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Predatory Pricing: Lessons for Developing Countries

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Greater consumer choice and lower prices are the benefits of having competition in any market. In a highly competitive market, a business would be encouraged to lower prices in order to attract customers and gain market share. However, the difficulty arises in determining the point at which a low price becomes a predatory price. Predatory pricing is the practice of offering goods or services at exceptionally low prices, thereby forfeiting some profit in order to drive out competitors or deter the entry of new players in the market.

This Briefing Paper examines the anti-competitive practice of predatory pricing and shows the different tests that are undertaken to identify this trend. It intends to identify some issues that competition authorities usually need to consider when trying to distinguish between competitively harmful predation from merely aggressive and competitively beneficial conduct.

Introduction

Lower prices and greater consumer choice are the important objectives of competition. Consumers benefit from lower prices which are generally the result of a competitive and regulated market. However, harm could be caused to consumers and competition if a player in the market uses unrealistically low prices to drive out other players and fulfil the objective of facing lesser competition in the market.

However, there arises a certain difficulty (i.e. in distinguishing highly competitive pricing from predatory pricing) that a firm/company, which cuts its prices or substantially reduces its profit margin, may not necessarily be engaging in the predatory pricing practice. It may simply be responding to new competition or a change in market demand; thus there is a real danger in misjudging such beneficial practices as predatory. For example, in *American Drugs vs. Wal-Mart Stores*[1] , the plaintiff argued that Wal-Mart was regularly selling products below cost in violation of the Arkansas Unfair Practices Act.

According to the Arkansas Supreme Court, there was no proof that Wal-Mart specifically intended to destroy competition. However, there was evidence that Wal-Mart regularly sold varying items below cost to entice people into its store and increase traffic. The strategy of selling below competitor's price and even below Wal-Mart's own cost, which it admitted too, is different from a sustained strategy adopted to destroy competition by selling below cost over a prolonged period of time.

A company resorts to predatory pricing when such a practice results in the significant gain in market power. In a competitive market with many competitors, the exclusion of some players might not lead to a sufficient weakening of competition, so as to allow the company to reap the benefits of anti-competitive practice. In order for predation to be successful, the exclusion of competititors in the market would be instrumental in maintaining or creating the predator's dominant position, thereby allowing the predator to charge high prices later on.

Over the years, many different tests, as discussed below, have been devised to aid competition authorities and courts in differentiating between predatory pricing from highly competitive pricing.

Tests to Determine Predatory Pricing

Price Cost Tests

Areeda-Turner Test: The Harvard law professors Areeda and Turner put forward the most influential test for analysing allegations of predatory pricing which has widely been adopted by the US courts as a standard. "The test focuses on short-run costs and presumes prices to be predatory if they are below the short-run marginal costs of providing the product or service, unless it is higher than average total cost (ATC). Since marginal costs are difficult to determine, they are substituted with average variable cost (AVC) as a more practical proxy".[2]

AVC & ATC Test: Certain traditional tests such as the AVC (the non-fixed costs per unit of output) and ATC (the sum of all costs divided by output) have been criticised but are still in use because they are simple in application as compared to other costs tests. For example, AVC has been advocated as a practical proxy for short run marginal cost, i.e. the change in cost incurred by producing one additional unit of output, which is argued to be the ideal cost measure but is unobtainable in practice. ATC, on the other hand, may be difficult to apply where there are important costs that are common across time periods and

that can only be allocated arbitrarily. Several other jurisdictions consider and/or apply the average avoidable cost test, which focuses solely on the range of a firm's output that is alleged to be predatory in nature.[3]

Structural Test

These involve a two-tier approach where predatory pricing is alleged, the market structure is first analysed and then an inquiry is undertaken into the defendant's pricing conduct. In the first step, the market share of the alleged predator is analysed to determine monopoly power, followed by an analysis of the entry barriers in the relevant market. Only after the analysis, if it is found that predation is likely to occur, and then the next step is undertaken, i.e. the price cost tests, as explained above. The European Court of Justice (ECJ) in its *AZCO*[4] decision used the two-tier approach, focusing on the cost and the strategy of the alleged predator. The US Supreme Court has also established the two-tier approach[5] , holding the recoupment test as the primary test to determine predatory pricing.

Recoupment Test

Recoupment tests assume the occurrence of such pricing and test whether it is likely to succeed. Such a test aims to determine whether a company's predatory price action is likely to result in the elimination or deterrence of competition. And whether it can result in enough accumulation of supra-competitive profit for the recovery (recoupment) of losses sustained during the predatory attack.

Predatory losses could be recovered by charging a price higher than the price that would have been charged in its absence. It is the above competitive prices that harm the consumers in the long run. If the recoupment test indicates that there is little or no likelihood of recoupment, then predatory pricing would be irrational and therefore it is assumed that it has not been undertaken. As per the recoupment test, even if a company is charging below cost and recoupment is not possible to achieve, then this test enables courts or the competition authorities to dismiss the allegations of predatory pricing without having to go further and to conduct price cost tests. Many competition agencies undertake recoupment tests in cases of predatory pricing allegations, for example, the Matushita case (see Box I).

Defences of Predatory Pricing

Legitimate business justifications (LBJ) are used as a defence against an alleged predatory pricing case. LBJ exists when behaviour, which fails predatory pricing tests, is defended as justifiable because of special circumstances that render the conduct reasonable. "It's hard to imagine a firm that has never found it expedient or even necessary to sell products for at least a brief period at a price below cost, for reasons ranging from product introduction to distress sales of products that are perishable or subject to obsolescence".[6] The burden of proving LBJ lies with the defendant, i.e. the alleged predator. A wide variety of circumstances constitute LBJ, which are discussed below.

Box 1: Matsushita Case

Zenith, American TV set manufacturers ("the plaintiffs") alleged that the Japanese companies ("the defendants") were selling their products below costs in the US, while selling similar products in Japan at above cost levels to cross–subsidise the former loss making sales.

The Supreme Court, using the recoupment test, rejected the alleged claim as economically plausible. The court held that "the plaintiffs maintain that for the last 15 years or more at least 10 Japanese manufacturers have sold TV sets at less than cost in order to drive US firms out of business. Such conduct cannot possibly produce profits by harming competition; however, if the Japanese firms do drive some US firms out of business, they could not recoup the losses".

"So, 15 years of losses could be made up only by very high prices for the indefinite future (the losses are like investments, which must be recovered with compound interest). If the defendants should try to raise prices to such a level, they would attract new competition. There are no barriers to entry into electronics, as the proliferation of computer and audio firms shows. The competition would come from resurgent US firms, from other foreign firms (Korea and many other nations make TV sets), and from defendants themselves".

"The predation recoupment story, therefore, does not make sense, and we are left with the more plausible inference that the defendants did not sell below cost in the first place. They were just engaged in hard competition".

Source: Matsushita Electric Industrial Co. v. Zenith Radio Corp., 475 U.S. 574, 594 (1986)

Product introduction

Entry into a market or establishing a new brand does result in companies charging prices, which are at times below cost prices. Such pricing is rational when price does not remain below cost for long enough to harm competition, provided that promotional pricing does not occur regularly (see Box 2).

Loss leading

A company in order to allure its customers to buy additional products may price one or more of its product below cost. This is known as loss leader strategy. For example, a grocery store may offer orange juices at a lower price to lure the customers to enter the shop who are then likely to buy other higher margin items along with the orange juices.

Obsolete inventory

Sometimes pricing below cost is necessary to clear out older products and make space for new products.

The "meeting competition" defence

The "meeting competition" defence was developed in the US under the Robinson-Patman Act and it was also applied under the Sherman Act to predatory pricing cases. The US Courts have held that a company should not be held guilty of predatory pricing regardless of its costs, when it reduces price to meet lower prices already being charged by its competitors.[7]

Approaches to Predatory Pricing

EU and UK

The EU and the UK approach to predatory pricing is a mix of price-cost and intent tests, based on Article 82 of the EC Treaty, i.e. prohibition against abuse of a dominant position. However, a recoupment test is not required, since it is based on the logic that promotion of consumer welfare is the main objective of competition law. Accepting this logic, it is of no concern that a firm's unilateral conduct may eliminate a competitor as long as the elimination of competition does not cause harm to the consumers.

The ECJ in Tetra Pak II [8] held that there is no need to prove that an alleged predator had even a realistic chance of recouping its losses. The decision states: "It must be possible to penalise predatory pricing whenever there is a risk that competitors will be eliminated". ECJ shows concern for the fate of the competitors who may be affected by a dominant firm's below cost pricing strategy, regardless of whether their elimination affects consumer welfare.

However, in recent times there have been discussions in the EU about the use of recoupment tests when analysing predatory pricing cases. The Director General of the EC came out with a discussion paper on Article 82, in which one of the recommendations is the need for including recoupment tests. According to the paper, the recoupment tests are good indicators of market power, while a purely cost-based analysis can be more complicated than the analysis of market structures allowed by recoupment.

Australia

The Australian Competition and Consumer Commission (ACCC) defines predatory pricing as "the intention of the price cutting must be to eliminate or substantially damage a competitor, prevent the entry of a person into the market or deter or prevent a person from engaging in competitive conduct in a market. It is this clear purpose that turns price cutting by a company with substantial market power into predatory pricing. Once competitors are eliminated the likely results are that the company can raise its prices, recoup its losses, and exploit consumers".[9]

In a recent predatory pricing case, the High Court of Australia ruled that the recoupment test was mandatory. [10] It determined that it must be proved that the company has "substantial market power". The ability of a company to raise prices above competitive levels and remain unchallenged by its competitors over a reasonable time period signals its market power. Once market power is established, it would then be necessary to check whether the company has taken advantage of it, i.e. it must have done something that a company would not ordinarily do in a competitive market. In a predatory pricing case, pricing products below their marginal cost leads to the conclusion that the company is undertaking a strategy that is predatory in nature. Thus, a structural approach test is undertaken while dealing with predatory cases.

The importance of undertaking a recoupment test can be derived from the decision of the High Court of Australia in the said predatory pricing case. It states: "A firm does not possess 'substantial market power' if it does not have the power to recoup all or a substantial part of the losses caused by price cutting by later charging supra-competitive prices. If it cannot successfully raise prices to supra-competitive levels after deterring or damaging…competitors by price-cutting, the conclusion is irresistible that it did not have substantial market power at the time it engaged in the price cutting".[11]

US

The US Supreme Court has warned that "setting the liability standards too low can lead to the perverse result of antitrust lawsuits themselves being used as a tool for keeping prices high".[12] It has formulated some principles that it and the lower courts in US have used to differentiate aggressive price competition from predatory pricing strategy.

First, Section 2 of the Sherman Act serves to protect competition and markets from unreasonably exclusionary conduct that is dangerous and likely to create or maintain monopoly. The objective of protecting competition is not the same as that of protecting competitors.

Second, intent statements to defeat or drive off competitors do not establish liability. The Supreme Court rejected arguments that predatory intent, even when accompanied with malice, can alone establish liability. Instead, liability in predatory pricing cases demands rigorous objective analysis showing that a predatory price scheme was not only intended to harm competitors but also harm the consumers. [13]

Box 2: First Edinburgh Buses Not Predatory

The Office of Fair Trade (OFT) received a complaint from a rival bus operator, Lothian Buses Plc that First Edinburgh was abusing a dominant position by predatory pricing and by increasing services in the Greater Edinburgh area.

The OFT concluded that it was not abusive for First Edinburgh to reduce its fares or increase services as the balance of evidence suggests that this was a reasonable commercial strategy from which passengers benefited, rather than an unlawful attempt to push Lothian out of the market. The OFT investigation found that Lothian, rather than First Edinburgh, was the largest bus operator in the Greater Edinburgh area, but that First Edinburgh was likely to be a dominant player in the area surrounding Edinburgh. In some circumstances a firm that has a dominant position in one market may be found to have abused that position by conduct in another market.

The OFT found evidence that First Edinburgh's prices were low enough in comparison to its costs to raise questions about predation. However, there was evidence that First Edinburgh did not intend to drive Lothian (the larger firm locally) from the market, and that it did not believe that it was capable of doing so. More compelling evidence was found that First Edinburgh was pricing low in an attempt to establish a more secure commercial basis for its Edinburgh operation.

The OFT therefore concluded that First Edinburgh's conduct represented legitimate competition. Consumers in Greater Edinburgh benefited from a period of low fares and higher frequencies "without competition being weakened".

Source: http://www.oft.gov.uk/News/Press+releases/2004/75-04.htm

"An alleged predatory price claim raises three inquiries:

- What is the relevant market alleged to have been monopolised?
- Did the alleged predator achieve its monopoly power by price cutting its product below an appropriate measure of its cost?
- Is the alleged predator dangerously likely to recoup its investment in predation by extracting supra-competitive profits after its competitors have been vanquished?"[14]

The first step is to define the relevant market, because without understanding or knowing the market, it is impossible to determine if the alleged predator has established or is close to establishing monopoly. While undertaking the inquiry some factors such as substitutability or inter-changeability between products, differences in prices between products, whether consumers can or cannot switch between products, etc., are to be taken into consideration.

The second step is to define the appropriate cost test. In the Brooke Group Case[15], the US Supreme Court applied the Areeda/Turner test of using average variable cost. The cost test undertaken in the said case implied but did not dictate that AVC is the most appropriate measure of cost in every predatory pricing case. Note that the Court did reject earlier cases that held that total costs may be an appropriate measure. The third step is to inquire whether the alleged predator is likely to recoup its investments, i.e. the recoupment test.

Conclusion

Predatory pricing is a serious threat to competition and consumer welfare that requires serious scrutiny from competition agencies and courts across the globe. Caution needs to be taken by competition agencies when analysing predatory pricing cases, otherwise they may discourage welfare-enhancing competitive behaviour.

In the event of a competition authority is looking for evidence that an alleged predator intended to adopt a predatory pricing strategy, the following factors are to be considered to determine the intent:

- **That the below price cuts are targeted at rivals:** In this case, for example, if a firm operates in several geographic markets but implements price cuts in only one of the markets in which it faces competition, then that behaviour is consistent with predatory intent. However, if it decreases its prices in all the geographic market, then it suggests a more harmless reason for lower prices, and since the firm's costs have declined it is legitimately adjusting its prices to maximise profits.
- **That attempts are made to acquire the target company:** If the alleged predator had tried to acquire its rivals firms in the past, or is trying to do so while the alleged predation is on, then this may be the indication of a predatory intent. Having failed to acquire its rival firm, perhaps by a merger, it might do so using a predatory pricing strategy.
- **Those moves are directed towards predatory intent:** The other strategic moves like timing, duration and extent of price cuts by the alleged predator would help to establish predatory intent.

Thus if a predatory intent is established, tests need to be undertaken to determine predatory pricing allegations. The most practical and workable test would be the two-tier test that includes screening the market structure which would show that predatory pricing is likely to occur, including aspects of dominance and barriers to entry. Only cases in which affirmative findings are made should pass on the second test, i.e. the courts would then need to decide on a cost based test.

Endnotes

1 *Wal-Mart Stores vs. American Drugs, Inc., No. 94-235, Supreme Court of Arkansas.*
2 Barthel, C (2002), "Predatory Pricing Policy under EC and US Law", Faculty of Law, University of Lund.
3 Policy Brief (2005), "Preserving Competition: Keeping Predators at Bay", OECD.
4 *Case C-62/86, AZCO ChemieBV vs. Commission (1991) ECR I-3359 at para 71.*
5 *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 US 224.*
6 Baumol, W (1996), "Predation and the Logic of the Average Variable Cost Test", 39 Journal of Law and Economics.
7 "Predatory Foreclosure", OECD (2005), Available at http://www.oecd.org/dataoecd/26/53/34646189.pdf
8 *Tetra Pak II, C-333/94 P (1996) ECR I-5951, para. 44.*
9 "What is Predatory Pricing", Australian Competition & Consumer Commission. Available at http://www.accc.gov.au
10 *Boral Masonry Ltd vs. ACCC (2003) HCA 5*
11 ibid.
12 *Matsushita Electric Industrial Co. vs. Zenith Radio Corp., 475 U.S. 574, 594 (1986).*
13 *ibid.*
14 "The Air & Space Lawyer" (2006), American Bar Association, Vol. 20, No. 4, available at http://discussions.abanet.org/forums/airspace/javascripts/AirSpaceSP06.pdf
15 Supra note 7.

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