



POLICY BRIEFS

Preserving Competition: Keeping Predators at Bay 2005

Introduction

Policy Briefs offer easy to read, short syntheses of reports and country reviews, focusing on their most important findings. This Policy Brief looks at how to preserve competition by keeping predators at bay.

Overview

Predatory pricing is the practice of offering goods or services at exceptionally low prices, thereby forfeiting some profit in order to drive competitors out of the market, discipline them, and/or deter entry. It is among the most frequently discussed topics in competition law and economics.

Generally speaking, pricing is considered predatory when it cannot be profitable unless competition is eliminated or at least restrained. Once a predator has acquired or successfully maintained market power, it raises its price above the competitive level to recoup the losses it sustained during the predatory period and earn enhanced profits thereafter. Consequently, even though consumers benefit from low prices in the short run, they ultimately suffer due to the loss of competition.

In spite of all that has been written about predatory conduct, some core issues remain unresolved. Different jurisdictions continue to hold a number of conflicting views concerning how to detect and deter predatory conduct. Indeed, within some jurisdictions, courts and competition authorities still have not adopted a clear position on this issue. This Policy Brief addresses some issues that competition authorities usually need to consider when trying to distinguish competitively harmful predation from merely aggressive but competitively benign or beneficial conduct.

Related Topics

- Resale below Cost (2005)
- Competition on the Merits (2005)
- Predatory Foreclosure (2004)
- Predatory Pricing (1989)

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... or competitors?**

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**Protect competition
... or competitors?**

Despite the controversy surrounding predatory pricing, there is a broad consensus among OECD members that the goal of competition law enforcement ought to be the protection of competition, not of competitors. Although the wording of some jurisdictions' competition laws suggests that they aim to prevent harm to competitors, the competition authorities' practice is nevertheless to focus on harm to competition rather than on harm to individual firms. Several tests that help to detect predatory pricing take this distinction into account and aim to catch only behaviour that damages competition. For example, most jurisdictions require that an alleged predator's prices be set below its own costs before those prices can be deemed predatory. To penalise a firm simply because its prices are below those of a competitor would be to protect competitors from the effects of competition. Similarly, the recoupment test (which focuses on the predator's potential gains after its predatory attack) does not capture conduct that merely eliminates certain competitors; the conduct must be expected to result in the predator's eventual ability to act with less restraint from competition. ■

**How to test for
predatory prices?**

One way to detect predatory prices is to compare a firm's prices with its costs to see whether it is pricing below cost. There is, however, no consensus on the best measure of cost to use in predatory pricing cases. Many enforcement agencies prefer to maintain enough flexibility to tailor the cost measure used to the facts of each case. Indeed, practices vary widely among jurisdictions concerning the cost measures used to analyse predatory pricing. Traditional tests such as the average variable cost (AVC, the non-fixed costs per unit of output) and average total cost (ATC, the sum of all costs divided by output) tests have long been criticised but continue to be used because they often have the virtue of being easier to apply than other cost tests. AVC, for example, has been advocated as a practical proxy for short-run marginal cost (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. AVC, however, can be significantly less than short-run marginal cost at the high levels of output at which predation is likely to occur. In some industries, it makes little sense even to try to approximate marginal cost because it is close to zero, whereas fixed costs are relatively high. In other industries, it may be hard to distinguish variable from fixed costs in the first place. ATC, on the other hand, may be difficult

to apply where there are important common costs that can only be allocated arbitrarily. Several jurisdictions consider and/or apply the average avoidable cost test, which focuses solely on the range of a firm's output that is allegedly predatory. It also takes fixed costs into account when they are specifically associated with the capacity expansion that sometimes accompanies a predatory campaign.

There is no consensus among jurisdictions on the question of whether prices above cost, particularly ATC, can be considered predatory. In New Zealand, for example, although pricing below cost is a relevant factor, it is not requisite to determining that the line between legitimate competition and anti-competitive conduct has been crossed. Setting a price above total costs in Korea could still be considered predatory if that price is below the "ordinary transaction price". Most other jurisdictions, however, do not usually consider prices to be predatory unless they are below some measure of a firm's costs. The economic rationale underpinning that policy is that in general an equally efficient competitor would not be excluded by a price that is above all measures of cost. Therefore, to punish firms that merely cut their prices without setting them below cost would risk promoting the entry and survival of inefficient firms. That, in turn, would risk protecting competitors rather than competition. ■

Should the recoupment test be used?

The recoupment test aims to determine whether a company's allegedly predatory pricing strategy would be likely to eliminate and deter competition, and whether it is likely that the company would then be able to collect at least enough profit to recover the losses it sustained during its predatory attack. In other words, it does not focus on whether prices are below some measure of cost, but rather it assumes that they are and asks whether that is because the firm is merely responding to intense competition or because it has made a calculated decision to invest in exclusion. The recoupment test should be routinely applied in predatory pricing cases. Its primary value is its ability to help competition agencies ensure that they are targeting behaviour likely to harm consumer welfare, and that they do not inadvertently reduce that welfare. The test accomplishes this by screening out cases in which the characteristics of the incumbent firm and the market make recoupment implausible, even if the firm sustained losses for some period of time. Such conditions may exist, for example, when entry barriers are low or when rivals are well-funded and determined to survive a price war. In general, when

the challenged conduct has persisted for so long that it could not have been a rational strategy based on the prospect of eventual profits, the recoupment test ends the inquiry in the incumbent's favour. When recoupment is implausible, consumers are at low risk of long term harm. In fact, they are made better off by the dominant firm's price cutting while it lasts, which is why it could be harmful if a competition agency intervenes.

Many competition agencies now take recoupment into account in predatory pricing cases, even if the law in their jurisdiction does not require them to do so. In some instances, these agencies use the recoupment test only as a cross-check to ensure that their conclusions about dominance are correct. Some jurisdictions believe that performing a separate recoupment analysis may not be necessary because the process of testing for dominance overlaps with the recoupment test. The overlap may only be partial, however. Some elements of a complete recoupment analysis may not be presently reflected in the dominance test used by most, if not all, countries. A factor such as relative financial strength, for example, is vital in recoupment analysis but may not play a role in testing for dominance.

It may be the case that a predator never recovers its losses in the market where they took place, but the predatory campaign is likely to be profitable nonetheless. This could happen if the predator participates in multiple markets and, as a result of its predatory attack in one market, acquires a broad reputation for being willing to absorb losses over time in order to eliminate rivals and discourage potential entrants. Such reputational effects can significantly increase the likelihood of recoupment. In other words, a predatory reputation may not only have lasting effects on the market in which a predatory attack is carried out, but it could be even more helpful to a business that operates in several markets. In that situation, the effects of notoriety gained in one market may echo throughout the firm's other markets. The predator may then be able to reap the rewards of predatory pricing in several markets even though it incurred the costs in only one. This is a potent theoretical concept because it means that adequate recoupment does not have to come from the market in which the predation occurred. In fact, predatory losses may never be recouped from the market in which the predation took place, but because multi-market reputational effects may enable the predator to recoup in other markets, the strategy may still harm consumers. ■

Is below-cost pricing always predatory?

Below-cost pricing – even by dominant firms – is not always predatory. Competition authorities should take into account any legitimate business justifications offered by alleged predators. Firms sometimes price below cost for legitimate reasons. For example, even dominant firms may implement promotional pricing from time to time to get rid of obsolete or perishable inventory. In addition, recent studies have shown that setting customers' membership fees below cost in network effects industries enhances competition. Therefore, it cannot be inferred automatically that below-cost pricing is necessarily anti-competitive. To make such an inference, a competition authority should have evidence that such pricing is part of a long run strategy to inflict losses on or deter competitors to such an extent that, eventually, profits are likely to increase due to the lessening of competition. Ordinarily, the burden of establishing a legitimate business justification for below-cost pricing will fall on the alleged predator if it wishes to use that defence. The company will need to show that it was pricing below cost for non-predatory reasons, and it should be able to support the conclusion that it would have set the same prices even if doing so would not have harmed competition.

Sometimes, a firm will lower its prices below cost to match a competitor's price. The "meeting competition" defence allows a dominant firm to do so. This defence is recognised in many jurisdictions, but its rationale is not entirely sound and it can be difficult to apply in the presence of non-price competition. Accepting this defence is often justified by stating that it would be contrary to the purpose of the competition laws to force a company to maintain non-competitive prices, or that even dominant firms must be allowed to compete. Those rationales beg the question of what legitimate competition is. If dominant firms are always permitted to match the prices of any other firm, then even far more efficient entrants may never be able to win the customers they need to survive. Therefore, they may be unable to bring competition to the market over the long run. Furthermore, the meeting competition defence permits incumbent firms to build reputations as aggressive price-cutters who are willing to sustain losses in order to stave off entrants with superior cost structures. Such reputations may deter entry. Finally, the meeting competition defence may not account for differences in quality, which could enable an incumbent, in effect, to undercut its rivals' prices while technically satisfying the condition of matching their prices. In other words, the incumbent goes beyond merely meeting the competition when its product is of higher quality

than its competitors' products are. It is difficult for courts to take such differences into account. Although such exercises have been attempted, they have the appearance of being arbitrary. It is therefore suggested that the meeting competition defence be abandoned. ■

For further information

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For further reading

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