than that the Excessive Limb is *prima facie* satisfied.

314. We therefore conclude that the Pfizer Product Unit Prices for the Capsules were excessive and in breach of the Excessive Limb. As in the case of Flynn, we do not consider the legitimacy or otherwise of the Producer Surplus accruing to Pfizer at the Excessive Limb stage. As in the case of Flynn, that would be to place too great a burden on the gateway role played by the Excessive Limb.

315. Before we turn to the Unfair Limb, we should however explain why we have derived only limited assistance from the prices of Tablets:

(1) Pfizer placed considerable reliance on the £30 Drug Tariff for Tablets and the prices at which the Tablets sold. We have reproduced as Figure/Table 11 (at [265]) a graph derived from the Pfizer Grounds of Appeal setting out this data.

(2) The CMA, we should stress, accepted neither the relevance of the £30 Drug Tariff nor the "comparator" prices of Tablets. We do not consider that the CMA's reasons for rejecting this evidence hold water:[449] but there are other reasons for attaching limited weight to this data:

(i) For reasons that we have given, the Drug Tariff rate is not a comparator price at all.[450] It represents, at most, a *de facto* price ceiling, under which different Sellers compete. In a case of Real

[449] See [184].
[450] See [254].

World Competition, the pharmacies (the recipients of the Drug Tariff) will benefit from competition and the difference between the Drug Tariff rate and the purchase price will be competitively appropriate.

(ii) In other words, one of the Drug Tariff's functions is to turn pharmacies into consumers who are able to "shop around" in a competitive market to maximise the difference between the Drug Tariff rate and the pharmaceutical products the pharmacy is obliged to dispense. Apart from this, the Drug Tariff says nothing about the appropriate price for any given drug.

(iii) In a case of Real World Competition, we accept that the prices between providers of Tablets might be informative as to the Reasonable Rate of Return. This, however, is not a case of Real World Competition at all, because all of the Sellers of Tablets themselves benefited from market dominance because of Continuity of Supply. Just as the CMA concluded that Pfizer was in a dominant position so far as the Capsules were concerned, so too is each and every Seller of phenytoin sodium Tablets. We appreciate that the pricing of Tablets as set out in Figure/Table 11 shows some degree of price competition indicative of a degree of substitutability that demonstrates that the MHRA Guidance was not stringently followed. Nevertheless, just as in this case, we do not consider that this precludes a finding of dominance because of Continuity of Supply. For the reasons the CMA concluded that there was dominance in Market 1 (Manufacture) and Market 2 (Distribution), so too we conclude that the Seller of each Tablet was in a position of dominance.

(iv) Tablet prices are, therefore, a difficult indicator. We take the evidence into account, but we do not consider that it is sufficient to alter our conclusion in regard to the Excessive Limb. Put another way, our view as to the robustness of the Reasonable Rate of Return we have assessed stands.

(b) The Unfair Limb

(i) Case 1, Case 2 or Case 3?

316. We propose to consider the Unfair Limb by reference to an ultimate consumer having the characteristics described in [298]. We are in no doubt, viewing matters in this light, that Pfizer's sale of Capsules to the ultimate consumer falls outside Case 3.[451] The sale of Capsules cannot be said to provide no benefit to the consumer at all. The consumer benefits through the continued supply of Capsules manufactured by Pfizer. This, for reasons articulated, is of objective benefit to patients. This objective benefit is something of economic value for which ultimate consumers, as a class, would be prepared to pay a premium. In other words, the Consumer Surplus is such that, assuming an ability to pay, there will be some willingness to pay over-and-above CMA Cost Plus rates.

317. We consider this to be an instance of Case 2,[452] where the Seller, Pfizer, is providing distinctive value to the ultimate consumer in the form of a differentiated product. The effect of the Continuity of Supply issue and the MHRA Guidance is to render each phenytoin sodium product different, even though these products are pharmacologically the same. This is a form of distinctive value that a Seller like Pfizer is entitled to charge for.

318. We should, for the avoidance of doubt, make clear that this is not an instance of Case 1.[453] This follows from what we have said in the immediately previous paragraphs: given the product differentiation that exists by reason of the Continuity of Supply issue, there are no rival Sellers of substitutable products where aggregate demand exceeds the supply of the most efficient Seller. Pfizer is not the most efficient Seller: Pfizer is the only Seller of a Product with certain unique characteristics. In this case, oddly, the unique characteristic is that the Product is manufactured by Pfizer. The Continuity of Supply issue gives Pfizer's Capsules some of the characteristics of a patented product.

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[451] See [199].
[452] See [197].
[453] See [196].

(ii) Is the level of Producer Surplus charged by Pfizer "unfair"?

319. Our conclusion that this is an instance of Case 2 means that some Producer Surplus is justifiable as fair under the Unfair Limb. It is not the case that any Producer Surplus that a Seller might choose to charge is fair. The question, in each case, is whether the level of Producer Surplus in fact received by the Seller can be said to be unfair by reference to criteria that can be objectively stated. In this regard:

(1) We will have regard to the various relevant factors that we have described at [242]. However, we make clear that the list of relevant factors is not closed and that the facts of the instant case will always be central. This is, fundamentally, a question of considered judgment.

(2) We start with a presumption that the prices charged by Pfizer are defensible. This is a case where some Producer Surplus can, properly, be charged for by the Seller, and it would be in principle wrong for the starting point to be CMA Cost Plus.

(3) We do not see any material difference between Capsule dosages, and therefore propose to give primary consideration to the Product Unit Price, Profit Margin and Producer Surplus of the 50mg Capsule dosage, where Pfizer's Profit Margin was 111%, of which 15% constitutes the Reasonable Rate of Return[454] and 96% (i.e. 111% minus 15%) Producer Surplus. The 100mg and 300mg Capsule dosages obviously lie *a fortiori* the 50mg case. We will return to consider separately the case of the 25mg strength Capsule.

(4) When considering the case of the 96% Producer Surplus, we are very conscious that it is not our function to state what the "right" Product Unit Price, Profit Margin or Producer Surplus is.[455] Our role is not to second guess what the outcome of Real World Competition would be. Our role

[454] See [313].
[455] See [241], where the Court of Appeal's statements on this point are set out.

is to state whether, in our view, the Producer Surplus charged by Pfizer as part of its prices was unfair. Unless we can articulate, clearly and objectively, why Producer Surplus is unfair in its extent, not its existence, we should leave well alone.

320. In our judgment, Pfizer's Product Unit Price, Profit Margin and Producer Surplus (all names for the same thing, but it is the size of the Producer Surplus that is determinative) were unfair in the case of the 50mg, 100mg and 300mg Capsules for the following reasons:

(1) We accept that all Enterprises – and in particular, Enterprises engaged in the pharmaceutical sector – rely upon any Producer Surplus that they can charge in order to recover Extraneous Costs.[456] The pharmaceutical sector as a whole is engaged in developing new products and should be encouraged to do so. That means that the costs of failure need to be recovered somehow. The only way to discharge such legitimate Extraneous Costs is by charging a Producer Surplus where such can be maintained.

(2) We also accept that the Capsules manufactured by Pfizer do real good. AEDs that eliminate or ameliorate seizures in epileptics deliver significant and unquantifiable human benefit.[457] They also deliver significant benefit in the form of avoided costs namely: (i) the costs of treating a seizure that could have been avoided through prescription of Capsules; and (ii) the costs to the wider economy in an epileptic being off work or unable to assist in family life, etc. We accept that these benefits vastly outweigh the price of the Capsules, although we are in no position to quantify these benefits (even the economic ones).

(3) These factors all justify some Producer Surplus, but not the Producer Surplus charged in the case of the 50mg (and 100mg and 300mg) Capsules. That is because there is an unfair (indeed, grotesque)

[456] See [242(4)].
[457] See [242(5)].

mismatch between the distinctive value generated by the Capsules[458] and the Consumer Surplus that would be derived by the ultimate consumer:[459]

(i) The distinctive value generated by the Capsules is limited to the provision of Continuity of Supply. That has undoubted psychological benefits, which are valuable, but the Capsules deliver no medical benefit that could not equally be delivered by differently manufactured Capsules or Tablets. There was evidence of considerable switching between phenytoin sodium products and – apart from the important psychological aspect – the experts were relaxed about this.[460]

(ii) Turning then, to the ultimate consumer – as we have defined them[461] – we consider that such a consumer would be prepared to pay a premium in order to procure Continuity of Supply to them. Put another way, assuming an ability to pay, there would be a willingness on the part of the ultimate consumer to pay materially above CMA Cost Plus. In short, at the CMA Cost Plus price, there would be very significant Consumer Surplus, which would remain significant (although of course less) even if the Product Unit Price were higher so as to accommodate a material Producer Surplus accruing to Pfizer.

(iii) At some point the ultimate consumer (rather than paying 50mg, 100mg or 300mg Product Unit Prices) would either pivot to 25mg Capsules (and simply take more Capsules to achieve the same dosage) or to phenytoin sodium differently administered (e.g., Tablets).

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[458] See [242(3)].
[459] See [242(6)].
[460] See [177].
[461] See [298].

(iv) The reason this movement away from the Capsules does not occur in the real world is because Pfizer has been taking advantage of the noble – but inconsistent – objectives of our health care system. This system wants to obtain value for money, but not at the price of patient welfare. Hence the clear tension between the firm strictures of the MHRA Guidance in regard to Continuity of Supply and the concerns expressed by CCGs as to cost.[462] Because the system needs to consider the aggregate class of epileptics being prescribed Capsules, and cannot consider the individual case, there is an invidious choice between keeping costs under control and maximising patient benefit. In adopting the MHRA Guidance, the latter has been prioritised over the former, thereby giving market power to Pfizer.

(4) This is why there is an unfair – and we repeat, grotesque – mismatch between the distinctive value generated by the Capsules and the Consumer Surplus as it would be regarded by the ultimate consumer. The competition lawyer considering the Chapter II prohibition has a luxury not granted the administrators of our health care system: after the event, we can consider by reference to different (but extremely clear) criteria the fairness or otherwise of prices charged. In this case, for the reasons we have given, we conclude with no doubt in our minds that the Product Unit Prices for 50mg, 100mg and 300mg Capsules were unfair within the Chapter II prohibition.

(5) Our conclusion as regards the 25mg Capsules is different. We do not consider that the price of these Capsules could objectively be said to be unfair. Indeed, we rely upon the pricing adopted by Pfizer in relation to the 25mg Capsules to support the conclusion that the prices for the other dosages were unfair. We thus conclude – taking fully into account the comparables deployed by Pfizer – that the prices for 50mg, 100mg and 300mg Capsules are unfair within the meaning of the Unfair Limb both

[462] This was the evidence of Mr White, Mr Green and Ms Smith (see [41(2), (3) and (4)]).

in themselves and when compared to the prices charged by Pfizer for the 25mg Capsules.

(c) Conclusion

321. We conclude that the requirements of the Excessive Limb and of the Unfair Limb are met in the case of the 50mg, 100mg and 300mg Capsules, and that Pfizer has, therefore, infringed the Chapter II prohibition.

L. PENALTY

(1) Approach

322. By virtue of section 36(2) of the Competition Act 1998, on making a decision that conduct has infringed the Chapter II prohibition, the CMA may require the undertakings concerned to pay a penalty in respect of the infringement.

323. Pursuant to section 36(3), a penalty may only be imposed if the body imposing the penalty (whether that be the CMA or, on re-making a Decision, this Tribunal) is satisfied that the infringement has been committed intentionally or negligently.

324. We have found that the Decision must be set aside; but that the outcome of the Decision – namely that the Appellants infringed the Chapter II prohibition by selling the Capsules at unfairly high prices – is reached by the processes we have described. In terms of outcome (as opposed to reasoning), the only difference between our conclusions and those of the CMA in the Decision is that Pfizer did not infringe the Chapter II prohibition so far as the sale of 25mg Capsules are concerned. Given that the CMA approached the infringements collectively and not individually for the purposes of penalty, and given that (subject to all other considerations) we are minded to take the same approach, there is no material difference between the outcome of this Judgment and the outcome of the Decision.

325. In these circumstances, whilst we are clearly obliged to re-visit the decision on penalty, it is appropriate to pay close regard to the CMA's calculations of penalty, as well as its judgmental conclusions on seriousness, since the CMA's views (as those of the relevant regulator) are entitled to a high degree of weight when re-making a decision on penalty.

(2) Jurisdiction, intention and negligence

326. In *Napp Pharmaceutical Holdings Ltd v. Director General of Fair Trading*,[463] the Tribunal held that, for the purposes of founding jurisdiction to impose a penalty, it was unnecessary for the regulator to state whether the infringing conduct was intentional or negligent. It is obvious that when deciding whether a jurisdictional threshold triggered either by intentional conduct or by negligent conduct has been crossed, no specific determination as to intention or negligence (provided one of these exists) need be made.

327. This straightforward issue as to jurisdiction cannot (or at least should not) be used as a reason for avoiding grappling with the facts of whether infringing conduct is in fact intentional or negligent. That is because, as the Tribunal stated in *Napp*, it will be necessary to reach a view as to intention or negligence when considering the gravity of the infringement. An intentional infringement is much more serious than one done negligently when it comes to penalty. Accordingly, we consider the CMA's statement that "[t]he CMA is not…obliged to specify whether it considers that the infringement intentionally or merely negligently"[464] to be correct on the question of jurisdiction to fine, but incorrect when it comes to exercising that jurisdiction. Where a regulator has concluded that it has jurisdiction to impose a penalty, it is obliged to state the reasons for the level of the penalty clearly and unequivocally: a statement like "the CMA finds that the Infringements were committed intentionally or, at the very least, negligently"[465] will not do, because it involves a failure properly to articulate the basis for the level of any fine imposed.

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[463] [2002] CAT 1 at [453] to [455].
[464] Decision/[9.32].
[465] Decision/[9.5].

328. Accordingly, we propose to address the question of state of mind in a more specific way than the CMA did in the Decision, not because this matters for jurisdictional purposes (where, as *Napp* says, the regulator can properly be indifferent as between intention and negligence, provided one or other is indicated), but because it is of great importance when considering the level of the penalty.

(3) Pfizer's and Flynn's state of mind

(a) Ignorance of the law is no defence

329. The Decision states that:[466]

> Intention or negligence relates to the facts, not the law. The CMA is not required to show that the undertaking knew that its conduct infringed the Act – what matters is not whether the undertaking was aware of "any specific legal characterisation" of its conduct, but instead "whether it was aware of its anti-competitive nature". In cases of exploitative abuse, by analogy, this means that the undertaking must have been aware of the exploitative nature of the conduct.

330. Thus, it is unnecessary for the Enterprise to have any understanding of whether it is dominant in the market, or even what dominance means; nor does the Enterprise need to have any understanding of what constitutes or does not constitute an abuse of a dominant position. The Enterprise needs to have an understanding of the essential facts underpinning the legal finding of abuse.[467]

331. The Decision records that the parties "submitted that the law relating to unfair pricing was sufficiently uncertain that they could not reasonably have been expected to understand that their conduct was unlawful".[468] The CMA rejected these arguments on the ground that "[t]he premise of the Parties' argument is mistaken, as it is not necessary for an undertaking to be aware of the law or the precise legal characterisation of its conduct in order for it to commit an intentional or negligent infringement".[469] We agree with this. But it is appropriate to note that the law in regard to unfair pricing – at least as we have

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[466] Decision/[9.34]. See also the further consideration, and further authority, cited at Decision/[9.34] to [9.37].
[467] Decision/[9.38].
[468] Decision/[9.48].
[469] Decision/[9.49].

stated it – is actually straightforward for any Enterprise to understand. It is to be expected that any Enterprise will have a clear appreciation of the costs of producing a given good or service and an equally clear appreciation of the price that that good or service can command. Enterprises – whatever their size and nature – will be considered to generate sufficient profit to enable them to stay in business. Where the Enterprise finds it easy to do so – because it is able to price independently of cost and independently of what competitors may be charging – then the warning signs of a competition law infringement exist. Although, of course, the existence of an infringement must be rigorously tested for and objectively justified on the evidence, our framing of the Excessive and Unfair Limbs are not difficult to understand and are very closely aligned to what the Enterprise will already know about their business. Accordingly, for this further reason we reject the Appellants' contentions in this regard.

(b) Attribution

332. In many cases involving corporate actors and their states of mind, difficult questions of attribution arise, particularly in the case of subjective states of mind like intention. In the case of competition law infringements, the concept of the "undertaking" renders such issues academic. Thus:[470]

> …the "unit of account" for purposes of competition law infringement and penalty is the "undertaking", an economic and not a legal characterisation of an organisation. Thus, provided that legally recognised entities (be they natural persons, legal persons or organisations of natural and legal persons like partnerships or unincorporated associations) form part of the same economic unit, their conduct, knowledge and state of mind can be pooled and collectively attributed to the undertaking…

333. In this case, we have no hesitation in concluding that both Pfizer and Flynn intentionally infringed the Chapter II prohibition. We have reached this conclusion for the following reasons:

(1) For a Seller in a market, price and price setting is a critical part of staying in business. Just as any Enterprise will have the control of costs well in mind, so too will that Enterprise have a very clear understanding of what

[470] *Allergan plc v. The Competition and Markets Authority*, [2023] CAT 57 at [95]. See also [96]; and *Hydrocortisone 1*/[161]*ff*.

drives its margins, both in terms of individual product and in terms of overall profitability. Cost and price are the central considerations that will inform most, if not all, aspects of a commercial Enterprise's consideration.

(2) With this focus on cost and price, every Enterprise will have an awareness – profounder than that of any regulator or reviewing court – of the competitive environment in which they function, which drives both cost (the price the Enterprise must pay for the Factors of Production they need to obtain) and price (the cost to that Enterprise's Buyers).

(3) In this case we are concerned with the price and the cost of the various Capsule dosages, and with the profit that constitutes the difference between these metrics. We have – in order to resolve these appeals, considered these metrics in a very specific way: we have focussed on Product Unit Cost and Product Unit Price and Profit Margin, as derived from the Focal Product Spreadsheets. We anticipate that Pfizer and Flynn did not parse their costs and prices in quite this way. However, we find that both Pfizer and Flynn will have been well-aware, in relation to the Capsules, of both their cost and their price and the profit margin that accrued to them because the latter dramatically exceeded the former. In short, the Appellants will have known that there was a significant difference to their very considerable benefit between cost and price, and that the Capsules represented "good business" for them. Not only were the per unit margins great, but the overall revenues derived from the volumes of Capsules sold rendered the revenues to both Pfizer and Flynn enormous.

(4) Pfizer and Flynn must have been aware that the products they were selling had certain characteristics that enabled them to price at will. Not only were the Capsules medically necessary, because of the issue of Continuity of Supply, Pfizer and Flynn would have appreciated that substituting other phenytoin sodium products for the Capsules would be difficult.

(5) The ability effectively to price at will is clear from the original arrangements between Flynn and Pfizer in 2012 and their joint decision to "de-brand" the Capsules. The reason for de-branding was to escape the PPRS price control: the only reason to seek to escape a price control is an appreciation that the price control is exactly that – a fetter on the ability to price higher. The PPRS scheme does not apply to unbranded products because it is assumed that competition will act as a control on price. In this case, both Pfizer and Flynn knew – for the reasons we have articulated – that there were no competitive controls over the prices they could charge for the Capsules. We conclude that throughout the Relevant Period, Pfizer and Flynn knew the margins they were making, and knew that they were pricing at well-above CMA Cost Plus.

(6) That, of course, is not enough to justify a conclusion that there was an intention to infringe the Chapter II prohibition by pricing unfairly. Unfair pricing is not a legal concept. To achieve an objective outcome, unfair pricing is best analysed through the economic lens of Consumer and Producer Surplus. But the requisite intention to infringe can be established without reference to these economic concepts. The key questions are these:

(i) Is the Enterprise able to charge a price that is not particularly informed by its costs?

(ii) If so, <u>why</u> is the Enterprise able to do so?

(7) It will readily be appreciated that these are, in lay terms, precisely the sort of questions that this Judgment has been concerned with. In particular, the second question – why can the Enterprise price in a manner that is above cost but at prices not otherwise informed by cost? – raises exactly the questions regarding the Producer Surplus that we have been considering. In this case:

(i) Both Pfizer and Flynn knew that they were pricing at well above cost and at prices that involved some form of Producer Surplus.

We do not consider that it can plausibly be suggested that the Capsule Prices were at what we have referred to as CMA Cost Plus, no matter how generously this was calculated.

(ii) Nor do we consider the prices of "competitors" or other Sellers in the same market to be particularly relevant. Pfizer and Flynn may have been pricing in line with an industry standard, but that says nothing about how the industry sees its prices. Equally, the Drug Tariff is no justification for a fair price, for the reasons that we have given.

(iii) Pfizer and Flynn were aware that they were able to price independently of cost and independently of competitive constraints. As successful Enterprises, they will have been well-aware of why this was the case. They were in a dominant position because of the need for Continuity of Supply, which was not something they delivered to the market, but rather something that they took advantage of. In short, they priced not because demand exceeded supply (Case 1), nor because of any particular innovation (Case 2), but because there was a basic human need for the Capsules, which only they could satisfy. The human need was not as stark as it might have been – the State intervened to pay – but that does not disguise the fact that both Pfizer and Flynn were gouging the market in a manner that can only be characterised as unjustifiable or opportunistic or – in a word – unfair.

(8) This is something that Pfizer and Flynn intended. They did not accidently or negligently overprice. They had market power given them; and they abused it.

334. Accordingly, there is jurisdiction to impose a penalty; and the basis on which we assess that penalty is one of intentional infringement of the Chapter II prohibition. Questions of negligence do not arise.

(4) Conduct of minor significance

335. Section 40 of the Competition Act 1988 provides as follows:

> (1) In this section "conduct of minor significance" means conduct which falls within a category prescribed for the purposes of this section.
>
> (2) The criteria by reference to which a category is prescribed may, in particular, include –
>
> > (a) the turnover of the person whose conduct it is (determined in accordance with prescribed provisions);
> >
> > (b) the share of the market affected by the conduct (determined in that way).
>
> (3) A person is immune from the effect of section 36(2), so far as that provision relates to decisions about infringement of the Chapter II prohibition, if his conduct is of minor significance, but the CMA may withdraw that immunity under subsection (4).
>
> (4) If the CMA has investigated conduct of minor significance, it may make a decision withdrawing the immunity given by subsection (3) if, as a result of its investigation, it considers that the conduct is likely to infringe the Chapter II prohibition.
>
> (5) The CMA must give the person, or persons, whose immunity has been withdrawn written notice of its decision to withdraw the immunity.
>
> (6) A decision under subsection (4) takes effect on such date ("the withdrawal date") as may be specified in the decision.
>
> (7) The withdrawal date must be a date after the date on which the decision is made.
>
> (8) In determining the withdrawal date, the CMA must have regard to the amount of time which the person or persons affected are likely to require in order to secure that there is no further infringement of the Chapter II prohibition.

336. Section 40(2)(a) refers to turnover determined in accordance with prescribed provisions. Those provisions are the Competition Act 1998 (Small Agreements and Conduct of Minor Significance) Regulations 2000, which provide:

> 4. The category of conduct prescribed for the purposes of section 40(1) of the Act is 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.
>
> 5. Where in the application of regulation…4 there is a calendar year in respect of which an undertaking has no business year ending in the

> preceding calendar year then the applicable turnover shall be the turnover for the preceding calendar year.

337. In this case, Flynn (but not Pfizer) contended that they were entitled to immunity by reason of their low applicable turnover. Flynn's turnover was below the relevant threshold in 2011 (£14.2m), 2012 (£19.2m), 2013 (£46.5m) and 2015 (£49.9m), but above the threshold in 2014 (£54.1m).[471] The CMA rejected Flynn's immunity argument because of the turnover in 2014, which exceeds the relevant threshold.[472]

338. We agree that the CMA was right to reject Flynn's immunity argument, but for the following reasons:

(1) The section 40 immunity does not operate to abrogate in any way the substantive effects of the Chapter II prohibition. An Enterprise will always be subject to the obligation to comply with the Chapter II prohibition, and may (for example) be the subject of a private infringement action.

(2) Nor does section 40 provide any immunity against an investigation by the CMA to an Enterprise whose turnover falls below £50m. This is clear from section 40(4), which expressly makes clear that the CMA may investigate conduct of minor significance. Of course, the decision to investigate in any case is an important administrative discretion vesting in the CMA. The CMA is a public body with limited resources, and it must (subject to judicial review) decide how best to deploy those resources.

(3) What section 40 does is – without in any way altering the substantive law under the Chapter II prohibition to provide immunity – provide an additional reason for the CMA not to investigate conduct of minor significance. But section 40 does not, as we have noted, remove the power to investigate from the CMA. Rather, it makes clear in section

[471] Decision/[9.13].
[472] Decision/[9.17]*ff*.

40(3) that where the CMA has investigated conduct of minor significance (as it has done here) the CMA may make a decision withdrawing the immunity if it considers the conduct under investigation likely to infringe the Chapter II prohibition. That is what has occurred here:

(i) The CMA has concluded that Flynn's conduct is likely to infringe the Chapter II prohibition, and it has proceeded to investigate that conduct.

(ii) The CMA has ensured that – consistent with section 40(8) – Flynn had time to adjust its conduct so as to avoid any further infringement.[473]

(iii) The decision to withdraw immunity under section 40(5) must have been taken over a decade ago, in February 2014.[474] Although we have been shown no formal document withdrawing immunity, Flynn must have known of that decision since at least 2014, and have (without objection) been involved in two CMA investigations of their conduct in regard to the Chapter II prohibition since that date.

Accordingly, the question whether Flynn was or was not entitled to immunity by reason of its low turnover does not arise. Even if Flynn qualified, that immunity was withdrawn many years ago, and Flynn cannot now resurrect it.

(5) Calculation of financial penalties

339. The CMA issued a single fine in relation to all four of Pfizer's infringements and all four of Flynn's infringements.[475] We propose to adopt the same approach as regards the three infringements we have found against Pfizer (the prices of

[473] See [22].
[474] This was when the CMA extended the investigation to include Flynn's pricing conduct: [21].
[475] Decision/[9.81] and [9.82].

the 25mg Capsules do not infringe the Chapter II prohibition, for reasons we have given) and the four infringements we have found against Flynn.

340. Like appeals on substantive points, appeals against penalties are on the merits. That does not mean that this Tribunal should not defer to the articulated judgment of the regulator, where that articulated judgment discloses no material errors. Although we have concluded that the substance of the Decision cannot stand, and have been obliged to re-consider the question of infringement, our conclusions (reached by way of a very different process to that used by the CMA) are sufficiently similar for us to be able to adopt the calculation of financial penalties set out in Decision/[9.81]*ff*. Although the CMA sought to ride both fining jurisdictions – intentional and negligent – we consider that the CMA's approach proceeded on the basis that the infringements were *intentional* and that the penalties were calculated on this basis. It would not, therefore, be appropriate for us to look to increase the penalties still further and we consider that it is more consistent with our role of follow the CMA's approach, provided no material error is disclosed. This is therefore, in large part, a mechanistic process, and we find no error is disclosed on the face of the CMA's calculations. More importantly, although the CMA's approach to assessing the Excessive and Unfair Limbs was wrong, the CMA was correct in regarding these infringements as extremely serious.[476] Indeed, where the CMA hedged, and left open the possibility of a negligent infringement by the Appellants of the Chapter II prohibition, we are in no doubt that these were intentional infringements, which harmed the healthcare system in this country by extracting from a limited budget monopoly rents. Although this is rightly a long judgment – competition law infringements must be established to the proper standard and the reasoning fully set out, particularly where the decision under appeal is materially flawed – the infringements in this case are extreme and can be shortly stated in the manner that we have just done.

341. For these reasons, we affirm the penalties assessed by the CMA for the reasons above and as set out in the Decision itself. As we have explained, we consider that they were calculated on the basis of an intention to infringe and although

[476] Decision/[9.90]*ff*.

the CMA could, and should, have been clearer on this point, we do not consider it would be appropriate to increase the penalties because they were assessed on the basis of negligence. We do not consider that this is what the CMA in fact did. Subject to one qualification, we therefore affirm the fines of £63,300,000 and £6,704,422. The one qualification relates to Pfizer's pricing of the 25mg Capsules, which we have found did not infringe the Chapter II prohibition. It is appropriate that we adjust the fine downwards. We do so by reference to the total monthly Profit Margin accruing to Pfizer as disclosed in Figure/Table 19. Total Profit Margin across all Capsule sales was £1,187,600, of which the Profit Margin of 25mg Capsules was £12,647 or 1.06%. We reduce Pfizer's penalty by 1% or £630,000 accordingly.

M. DISPOSITION

342. For the reasons we have given:

(1) The Decision is set aside on the grounds of the material errors identified in the Pfizer and Flynn Grounds of Appeal, which succeed for the reasons set out in this Judgment.

(2) We exercise our jurisdiction to remake the Decision and find (again for the reasons given in this Judgment) that all four of the infringements alleged against Flynn are made out, and that three of the four infringements alleged against Pfizer are made out. Pfizer's prices for the 25mg Capsules did not infringe the Chapter II prohibition.

(3) Subject to a downward adjustment in Pfizer's penalty, reducing it from £63,000,000 to £62,370,000, we affirm the penalties imposed by the CMA for the reasons given in this Judgment and in Chapter 9 of the Decision.

343. This Judgment is unanimous. We should be clear that – in accordance with the Tribunal's established practice – [342] constitutes the *dispositif* of these appeals and no further order is necessary or appropriate. We will, in due course, hear from the parties on consequential matters.

The Honourable Mr Justice Marcus Smith | Eamonn Doran | Professor Michael Waterson

Charles Dhanowa OBE, KC (Hon)
Registrar

Date: 20 November 2024

ANNEX 1

TERMS AND ABBREVIATIONS USED IN THE JUDGMENT

(Judgment/[1] footnote 1)

TERM / ABBREVIATION	FIRST USE IN THE JUDGMENT
AED	[7]
Aggregate Consumer Surplus	[65(3)]
Aggregate Producer Surplus	[65(3)]
Annex 1	[1] fn 1
Annex 2	[1] fn 1
Annex 3	[14]
Annex 4	[76]
Annex 5	[148]
Annex 5 Example	[148]
Anti-Epileptic Drug	[7]
Appellants	[1]
Average Consumer Surplus	[65(4)]
Average Producer Surplus	[65(4)]
Buyer	[61(1)]
Capital	[60(1)]
Capsules	[1]
Case 1	[196]
Case 2	[197]
Case 3	[199]
CAT Decision	[5]
CCG	[30]
CMA	[1]
CMA Cost Plus	[32(4)]
CMA Defence	[30] fn 40
CoA Decision	[5]
Compare The Market	[108] fn 171
Consumer Surplus	[61(1)]
Continuity of Supply	[10]
De Coninck 1	[45(3)]
De Coninck 2	[45(3)]
De Coninck 3	[45(3)]
De Coninck 4	[45(3)]
De Coninck 5	[45(3)]
De Coninck 6	[45(3)]
De Coninck 7	[45(3)]
Decision	[1]

DHSC	[32(5)]
Drug Tariff	[123]
Enterprise	[59]
Entrepreneurship	[60(1)]
Epanutin	[12]
Excessive Limb	[23(1)(i)]
Extraneous Costs	[148(1)(i)]
Face Mask Example	[194(3)]
Factors of Production	[60]
Fakes 1	[41(1)]
Fakes 2	[41(1)]
Flynn	[1]
Flynn Grounds of Appeal	[35]
Focal Product	[32](4)(i)]
Focal Product Spreadsheets	[68]
Green 1	[41(3)]
Green 2	[41(3)]
Harman 1	[45(4)]
Harman 2	[45(4)]
Harman 3	[45(4)]
Hawkins 1	[41(5)]
Hydrocortisone 1	[19]
Hydrocortisone Decision	[19]
Impaired Competition	[244(3)]
Labour	[60(1)]
Land	[60(1)]
MA	[13]
Majumdar 1	[45(1)]
Majumdar 2	[45(1)]
Market 1 (Manufacture)	[53(1)]
Market 2 (Distribution)	[53(2)]
Marketing Authorisation	[13]
McGuire 1	[47(2)]
MHRA	[177(5)(ii)]
MHRA Guidance	[177(5)(ii)]
NHS	[7]
NICE	[274]
Normal Profit	[63]
Per Unit Cost of Capital	[167(3)(ii)]
Pfizer	[1]
Pfizer Grounds of Appeal	[35]
Pfizer/Flynn Customers	[13]
Pfizer/Flynn Patients	[13]

Phenytoin 1 (CAT)	[5]
Phenytoin 1 (CoA)	[5]
Phenytoin 1 Decision	[5]
Phenytoin Sodium Flynn Hard Capsules	[13]
Phenytoin Sodium NRIM Capsules	[17]
Physical Capital	[60(1)(iii)]
PPRS	[110]
Producer Surplus	[61(2)]
Product	[61(1)]
Product Unit Cost	[32(4)(ii)]
Product Unit Price	[58]
Profit Margin	[57]
PUCC	[167(3)(ii)]
Real World Competition	[79(3)]
Reasonable Rate of Return	[32(4)(iii)]
Relevant Period	[2]
Remittal Order	[24]
Return on Capital Employed	[80(3)(ii)]
Return on Sales	[80(3)(ii)]
ROCE	[80(3)(ii)]
ROS	[80(3)(ii)]
Sander 1	[44(1)]
Seller	[61(2)]
Skedgel 1	[47(1)]
Skedgel 2	[47(1)]
Smith 1	[41(4)]
Tablets	[17]
Unfair Limb	[23(1)(i)]
WACC	[88]
Walker 1	[44(2)]
Walker 2	[44(2)]
Walker 3	[44(2)]
Walker 4	[44(2)]
Walker 5	[44(2)]
Webster 1	[45(2)]
Weighted Average Cost of Capital	[88]
White 1	[41(2)]
White 2	[41(2)]
Williams 1	[45(5)]
Williams 2	[45(5)]
Williams 3	[45(5)]
Williams 4	[45(5)]

ANNEX 2

LIST OF FIGURES AND TABLES IN THE JUDGMENT

(Judgment/[1] footnote 1)

Figure/Table 1	A diagrammatic representation of Aggregate Consumer Surplus and Aggregate Producer Surplus	Judgment/[65(3)]
Figure/Table 2	The Profit Margin graphically represented	Judgment/[76]
Figure/Table 3	Pfizer's Product Unit Cost of the Capsules over the whole of the Relevant Period	Judgment/[100(3)]
Figure/Table 4	The CMA's assessment of stock requirements	Judgment/[105(2)]
Figure/Table 5	The CMA's assessment of working capital requirements	Judgment/[105(3)]
Figure/Table 6	The CMA's assessment of the capital employed by Flynn in the production of the Capsules	Judgment/[105(4)]
Figure/Table 7	Stylised example of costs allocation to generate a Product Unit Cost	Judgment/[137(7)]
Figure/Table 8	The Profit Margin broken down into Reasonable Rate of Return and Producer Surplus	Judgment/[145(2)]
Figure/Table 9	ROCE applied to the Vanilla Coffee Shop and the Robo Shop	Judgment/[148(3)(iv)]
Figure/Table 10	ROS on Flynn products sold	Judgment/[173]
Figure/Table 11	Graph from the Pfizer Grounds of Appeal/[155]	Judgment/[265]
Figure/Table 12	Table of Tablet ASPs	Judgment/[2267(2)(iv)]
Figure/Table 13	The approach to considering the Unfairness Limb in the case of multiple Sellers in the same supply chain	Judgment/[293]
Figure/Table 14	Volume of sales differences in Relevant Period Month 1	Judgment/[300(1)]
Figure/Table 15	Averaged Annex 3 values	Judgment/[301]
Figure/Table 16	Flynn's Profit Margin averaged over the Relevant Period	Judgment/[305]
Figure/Table 17	Flynn's Capital employed and total revenue generated	Judgment/[306(1)]

Figure/Table 18	Pfizer's Profit Margin averaged over the Relevant Period	Judgment/[311]
Figure/Table 19	Total monthly Profit Margin to Pfizer	Judgment/[313(5)]

ANNEX 3

DATA FROM THE FOCAL PRODUCT SPREADSHEETS

(Judgment/[15])

Description	Capsule Dosage			
	25mg	50mg	100mg	300mg
Relevant Period Month 1: Sep 2012				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	10,992	21,264	34,416	13,800
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£7.08	£42.50	£42.50
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	8,059	17,061	26,054	11,255
(f) Flynn Product Unit Price	£13.77	£13.98	£59.06	£59.06
(g) Pfizer's Profit Margin	£1.23	£3.91	£38.08	£38.06
	38%	124%	862%	858%
(h) Flynn's Profit Margin	£8.04	£6.06	£19.89	£20.98
	140%	76%	51%	55%
Relevant Period Month 2: Oct 2012				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	14,249	26,153	35,156	17,401
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£7.08	£42.50	£42.50
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	14,666	24,582	26,931	14,680
(f) Flynn Product Unit Price	£13.76	£13.97	£59.04	£59.02
(g) Pfizer's Profit Margin	£1.23	£3.91	£38.09	£38.06
	38%	124%	862%	858%
(h) Flynn's Profit Margin	£8.03	£6.05	£19.87	£20.94
	140%	76%	51%	55%
Relevant Period Month 3: Nov 2012				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	12,864	9,103	9,900	7,966
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£7.08	£42.50	£42.51
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	9,657	14,394	25,862	12,663
(f) Flynn Product Unit Price	£13.77	£13.98	£59.06	£59.06
(g) Pfizer's Profit Margin	£1.23	£3.91	£38.08	£38.07
	38%	124%	862%	858%
(h) Flynn's Profit Margin	£8.04	£6.05	£19.89	£20.97
	140%	76%	51%	55%
Relevant Period Month 4: Dec 2012				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	17,988	52,000	58,707	18,119
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£7.08	£42.50	£42.50
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08

Description	Capsule Dosage			
	25mg	50mg	100mg	300mg
(e) Total volume sold by Flynn	14,514	44,794	59,823	23,789
(f) Flynn Product Unit Price	£13.77	£13.98	£59.06	£59.06
(g) Pfizer's Profit Margin	£1.23	£3.91	£38.08	£38.06
	38%	124%	862%	858%
(h) Flynn's Profit Margin	£8.04	£6.05	£19.89	£20.98
	140%	76%	51%	55%
Relevant Period Month 5: Jan 2013				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	5,907	33,000	68,500	15,899
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£7.08	£42.50	£42.50
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	12,008	22,860	51,567	12,815
(f) Flynn Product Unit Price	£13.77	£13.98	£59.06	£59.06
(g) Pfizer's Profit Margin	£1.23	£3.91	£38.08	£38.06
	38%	124%	862%	858%
(h) Flynn's Profit Margin	£8.04	£6.05	£19.89	£20.98
	140%	76%	51%	55%
Relevant Period Month 6: Feb 2013				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	9,716	27,500	23,086	11,890
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£7.08	£42.50	£42.50
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	11,844	20,701	33,595	13,954
(f) Flynn Product Unit Price	£13.78	£13.99	£59.08	£59.09
(g) Pfizer's Profit Margin	£1.23	£3.91	£38.08	£38.06
	38%	124%	862%	858%
(h) Flynn's Profit Margin	£8.05	£6.06	£19.91	£21.01
	140%	77%	51%	55%
Relevant Period Month 7: Mar 2013				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	17,161	19,909	47,081	18,128
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£7.08	£42.50	£42.50
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	9,427	20,588	24,538	12,499
(f) Flynn Product Unit Price	£13.78	£13.99	£59.07	£59.12
(g) Pfizer's Profit Margin	£1.23	£3.91	£38.08	£38.06
	38%	124%	862%	858%
(h) Flynn's Profit Margin	£8.05	£6.07	£19.91	£21.03
	141%	77%	51%	55%
Relevant Period Month 8: Apr 2013				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	4,012	20,639	593	24,823
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£7.08	£42.50	£42.50

Description	Capsule Dosage			
	25mg	50mg	100mg	300mg
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	7,236	13,984	21,785	9,022
(f) Flynn Product Unit Price	£13.77	£13.98	£59.06	£59.07
(g) Pfizer's Profit Margin	£1.23	£3.91	£38.08	£38.06
	38%	124%	862%	858%
	£8.04	£6.06	£19.89	£20.98
(h) Flynn's Profit Margin	140%	76%	51%	55%
Relevant Period Month 9: May 2013				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	10,748	22,047	45,719	13,345
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£7.08	£42.50	£42.50
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	10,147	20,330	23,417	13,991
(f) Flynn Product Unit Price	£14.08	£14.26	£60.15	£60.02
(g) Pfizer's Profit Margin	£1.23	£3.91	£38.08	£38.06
	38%	124%	862%	858%
	£8.35	£6.33	£20.98	£21.94
(h) Flynn's Profit Margin	146%	80%	54%	58%
Relevant Period Month 10: Jun 2013				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	12,488	24,000	31,854	12,068
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£7.08	£42.50	£42.50
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	10,477	21,855	13,857	13,214
(f) Flynn Product Unit Price	£13.81	£14.19	£60.06	£59.34
(g) Pfizer's Profit Margin	£1.23	£3.91	£38.08	£38.06
	38%	124%	862%	858%
	£8.08	£6.26	£20.89	£21.26
(h) Flynn's Profit Margin	141%	79%	53%	56%
Relevant Period Month 11: Jul 2013				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	9,184	17,880	7,992	14,400
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£7.08	£42.50	£42.50
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	12,457	27,726	21,126	15,452
(f) Flynn Product Unit Price	£14.02	£14.49	£60.05	£60.17
(g) Pfizer's Profit Margin	£1.23	£3.91	£38.08	£38.06
	38%	124%	862%	858%
	£8.29	£6.57	£20.88	£22.09
(h) Flynn's Profit Margin	145%	83%	53%	58%
Relevant Period Month 12: Aug 2013				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	7,784	20,160	22,464	12,300

Description	Capsule Dosage			
	25mg	50mg	100mg	300mg
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£7.08	£42.50	£42.50
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	10,797	22,779	17,250	14,463
(f) Flynn Product Unit Price	£13.80	£14.01	£59.17	£59.18
(g) Pfizer's Profit Margin	£1.23	£3.91	£38.08	£38.06
	38%	124%	862%	858%
(h) Flynn's Profit Margin	£8.07	£6.08	£20.01	£21.10
	141%	77%	51%	55%
Relevant Period Month 13: Sep 2013				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	14,112	33,480	27,108	18,960
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£7.08	£42.50	£42.50
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	8,636	22,240	44,744	11,792
(f) Flynn Product Unit Price	£14.01	£14.35	£59.50	£60.52
(g) Pfizer's Profit Margin	£1.23	£3.91	£38.08	£38.06
	38%	124%	862%	858%
(h) Flynn's Profit Margin	£8.28	£6.43	£20.33	£22.44
	144%	81%	52%	59%
Relevant Period Month 14: Oct 2013				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	10,864	23,880	42,768	13,800
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£7.08	£42.50	£42.50
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	11,752	29,283	29,201	14,258
(f) Flynn Product Unit Price	£13.80	£14.50	£60.06	£59.30
(g) Pfizer's Profit Margin	£1.23	£3.91	£38.08	£38.06
	38%	124%	862%	858%
(h) Flynn's Profit Margin	£8.07	£6.58	£20.89	£21.22
	141%	83%	53%	56%
Relevant Period Month 15: Nov 2013				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	15,344	30,720	36,288	18,600
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£7.08	£42.50	£42.50
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	11,150	22,290	16,381	13,300
(f) Flynn Product Unit Price	£13.80	£14.01	£58.65	£59.17
(g) Pfizer's Profit Margin	£1.23	£3.91	£38.08	£38.06
	38%	124%	862%	858%
(h) Flynn's Profit Margin	£8.07	£6.08	£19.48	£21.09
	141%	77%	50%	55%
Relevant Period Month 16: Dec 2013				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£0.00	£4.44

Description	Capsule Dosage			
	25mg	50mg	100mg	300mg
(b) Total volume sold by Pfizer to Flynn	3,976	9,480	0	4,200
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£7.08	£0.00	£42.50
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	11,081	21,884	19,721	13,330
(f) Flynn Product Unit Price	£13.81	£14.02	£59.78	£59.27
(g) Pfizer's Profit Margin	£1.23	£3.91	£0.00	£38.06
	38%	124%	£0.00	858%
(h) Flynn's Profit Margin	£8.07	£6.09	£20.61	£21.19
	141%	77%	53%	56%
Relevant Period Month 17: Jan 2014				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	4,480	13,200	10,044	6,900
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£7.08	£42.50	£42.50
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	8,980	18,984	12,394	11,282
(f) Flynn Product Unit Price	£13.83	£14.02	£66.09	£59.23
(g) Pfizer's Profit Margin	£1.23	£3.91	£38.08	£38.06
	38%	124%	862%	858%
(h) Flynn's Profit Margin	£8.09	£6.09	£26.93	£21.15
	141%	77%	69%	56%
Relevant Period Month 18: Feb 2014				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£0.00	£4.44
(b) Total volume sold by Pfizer to Flynn	14,056	25,920	0	15,000
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£5.60	£0.00	£19.11
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	7,155	17,158	13,939	10,092
(f) Flynn Product Unit Price	£13.82	£14.03	£58.43	£59.27
(g) Pfizer's Profit Margin	£1.23	£2.43	£0.00	£14.67
	38%	77%	N/A	331%
(h) Flynn's Profit Margin	£8.09	£6.11	£19.26	£21.19
	141%	77%	49%	56%
Relevant Period Month 19: Mar 2014				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	19,600	36,480	24,192	26,100
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	13,873	24,090	20,455	15,628
(f) Flynn Product Unit Price	£13.81	£14.00	£60.85	£59.16
(g) Pfizer's Profit Margin	£1.23	£3.33	£29.58	£29.56
	38%	105%	669%	666%
(h) Flynn's Profit Margin	£8.08	£6.07	£21.68	£21.08
	141%	77%	55%	55%
Relevant Period Month 20: Apr 2014				

Description	Capsule Dosage			
	25mg	50mg	100mg	300mg
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	9,632	20,880	22,788	9,900
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	18,377	36,261	35,121	22,599
(f) Flynn Product Unit Price	£13.79	£14.01	£48.04	£51.08
(g) Pfizer's Profit Margin	£1.23	£3.33	£29.58	£29.56
	38%	105%	670%	666%
(h) Flynn's Profit Margin	£8.06	£6.08	£8.87	£13.00
	141%	77%	23%	34%
Relevant Period Month 21: May 2014				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	22,400	38,399	51,839	23,999
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£27.22	£32.62
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	12,010	19,371	21,970	12,733
(f) Flynn Product Unit Price	£14.18	£14.34	£48.49	£52.37
(g) Pfizer's Profit Margin	£1.23	£3.33	£22.80	£28.18
	38%	105%	516%	635%
(h) Flynn's Profit Margin	£8.45	£6.42	£9.32	£14.29
	147%	81%	24%	38%
Relevant Period Month 22: Jun 2014				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	6,720	14,639	11,231	10,799
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£4.95	£26.40	£16.77
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	4,195	9,266	5,250	5,867
(f) Flynn Product Unit Price	£14.50	£14.74	£50.21	£53.47
(g) Pfizer's Profit Margin	£1.23	£1.78	£21.98	£12.33
	38%	56%	498%	278%
(h) Flynn's Profit Margin	£8.77	£6.82	£11.04	£15.39
	153%	86%	28%	40%
Relevant Period Month 23: Jul 2014				
(a) Product Unit Cost incurred by Pfizer	£0.00	£0.00	£0.00	£0.00
(b) Total volume sold by Pfizer to Flynn	0	0	0	0
(c) Pfizer Product Unit Price/Cost to Flynn	£0.00	£0.00	£0.00	£0.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	9,971	24,085	10,441	12,517
(f) Flynn Product Unit Price	£14.49	£14.73	£50.58	£53.20
(g) Pfizer's Profit Margin	£0.00	£0.00	£0.00	£0.00
	N/A	N/A	N/A	N/A
(h) Flynn's Profit Margin	£8.76	£6.81	£11.42	£15.12
	153%	86%	29%	40%

Description	Capsule Dosage			
	25mg	50mg	100mg	300mg
Relevant Period Month 24: Aug 2014				
(a) Product Unit Cost incurred by Pfizer	£0.00	£3.17	£0.00	£4.44
(b) Total volume sold by Pfizer to Flynn	0	9,600	0	3,600
(c) Pfizer Product Unit Price/Cost to Flynn	£0.00	£6.50	£0.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	5,587	12,817	10,404	8,263
(f) Flynn Product Unit Price	£14.55	£14.78	£50.19	£53.54
	£0.00	£3.33	£0.00	£29.56
(g) Pfizer's Profit Margin	N/A	105%	N/A	666%
	£8.82	£6.86	£11.02	£15.46
(h) Flynn's Profit Margin	154%	87%	28%	41%
Relevant Period Month 25: Sep 2014				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	18,928	34,920	15,012	22,200
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£7.70	£69.82	£51.04
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	12,349	23,196	24,975	14,411
(f) Flynn Product Unit Price	£14.51	£14.73	£49.90	£53.17
	£1.23	£4.53	£65.40	£46.60
(g) Pfizer's Profit Margin	38%	143%	1481%	1050%
	£8.78	£6.81	£10.73	£15.09
(h) Flynn's Profit Margin	153%	86%	27%	40%
Relevant Period Month 26: Oct 2014				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	10,976	20,520	22,572	12,600
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	10,919	20,644	15,927	12,756
(f) Flynn Product Unit Price	£14.48	£14.71	£49.88	£53.08
	£1.23	£3.33	£29.58	£29.56
(g) Pfizer's Profit Margin	38%	105%	670%	666%
	£8.75	£6.79	£10.71	£15.00
(h) Flynn's Profit Margin	153%	86%	27%	39%
Relevant Period Month 27: Nov 2014				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	10,696	20,160	15,552	12,300
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	10,390	20,124	14,371	13,298
(f) Flynn Product Unit Price	£14.55	£14.75	£49.20	£53.11
	£1.23	£3.33	£29.58	£29.56
(g) Pfizer's Profit Margin	38%	105%	670%	666%
(h) Flynn's Profit Margin	£8.82	£6.83	£10.03	£15.03

Description	Capsule Dosage			
	25mg	50mg	100mg	300mg
	154%	86%	26%	39%
Relevant Period Month 28: Dec 2014				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	10,192	19,560	13,932	13,200
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	13,081	23,568	16,618	13,906
(f) Flynn Product Unit Price	£14.53	£14.74	£49.21	£53.14
	£1.23	£3.33	£29.58	£29.56
(g) Pfizer's Profit Margin	38%	105%	670%	666%
	£8.80	£6.81	£10.04	£15.05
(h) Flynn's Profit Margin	154%	86%	26%	40%
Relevant Period Month 29: Jan 2015				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	10,752	20,040	9,936	12,900
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	7,861	15,609	11,410	10,803
(f) Flynn Product Unit Price	£14.53	£14.78	£49.11	£53.09
	£1.23	£3.33	£29.58	£29.56
(g) Pfizer's Profit Margin	38%	105%	670%	666%
	£8.80	£6.86	£9.94	£15.01
(h) Flynn's Profit Margin	154%	87%	25%	39%
Relevant Period Month 30: Feb 2015				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	9,016	15,000	8,532	8,470
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	8,613	16,507	11,754	10,809
(f) Flynn Product Unit Price	£14.55	£14.74	£49.01	£52.95
	£1.23	£3.33	£29.58	£29.56
(g) Pfizer's Profit Margin	38%	105%	670%	666%
	£8.82	£6.81	£9.84	£14.87
(h) Flynn's Profit Margin	154%	86%	25%	39%
Relevant Period Month 31: Mar 2015				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	9,352	19,920	10,800	12,600
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	10,395	22,581	16,271	12,422
(f) Flynn Product Unit Price	£14.48	£14.75	£49.04	£52.78
	£1.23	£3.33	£29.58	£29.56
(g) Pfizer's Profit Margin	38%	105%	670%	666%

Description	Capsule Dosage			
	25mg	50mg	100mg	300mg
	£8.75	£6.83	£9.87	£14.70
(h) Flynn's Profit Margin	153%	86%	25%	39%
Relevant Period Month 32: Apr 2015				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	9,856	21,480	18,792	12,000
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	12,607	21,884	16,257	13,311
(f) Flynn Product Unit Price	£14.52	£14.73	£49.04	£52.78
	£1.23	£3.33	£29.58	£29.56
(g) Pfizer's Profit Margin	38%	105%	670%	666%
	£8.79	£6.81	£9.87	£14.70
(h) Flynn's Profit Margin	153%	86%	25%	39%
Relevant Period Month 33: May 2015				
(a) Product Unit Cost incurred by Pfizer	£0.00	£0.00	£0.00	£0.00
(b) Total volume sold by Pfizer to Flynn	0	0	0	0
(c) Pfizer Product Unit Price/Cost to Flynn	£0.00	£0.00	£0.00	£0.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	7,831	18,394	12,139	11,162
(f) Flynn Product Unit Price	£14.45	£14.70	£48.41	£52.65
	£0.00	£0.00	£0.00	£0.00
(g) Pfizer's Profit Margin	N/A	N/A	N/A	N/A
	£8.72	£6.78	£9.24	£14.57
(h) Flynn's Profit Margin	152%	86%	24%	38%
Relevant Period Month 34: Jun 2015				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	20,272	39,720	26,892	24,298
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	10,342	18,382	13,578	12,621
(f) Flynn Product Unit Price	£14.52	£14.69	£48.73	£52.74
	£1.23	£3.33	£29.58	£29.56
(g) Pfizer's Profit Margin	38%	105%	670%	666%
	£8.79	£6.77	£9.57	£14.66
(h) Flynn's Profit Margin	153%	85%	24%	38%
Relevant Period Month 35: Jul 2015				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	11,200	18,000	12,852	12,300
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	11,699	18,290	13,728	12,837
(f) Flynn Product Unit Price	£14.49	£14.64	£48.51	£52.63
(g) Pfizer's Profit Margin	£1.23	£3.33	£29.58	£29.56

Description	Capsule Dosage			
	25mg	50mg	100mg	300mg
	38%	105%	670%	666%
	£8.76	£6.72	£9.34	£14.54
(h) Flynn's Profit Margin	153%	85%	24%	38%
Relevant Period Month 36: Aug 2015				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	11,480	18,000	13,068	12,900
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	10,433	19,570	14,631	12,071
(f) Flynn Product Unit Price	£14.46	£14.72	£48.80	£52.63
	£1.23	£3.33	£29.58	£29.56
(g) Pfizer's Profit Margin	38%	105%	670%	666%
	£8.73	£6.80	£9.63	£14.55
(h) Flynn's Profit Margin	152%	86%	25%	38%
Relevant Period Month 37: Sep 2015				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	10,304	19,320	13,932	11,700
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	9,482	20,281	13,814	11,941
(f) Flynn Product Unit Price	£14.46	£14.73	£48.65	£52.67
	£1.23	£3.33	£29.58	£29.56
(g) Pfizer's Profit Margin	38%	105%	670%	666%
	£8.72	£6.80	£9.48	£14.59
(h) Flynn's Profit Margin	152%	86%	24%	38%
Relevant Period Month 38: Oct 2015				
(a) Product Unit Cost incurred by Pfizer	£0.00	£0.00	£0.00	£0.00
(b) Total volume sold by Pfizer to Flynn	0	0	0	0
(c) Pfizer Product Unit Price/Cost to Flynn	£0.00	£0.00	£0.00	£0.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	11,086	20,575	12,881	13,429
(f) Flynn Product Unit Price	£14.44	£14.68	£49.22	£52.60
	£0.00	£0.00	£0.00	£0.00
(g) Pfizer's Profit Margin	N/A	N/A	N/A	N/A
	£8.71	£6.75	£10.05	£14.51
(h) Flynn's Profit Margin	152%	85%	26%	38%
Relevant Period Month 39: Nov 2015				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	20,272	40,320	25,272	25,200
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	9,499	18,430	12,604	11,139
(f) Flynn Product Unit Price	£14.45	£14.65	£48.69	£52.57

Description	Capsule Dosage			
	25mg	50mg	100mg	300mg
	£1.23	£3.33	£29.58	£29.56
(g) Pfizer's Profit Margin	38%	105%	670%	666%
	£8.72	£6.72	£9.52	£14.48
(h) Flynn's Profit Margin	152%	85%	24%	38%
Relevant Period Month 40: Dec 2015				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	9,352	18,120	11,988	8,623
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	11,437	25,148	17,851	13,850
(f) Flynn Product Unit Price	£14.55	£14.71	£48.84	£52.84
	£1.23	£3.33	£29.58	£29.56
(g) Pfizer's Profit Margin	38%	105%	670%	666%
	£8.82	£6.78	£9.67	£14.76
(h) Flynn's Profit Margin	154%	86%	25%	39%
Relevant Period Month 41: Jan 2016				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£0.00
(b) Total volume sold by Pfizer to Flynn	11,312	24,840	17,172	0
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£0.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	6,598	12,990	8,384	8,216
(f) Flynn Product Unit Price	£14.42	£14.59	£48.45	£52.46
	£1.23	£3.33	£29.58	£0.00
(g) Pfizer's Profit Margin	38%	105%	670%	N/A
	£8.69	£6.67	£9.28	£14.38
(h) Flynn's Profit Margin	152%	84%	24%	38%
Relevant Period Month 42: Feb 2016				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	6,888	13,200	8,424	24,900
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	7,806	16,955	13,136	10,278
(f) Flynn Product Unit Price	£14.42	£14.67	£48.85	£52.42
	£1.23	£3.33	£29.58	£29.56
(g) Pfizer's Profit Margin	38%	105%	670%	666%
	£8.69	£6.74	£9.68	£14.34
(h) Flynn's Profit Margin	152%	85%	25%	38%
Relevant Period Month 43: Mar 2016				
(a) Product Unit Cost incurred by Pfizer	£0.00	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	0	16,440	25,704	10,500
(c) Pfizer Product Unit Price/Cost to Flynn	£0.00	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	10,407	21,291	13,968	12,123

Description	Capsule Dosage			
	25mg	50mg	100mg	300mg
(f) Flynn Product Unit Price	£14.43	£14.67	£48.93	£52.56
(g) Pfizer's Profit Margin	£0.00	£3.33	£29.58	£29.56
	N/A	105%	670%	666%
(h) Flynn's Profit Margin	£8.70	£6.74	£9.76	£14.48
	152%	85%	25%	38%
Relevant Period Month 44: Apr 2016				
(a) Product Unit Cost incurred by Pfizer	£0.00	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	0	18,480	12,528	11,700
(c) Pfizer Product Unit Price/Cost to Flynn	£0.00	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	8,148	16,834	10,991	9,923
(f) Flynn Product Unit Price	£14.39	£14.67	£48.51	£52.47
(g) Pfizer's Profit Margin	£0.00	£3.33	£29.58	£29.56
	N/A	105%	670%	666%
(h) Flynn's Profit Margin	£8.66	£6.75	£9.34	£14.38
	151%	85%	24%	38%
Relevant Period Month 45: May 2016				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	25,975	18,392	12,528	11,400
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	10,232	20,551	12,975	12,690
(f) Flynn Product Unit Price	£14.50	£14.64	£48.48	£52.56
(g) Pfizer's Profit Margin	£1.23	£3.33	£29.58	£29.56
	38%	105%	670%	666%
(h) Flynn's Profit Margin	£8.77	£6.71	£9.31	£14.48
	153%	85%	24%	38%
Relevant Period Month 46: Jun 2016				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	9,800	19,680	12,420	11,700
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	10,242	17,419	13,194	11,106
(f) Flynn Product Unit Price	£14.52	£14.64	£48.30	£52.42
(g) Pfizer's Profit Margin	£1.23	£3.33	£29.58	£29.56
	38%	105%	670%	666%
(h) Flynn's Profit Margin	£8.79	£6.71	£9.13	£14.33
	153%	85%	23%	38%
Relevant Period Month 47: Jul 2016				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	9,072	16,560	12,960	10,800
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08

Description	Capsule Dosage			
	25mg	50mg	100mg	300mg
(e) Total volume sold by Flynn	9,020	18,715	12,888	11,040
(f) Flynn Product Unit Price	£14.51	£14.63	£48.36	£52.26
(g) Pfizer's Profit Margin	£1.23	£3.33	£29.58	£29.56
	38%	105%	670%	666%
(h) Flynn's Profit Margin	£8.77	£6.71	£9.19	£14.18
	153%	85%	23%	37%
Relevant Period Month 48: Aug 2016				
(a) Product Unit Cost incurred by Pfizer	£0.00	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	0	17,820	12,312	11,700
(c) Pfizer Product Unit Price/Cost to Flynn	£0.00	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	11,972	21,962	13,407	13,356
(f) Flynn Product Unit Price	£13.01	£13.32	£48.23	£47.75
(g) Pfizer's Profit Margin	£0.00	£3.33	£29.58	£29.56
	N/A	105%	670%	666%
(h) Flynn's Profit Margin	£7.28	£5.39	£9.06	£9.67
	127%	68%	23%	25%
Relevant Period Month 49: Sep 2016				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	19,712	19,320	13,500	11,100
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	8,171	18,014	12,205	11,769
(f) Flynn Product Unit Price	£14.54	£14.62	£48.20	£52.40
(g) Pfizer's Profit Margin	£1.23	£3.33	£29.58	£29.56
	38%	105%	670%	666%
(h) Flynn's Profit Margin	£8.81	£6.70	£9.03	£14.32
	154%	85%	23%	38%
Relevant Period Month 50: Oct 2016				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	13,048	17,280	11,988	11,700
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	9,438	19,027	13,803	11,218
(f) Flynn Product Unit Price	£14.78	£14.66	£48.48	£52.45
(g) Pfizer's Profit Margin	£1.23	£3.33	£29.58	£29.56
	38%	105%	670%	666%
(h) Flynn's Profit Margin	£9.05	£6.73	£9.31	£14.37
	158%	85%	24%	38%
Relevant Period Month 51: Nov 2016				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	9,184	18,240	13,608	11,100
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00

Description	Capsule Dosage			
	25mg	50mg	100mg	300mg
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	12,169	22,248	15,933	13,050
(f) Flynn Product Unit Price	£14.82	£14.72	£48.86	£52.61
(g) Pfizer's Profit Margin	£1.23	£3.33	£29.58	£29.56
	38%	105%	670%	666%
(h) Flynn's Profit Margin	£9.09	£6.79	£9.69	£14.53
	159%	86%	25%	38%
Relevant Period Month 52: Dec 2016				
(a) Product Unit Cost incurred by Pfizer	£3.27	£3.17	£4.42	£4.44
(b) Total volume sold by Pfizer to Flynn	2,757	4,905	3,536	2,913
(c) Pfizer Product Unit Price/Cost to Flynn	£4.50	£6.50	£34.00	£34.00
(d) Product Unit Cost incurred by Flynn	£5.73	£7.93	£39.17	£38.08
(e) Total volume sold by Flynn	2,412	5,135	3,292	2,912
(f) Flynn Product Unit Price	£15.05	£14.64	£48.52	£52.64
(g) Pfizer's Profit Margin	£1.23	£3.33	£29.58	£29.56
	38%	105%	670%	666%
(h) Flynn's Profit Margin	£9.31	£6.72	£9.35	£14.56
	163%	85%	24%	38%

Notes:

1. For each row labelled "(d) Product Unit Cost incurred by Flynn", all values are inclusive of (c). Pfizer's Product Unit Price is a cost to Flynn, which is included in (d).

2. For each row labelled "(g) Pfizer's Profit Margin":
   (i) the absolute figure in £ is equal to row (c) minus row (a); and
   (ii) the percentage figure is the profit margin expressed as a percentage of Product Unit Cost (a), this giving a ROS-type figure.

3. For each row labelled "(h) Flynn's Profit Margin":
   (i) the absolute figure in £ is equal to row (f) minus row (d); and
   (ii) the percentage figure is the profit margin expressed as a percentage of Product Unit Cost (d), this giving a ROS-type figure.

ANNEX 4

GRAPHICAL REPRESENTATIONS OF PROFIT MARGIN

(Judgment/[76])

Figure 1: Pfizer Profit Margin – 25mg

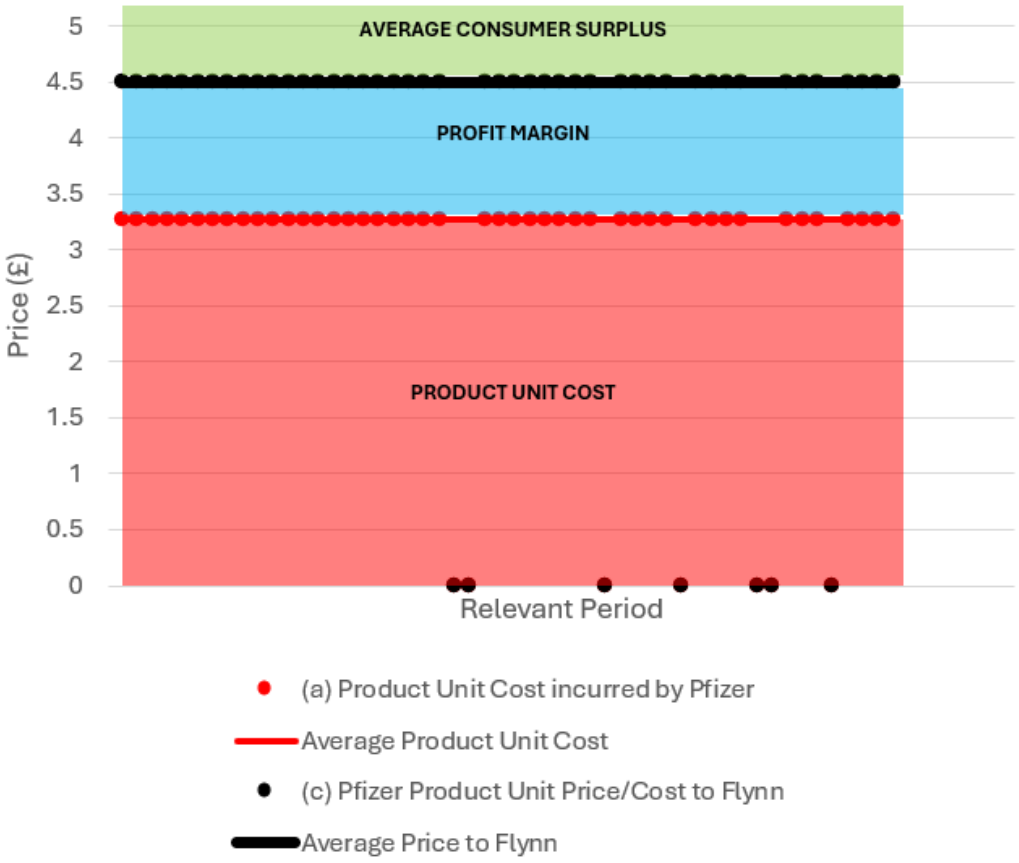


Figure 2: Flynn Profit Margin – 25 mg

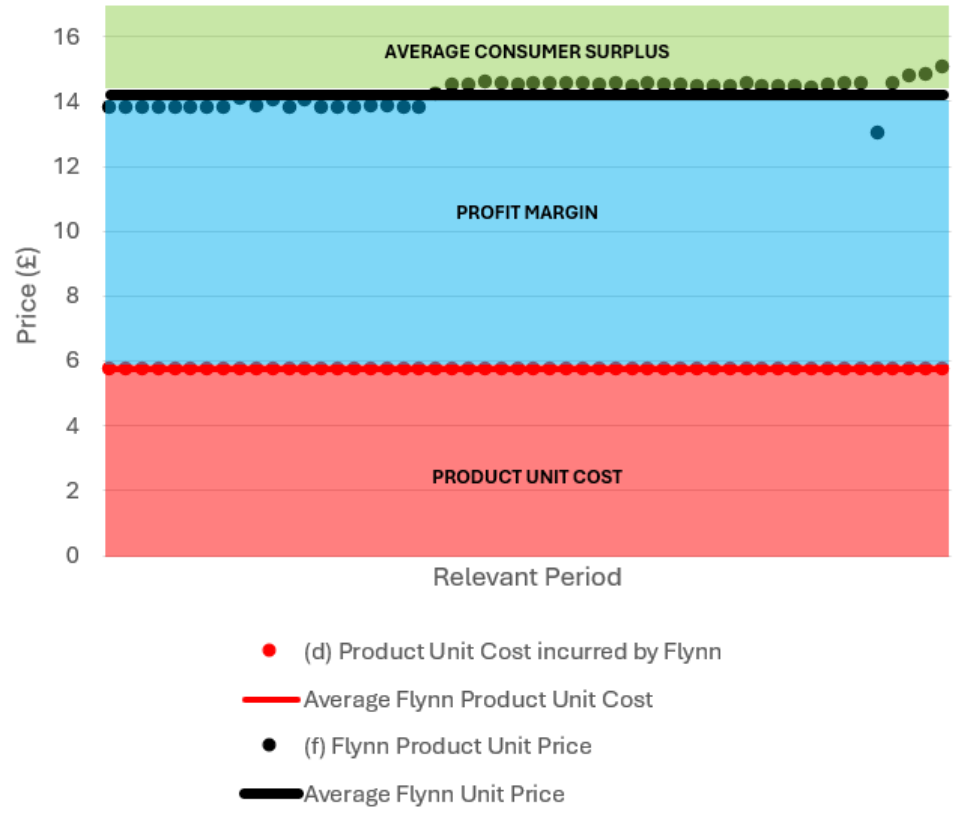


Figure 3: Pfizer Profit Margin – 50mg

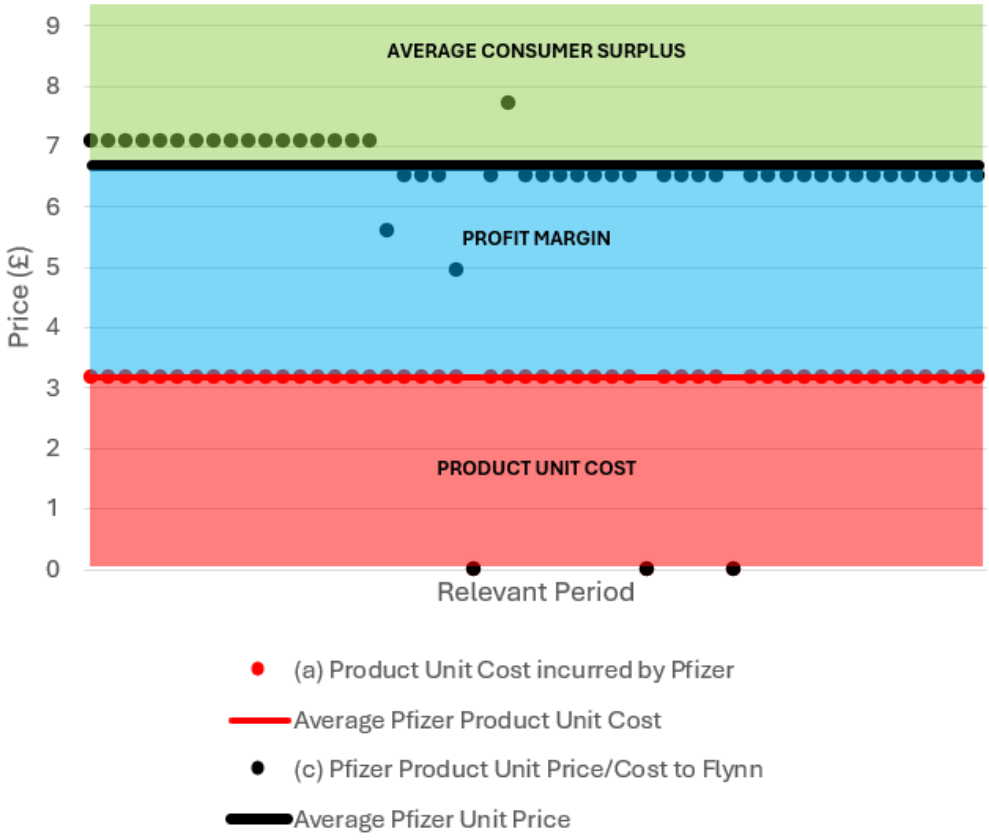


Figure 4: Flynn Profit Margin – 50mg

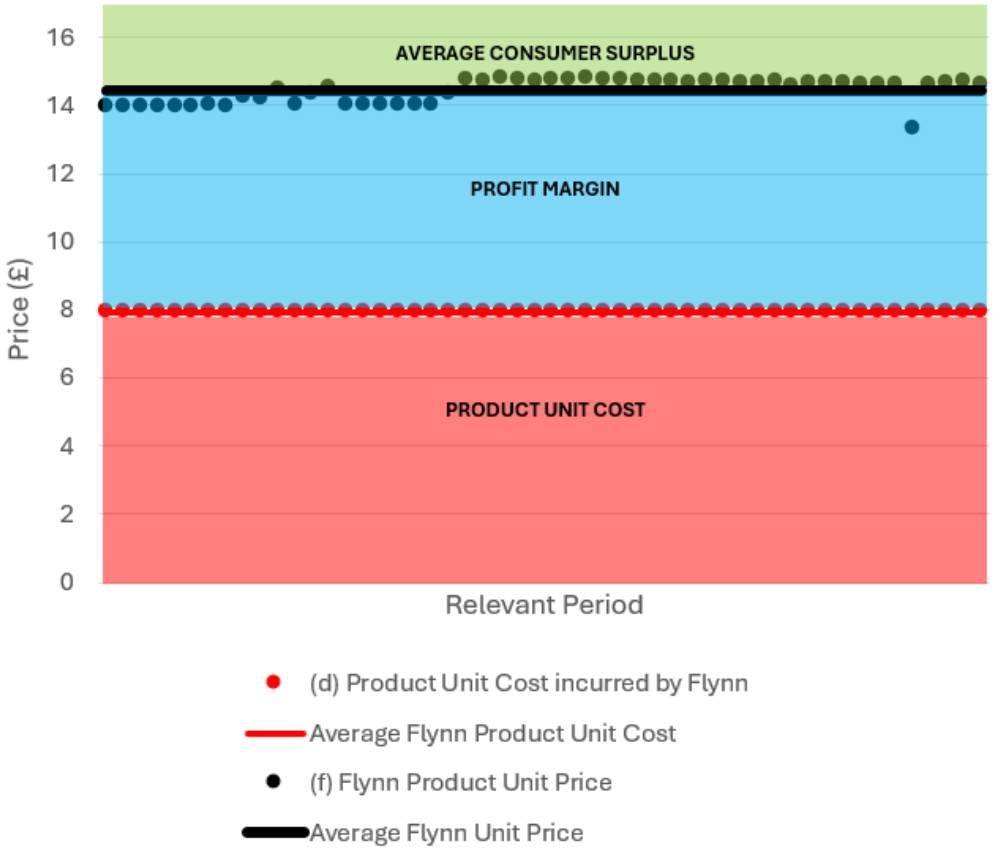


Figure 5: Pfizer Profit Margin – 100mg

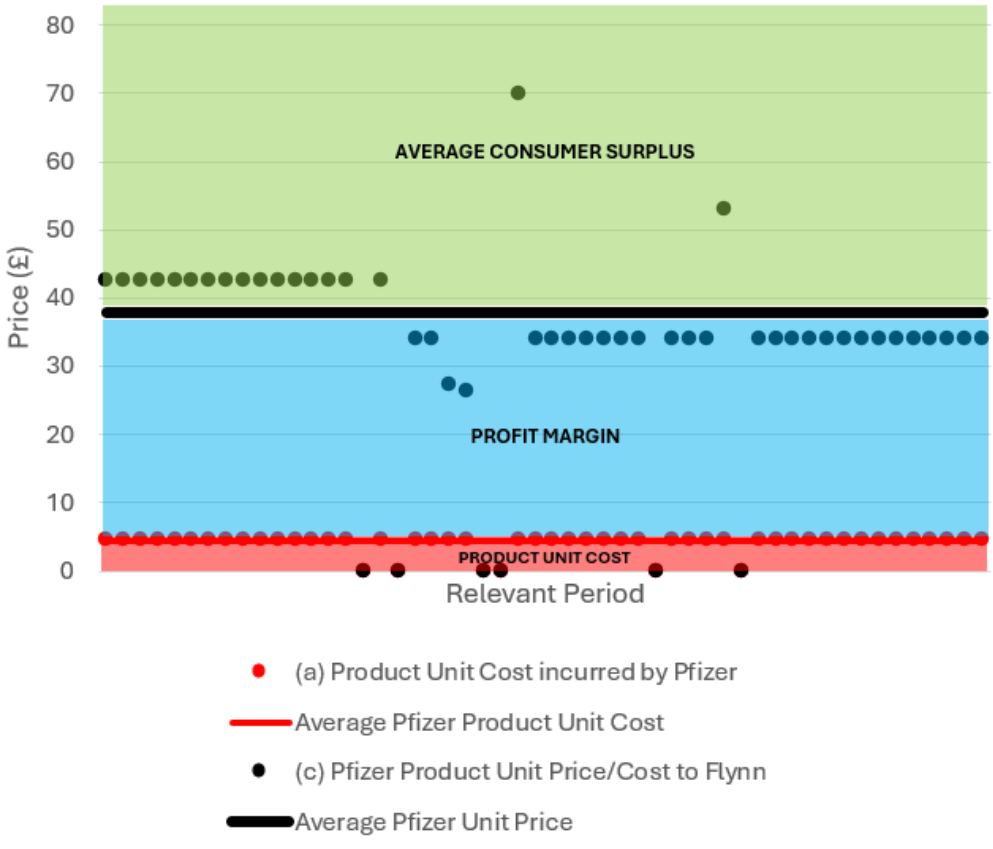


Figure 6: Flynn Profit Margin – 100mg

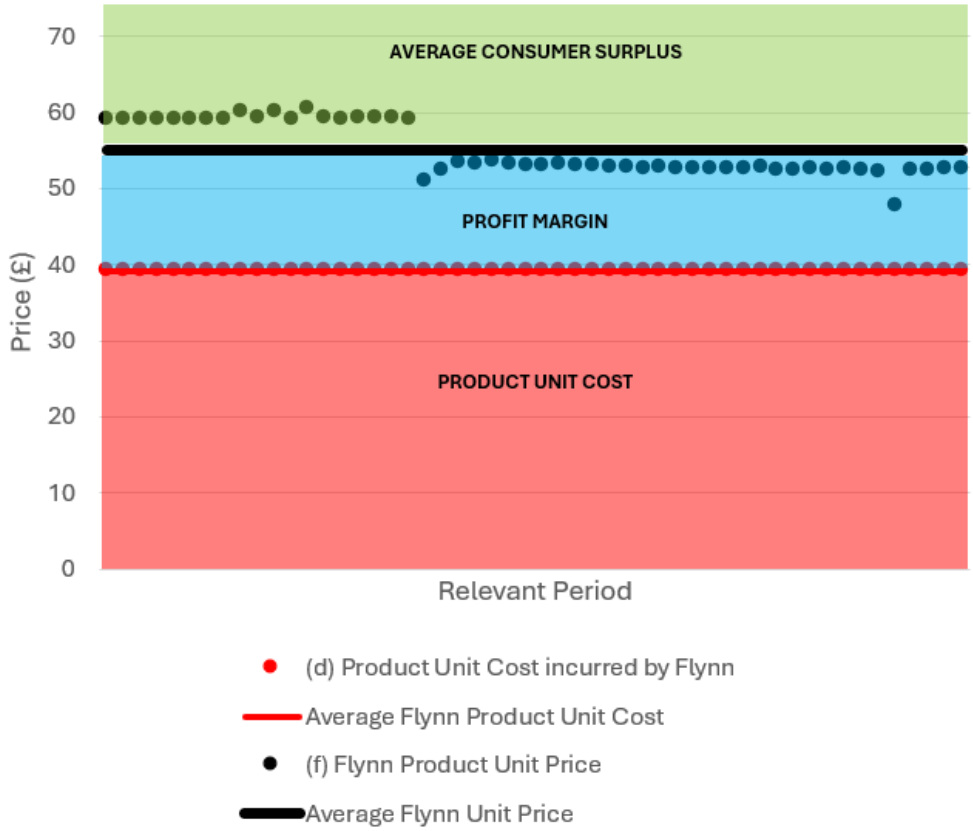


Figure 7: Pfizer Profit Margin – 300mg

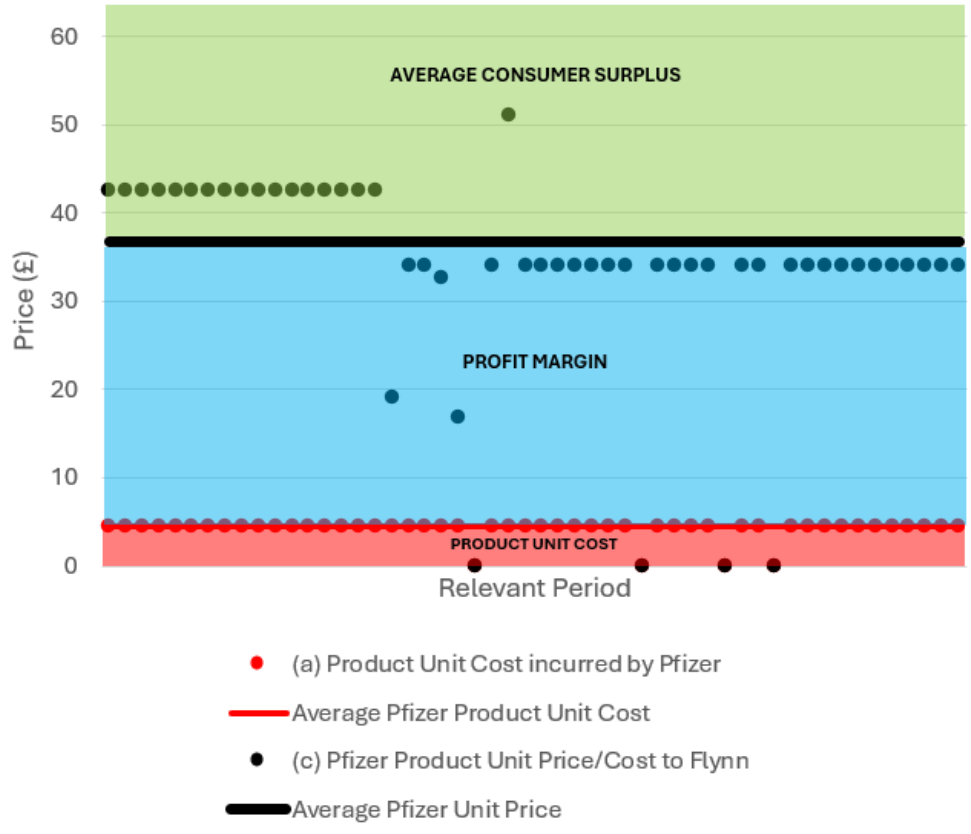
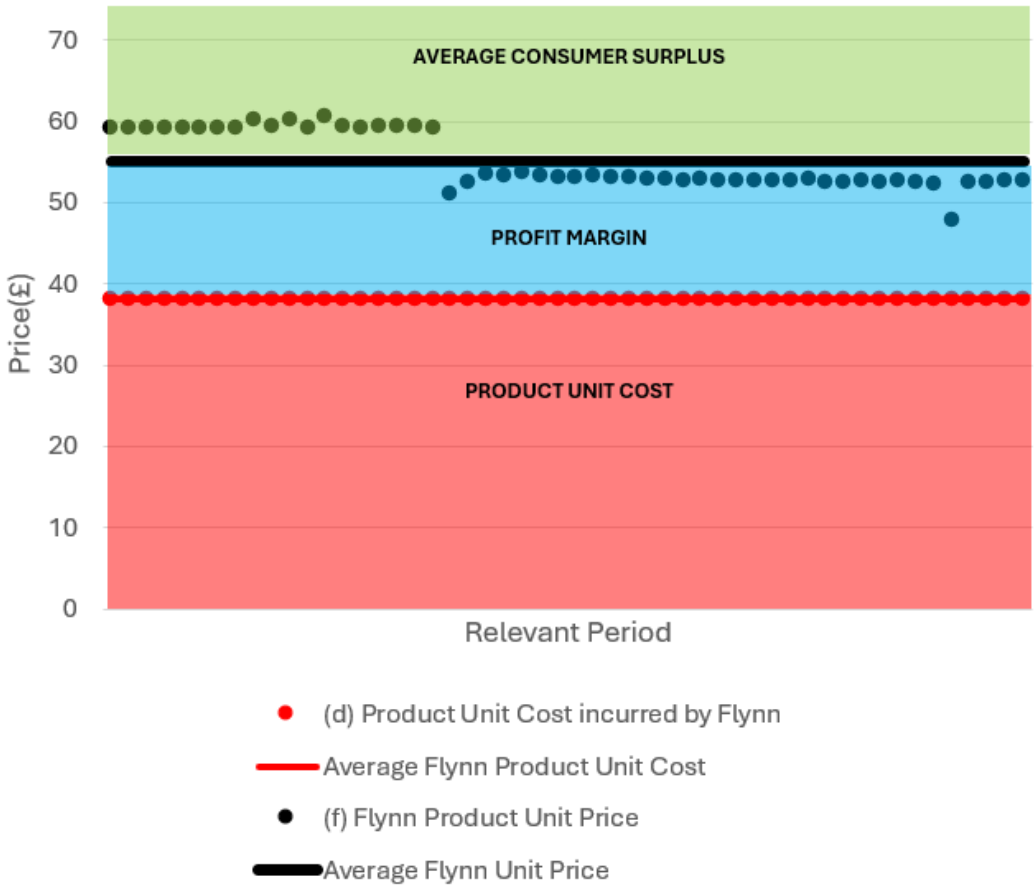


Figure 8: Flynn Profit Margin – 300mg



Note: Figures 1-8 above depict the product unit costs and product unit prices for Pfizer and Flynn for each of the Focal Products, as set out in Annex 3. The average product unit cost and average product unit price have been calculated after disregarding zero values, as these are months in which no relevant sales were recorded.

ANNEX 5

THE COFFEE SHOP EXAMPLE

(Judgment/[148])

1. The scenario is based on three competing coffee shops, one of which is dominant and (allegedly) overcharging, in circumstances where the other two are seeking to compete but are clearly failing to constrain the prices of the dominant undertaking.

2. More specifically, the three coffee shops have business models that operate in the following way:

   (1) *The "vanilla" coffee shop.* This shop provides the basics competently, and seeks to charge a price that is profit making at around 5% above total cost. Its model is based on baristas doing the work of making and serving coffee (i.e. relatively high costs of Labour) with minimal use of Physical Capital (i.e. some coffee machines, but not very much else). We shall refer to this as the **Vanilla Shop**.

   (2) *The robo-coffee shop.* This shop sells at higher prices and – with similar costs – higher margins than the Vanilla Shop. This is an innovative, machine-intensive and labour-light coffee shop, aiming to charge higher prices because of the "gimmick" factor. Its costs are differently incurred, with greater use of Physical Capital and less use of labour. We refer to it as the **Robo Shop**.

   (3) *The Apple coffee shop.* In a tribute to the tech manufacturer, this coffee shop provides outstanding and "beautiful" service, and charges accordingly. It is dominant in the market: these coffee shops are in the same product and geographic markets, and the "Apple" Coffee Shop is dominant, selling in excess of 60% of coffee in this area (whether measured in volume, price, by sub-product, etc.) We refer to it as the **Dominant Coffee Shop**, and its prices are the ones under investigation.

In a competition analysis, the products sold by the Vanilla Shop and the Robo Shop are informative, at best, as comparators.

3. The prices and cost bases of the three shops have been structured so as to facilitate answers on questions arising out of these appeals by reference not to controversial questions of fact but to hypothetical questions that cannot (for that reason) be controversial. In short, the scenario enabled the experts to engage in terms on points within their expertise, without being affected by controversies of fact. We are enormously grateful to all of the experts for their assistance in this regard. We will be reverting to the discussion with the experts on a number of occasions during the course of this judgment.

4. The facts of these hypothetical scenarios were as follows:

(All prices are in Ruritanian $)	**(1)** **"VANILLA" COFFEE SHOP**	**(2)** **"ROBO" SHOP**	**(3)** **"APPLE" COFFEE SHOP**
Products sold by each coffee shop	Espresso: **$5** Cappuccino: **$10**	Espresso: **$6** Cappuccino: **$12** "Bottomless" coffee (all you can drink in a morning): **$25**	Super-deluxe-espresso: **$45** Extra-wonderful cappuccino: **$120** Amazing "health" decaffeinated latte: **$250**
"Abortive costs"		The Robo Shop had several efforts at getting their robots to make drinkable coffee. The costs of prototypes 1, 2 and 3 were completely thrown away, but of course were incurred by the business: **$500,000** in total	The Apple Coffee Shop prides itself on innovative products. It is planning a "life-enhancing" coffee – price to be decided, but probably **$500**/cup. It has invested (Question: Is this a fixed or a variable cost? How do you allocate it to individual products?) **$100,000** already, and it plans to spend a further **$400,000**. No guarantee of success.
Cost of premises (rent) (Question: Is this a fixed or a variable cost? How do you allocate it to individual products?)	None expressed, so **$0** (this can be debated). This is a "mom-and-pop" coffee shop, run through generations, and the premises are owned, the owners living above the shop.	Commercial premises, let on a three-year lease, not breakable. Rent payable monthly in advance, annualised cost: Year 1: **$100,000**	Commercial premises, but owned by Mega-Corp, which uses coffee and a special environment to sell other products. The commercial premises are extremely beautiful, but in some

		Year 2: **$150,000** Year 3: **$200,000**	measure "dual purpose" (you can buy coffee, and browse). There is a three-year lease, not breakable, at a rent that is <u>not</u> commercial but lower because of the "dual" purpose. A "commercial", sole purpose, rent is set out in brackets: Year 1: **$50,000 ($500,000)** Year 2: **$75,000 ($750,000)** Year 3: **$100,000 ($1,000,000)**
"Semi-variable" costs – cups, spoons, etc (Question: Is this a fixed or a variable cost? How do you allocate it to individual products?)	**$10,000**	**$25,000** (because of the need to interface with the robot servers)	**$25,000** (just quality)
Staff (Question: Is this a fixed or a variable cost? How do you allocate it to individual products?)	**$100,000** (this is a traditional shop, and labour intensive. "Mom-and-pop" do not pay themselves a wage, but take what they can from the business. Neither do they pay rent on their flat.)	**$10,000** (robots/equipment replace staff)	**$100,000** (although capital investment is also high, this is "luxury" service.
Equipment to make coffee (assume all equipment is equally used for any type of coffee) (Question: Is this a fixed or a variable cost? How do you allocate it to individual products?)	**$10,000**	**$100,000**	**$100,000**
Variable costs (i.e. the ingredients used to make coffee) Split according to volumes sold, i.e. 20%, 20%, 60%	**$20,000**	**$20,000**	**$60,000**
Total costs of each business	**$140,000**	**$255,000**	**$335,000**
Rent	$0	$100,000	$50,000
Semi-variable	$10,000	$25,000	$25,000
Staff	$100,000	$10,000	$100,000

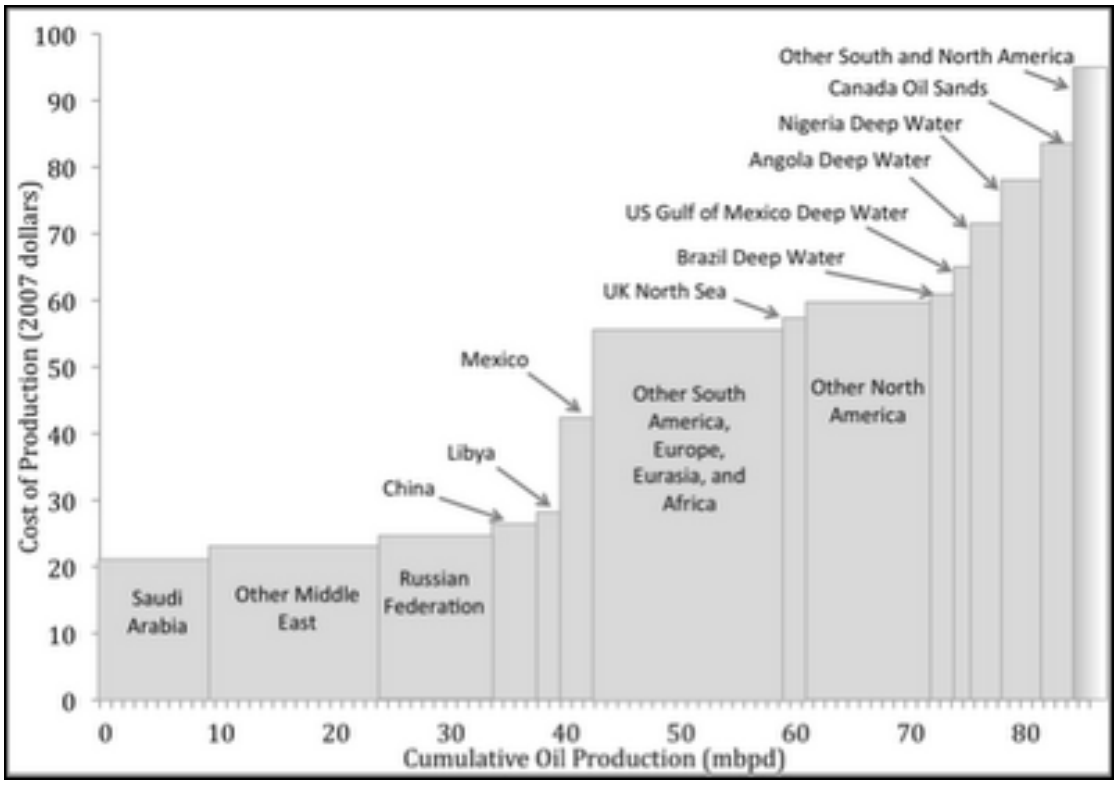
Equipment	$10,000	$100,000	$100,000
Variable	$20,000	$20,000	$60,000
Borrowing from bank	Nil	$300,000/annum, @10% interest, cost is **$30,000**	

ANNEX 6

CASE 1 PRODUCER SURPLUS EXAMPLE

(Judgment/[196])

1. The following graph[477] (which, to be clear, was not before the parties) shows (on the vertical or "Y" axis) the cost of producing one barrel of oil in US$, ranked according to producer cost and (on the horizonal or "X" axis) cumulative oil production in millions of barrels per day ("mbpd").



More specifically:

(1) In this case, the same product (oil) has multiple producers, each with dramatically different costs of production. We assume a competitive market[478] in the sense that each producer is seeking to sell as many

[477] Source: CERA 2008, *Ratcheting Down: Oil and the Global Credit Crisis.*

[478] We do not consider that the existence of OPEC makes a difference to this example, which is intended to be illustrative. The example would work if it was assumed that there was collusion between Saudi Arabia and Other Middle East.

barrels of oil as they can (i.e. all will sell to capacity) and that they are not colluding as to price. Depending on the level of aggregate demand, there will be no dominance. We will suppose, for the moment, a level of demand at 60 mbpd and that (at this level of demand) buyers are prepared to pay US$70/per barrel, although of course, they would like to pay less. On this basis, all producers up to US Gulf of Mexico Deep Water producers will have costs (excluding the Reasonable Rate of Return, as we do) that will enable them to sell in this market. US Gulf of Mexico Deep Water Producers – costs at US$70/barrel – can only sell in this market if they are prepared to take a loss. On our assumptions, they will not, because as well as covering costs, they will want to make a Reasonable Rate of Return.

(2) Looking to the other end of the costs scale, Saudi Arabia (costs at just over US$20/barrel) is clearly not dominant. Their production level is just under 10 mbpd, and there are at least 10 other sellers able to sell in this market in competition to Saudi Arabia.

2. We are – unrealistically, but it is a useful simplifying assumption – going presume that the Reasonable Rate of Return is a percentage of cost, and that that percentage is 10%.

3. Let us ask ourselves what price would be charged – in this market – by the cheapest producer (Saudi Arabia). The price of Saudi Arabian producers will not be CMA Cost Plus. That would be an economically irrational price to charge, being far too low. Depending upon aggregate demand, and elasticity of supply – two points we will come to – Saudi Arabia will price at the CMA Cost Plus level of the least efficient competitor who is able to sell product into the market. In short, Saudi Arabia's price – in a competitive market – will have nothing to do with its costs, save that price will sit (well) above those costs. We expand upon why this is the case in the following sub-paragraphs:

(1) We are assuming that Saudi Arabia – as with all of the producers – is selling as much as it can produce. In other words, the 10 mbpd figure for Saudi Arabian producers is an inelastic figure (on the supply side) that

cannot be increased. We are assuming this to be the case for all suppliers (all are supplying the maximum).

(2) As we have stated, we are supposing a level of demand at 60 mbpd and that (at this level of demand) buyers are prepared to pay US$70/per barrel. On this basis, UK North Sea producers can sell at above US$60/barrel. Indeed, they can sell at:

Cost (US$60/barrel) + Proper Return (US$6/barrel) = Price (US$66/barrel)

(3) But that is not the price at which these producers will sell. The price at which each producer will sell will actually be determined by the next most (in)efficient producer, here Other North America producers, whose Cost appears to be about US$62/barrel (the graph is not easy to read accurately, but that does not matter), and whose proper return would be US$6.20. The minimum price for these producers would be US$68.20/barrel. UK North Sea producers would not sell at US$66/barrel but at US$68/barrel (or just below the next most inefficient producer's minimum price).

(4) In short, the constraints on the price of UK North Sea producers are a combination of cost and Reasonable Rate of Return (which determine the "floor" below which these producers will not sell) and other producers' "floor" (which determines the "ceiling", above which these producers cannot sell). In short, the ceiling is a constraint derived from the next most (inefficient) producer in this case. As we shall see, for those like Saudi Arabian producers, the constraint is the CMA Cost Plus level of the least efficient competitor who is able to sell product into the market (i.e. in this case, UK North Sea producers).[479]

[479] We stress that even in this "real world" case, very many simplifying assumptions are being made here: no exchange rates; no flexibility or competition in terms of "proper return" – which we will have to deal with.

(5) In other words, Saudi Arabia will also sell at just above US$68/barrel, the price of its least efficient competitor, UK North Sea producers. If Saudi Arabian producers priced at above this level, they (like their least efficient competitor) would lose market share to the producer presently not in the market - Other North America producers. In other words, exactly the same constraint as operates on the UK North Sea producers.

4. Let us now assume an additional capacity in oil production capability of Saudi Arabia: say an additional capacity of 3 mbpd – which is the total capacity of the UK North Sea producers. Depending on the level of aggregate demand, it might pay Saudi Arabia to price at US$65/barrel, thus cutting out UK North Sea producers. Whether that is the case depends not on cost, but on aggregate demand. We are supposing a level of demand at 60 mbpd such that at this level of demand buyers are prepared to pay US$70/per barrel. At this level of demand, it will pay the Saudi Arabian producers to undercut the UK North Sea producers and drive them from the market. The model below assumes:

(1) Aggregate demand at 60 mbpd, which (with the levels of production shown in the graph) enables UK North Sea producers to stay in the market because of the supply constraints of other more efficient producers. In other words, if, as we will be assuming, the ability of one of the more efficient producers to supply the market increases, then the possibility of undercutting the less efficient producer arises.

(2) Cost per barrel of US$20/barrel for Saudi Arabian Producers, and US$60/barrel for UK North Sea Coast producers. The Proper Return, in each case, is 10% of Cost.

5. UK North Sea Coast producers produce and sell 3 mbpd. These producers are selling at the margin: they are the least competitive producer in the market, and were aggregate demand to fall by 3 mbpd or the supply of more efficient producers to increase, there is a risk that UK North Sea Cost producers could be undercut. It is the latter case that we will consider. Example 1 assumes capacity in Saudi Arabian producers of 10 mbpd; Example 2 assumes that that capacity increases to 13 mbpd.

	Case 1 Saudi Arabia capacity is 10 mbpd	**Case 2** Saudi Arabia capacity is 13 mbpd
Number of barrels sold by Saudi Arabia	10 mbpd	13 mbpd
Number of barrels sold by UK North Sea	3 mbpd	Nil
Price of UK North Sea	US$68/barrel	No price – not in the market
Cost of UK North Sea	US$60/barrel	US$60/barrel
UK North Sea profit (excluding proper return)	US$24 m/day = (US$68 – US$60) x 3m	Nil
Price of Saudi Arabia	US$68/barrel	US$65/barrel
Cost of Saudi Arabia	US$20/barrel	US$20/barrel
Saudi Arabia profit (excluding proper return)	US$480 m/day = (US$68 – US$20) x 10m	US$585 m/day = (US$65 – US$20) x 13

Thus, competition has some benefit. The price, in this scenario, falls by US$3/barrel – and producer profits are up. But the consumer does not win as much as they would on a pure Cost Plus basis.[480]

6. The example is illustrative of Case 1. It must be borne in mind that <u>everyone</u> is incentivised to be efficient, and it is no assumption in this model that either Saudi Arabia or UK North Sea are being deliberately inefficient. UK North Sea have every incentive to squeeze every cost because (in this case) they are at the margin. Saudi Arabia have less incentive, because their margins are so large, so that it may (like the monopolist) become lazy.

[480] We should stress that <u>exactly the same outcome</u> would pertain if Saudi Arabia were dominant.