PREDATORY FORECLOSURE

1. Introduction

Predation is among the most frequently discussed topics in competition law and economics. It has attracted a great deal of attention over the years not only because of some high-profile cases, but because the theoretical issues surrounding predatory conduct have sparked several interesting debates among academics and practitioners alike. Yet, in spite of all that has been written about predatory conduct, some core issues remain unresolved. A multitude of conflicting views remains among different nations concerning how to detect and deter predatory conduct. Even within some jurisdictions, a clear position still has not been adopted by the various courts and competition authorities. This note addresses issues that competition authorities will usually need to consider when trying to distinguish competitively harmful predation from merely aggressive but competitively benign or beneficial conduct. It also compares the advantages and disadvantages of several types of analysis that are currently in use.

2. Many different varieties of business conduct may be considered potentially "predatory," but they generally fall into two categories: predatory pricing and non-price predation. When a company pursues a predatory pricing strategy, it offers its goods or services at unrealistically low prices in the short term in order to achieve a longer term objective. More specifically, the company sacrifices profits for some period of time because it believes that by doing so it will drive its rivals out of the market, discipline them, and/or deter entry. It is rational to employ a predatory pricing strategy only when a company expects to acquire or maintain some degree of market power as a result of that strategy. Thus, a general definition is that pricing is 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 hopes not only to recoup the losses it sustained during the predatory period, but to enhance profits by holding its prices above the competitive level. Therefore, when a predatory pricing scheme is successful, even though consumers benefit from unrealistically low prices in the short run, they ultimately suffer due to the loss of competition.

3. The key controversies concerning predatory pricing are 1) what the best measure of cost to use in price-cost tests is; 2) whether to use a recoupment test; 3) whether and when intent evidence is relevant; and 4) whether the meeting competition defence should be allowed. This paper addresses each of those subjects and makes recommendations based on the academic literature and recent jurisprudence.

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1 See Janusz Ordover & Robert Willig, “An Economic Definition of Predation: Pricing and Product Innovation,” 91 Yale Law Journal 8, 9 (1981) ("although a practice may cause a rival’s exit, it is predatory only if the practice would not be profitable without the additional monopoly power resulting from that exit"). Causing a rival to exit is not essential for predation to work, however. If the predatory episode simply beats a competitor into a more submissive position in which it follows the predator’s pricing, the latter firm can still achieve its goals. In fact, this outcome may be preferable to forcing the competitor to exit because in that situation, the competitor’s assets might be sold at a bargain price, enabling the purchaser to enter the market with a lower cost structure that would cause even more trouble for the incumbent.
4. Non-price predation often involves making excessive investments that have the sole purpose and likely effect of weakening or eliminating competitors. Predatory investments could be made, for example, in extra capacity, product differentiation, or advertising. Furthermore, businesses may adopt strategies designed to raise their rivals’ costs. Because predatory pricing cases are more common than non-price predation cases, this note focuses on the former. There has, however, been a flurry of cases brought against airlines in recent years involving allegations not only of predatory pricing, but of predatory capacity expansion and product differentiation, as well. Together, these cases make an excellent laboratory in which to study predatory behaviour. In fact, the airline cases were a primary reason for the Committee’s decision to hold a roundtable on predatory foreclosure. Accordingly, one section of the paper is devoted specifically to them.

5. The key points of this paper are:

- A number of price-cost tests are available to help detect predatory prices. Although the Areeda-Turner test (which relies on average variable cost) has historically been the most widely accepted price-cost test, support appears to be growing for the average avoidable cost test. The latter test can focus solely on the range of a firm’s output that is allegedly predatory. It can also take fixed costs into account when they are specifically associated with the capacity expansion that accompanies a predatory campaign.

- Some commentators recommend taking action against incumbent firms that lower their prices in reaction to entry, even when those prices do not go below any measure of the incumbent’s cost. At least one major court decision has followed that approach. Other commentators are sharply critical of this idea, noting that its effect on consumer welfare is uncertain at best and that it encourages inefficient entry. Tolerating limit-pricing strategies seems to be preferable to encouraging higher prices and accommodating inefficient entrants.

- Recoupment is a controversial area in predatory pricing analysis. Depending on the policy objectives behind competition laws, the recoupment test may serve an essential function in predation cases. It helps to sort out which predatory actions are likely to harm competition (as opposed to competitors), and therefore acts as a safeguard of consumer welfare. It may also save agencies and courts from the difficulty that is sometimes encountered in conducting price-cost tests. If objectives other than consumer welfare are important, however, the recoupment test may be less vital.

- A likelihood of recoupment is not necessarily established when a firm is found to be dominant. Several other factors have to be considered, such as the ability to expand capacity, relative financial strength, and reputational effects.

- Another controversial subject is the relevance of intent evidence. There is a difference between general evidence of intent to eliminate a competitor and a specific, detailed plan to absorb losses in the short term for the purpose of eliminating competition and reaping supra-competitive profit in the long term. The former type of evidence is not particularly meaningful because it is commonplace for firms to strive to defeat their rivals in one way or another. The latter type is more helpful because it shows that, at the very least, the alleged predator believed that its plan could succeed. Nevertheless, it may be best to limit the use of such evidence to rebutting defendants’ attempts to establish legitimate business justifications for their below-cost prices, as opposed to using intent evidence to establish the prima-facie violation.
• Just because a firm is pricing below cost does not necessarily mean its actions are harming competition. There are some circumstances under which such pricing is not only benign, but actually pro-competitive. Agencies should thoroughly investigate any justifications that alleged predators proffer for their pricing.

• One justification that has generated disagreement among jurisdictions is the so-called “meeting competition” defence. Defendants using that defence are arguing that they should not be punished for merely matching a competitor’s price, as opposed to undercutting it, and that they have a right to defend themselves against firms who undercut them, even if that means pricing below the defendant’s own costs. The relationship between the defendant’s price and cost, however, is much more informative than the relationship between its price and someone else’s price. A price should not be deemed predatory just because it is below a rival’s price. But by the same token, it should not be deemed non-predatory just because it is not below a rival’s price. A matching price still has the power to exclude in some situations, such as when there are differences in the relevant products’ quality.

• In addition to having broad abuse-of-dominance statutes, some nations have specific resale-below-cost laws that punish retailers for pricing below their own costs. The elements of proof are much easier to satisfy than the elements under a traditional abuse-of-dominance framework. As a result, these resale-below-cost laws appear to capture pro-competitive conduct and have the effect of keeping prices higher in order to protect smaller, possibly less efficient competitors.

• A comparison of recent cases in the airlines industry shows how deeply divided different jurisdictions are in terms of their predation analyses. It also shows that the basic framework used in predatory pricing cases can also be applicable in predatory capacity expansion cases.

2. Predatory Pricing

2.1 The Concept of Predatory Pricing

6. In general, prices are predatory when they are so low that they can be considered rational only because they ultimately eliminate or deter competition, thereby enabling the predator to achieve or maintain some degree of market power. For example, in a classic predatory pricing scenario, an incumbent monopolist reacts to entry by lowering its price to a point at which the entrant is forced to operate at a loss. Under most definitions, a predatory price will force the incumbent to sustain losses, as well. By maintaining its low price for a period of time, the predator strives to damage the entrant to such an extent that it must exit the market. At that point, the predator raises its price to the monopolistic profit-maximising point and collects more than enough profits to compensate for its predatory losses.

7. There are many variations on that classic scenario. The predator does not necessarily have to be a monopolist, or even a dominant firm, for example. It might, in fact, be an oligopolist. Furthermore, predatory prices may not be aimed at eliminating an existing rival, but rather at deterring entry by potential competitors. Moreover, there is a spectrum of price cuts – usually measured against the predator’s costs – that may or may not be considered predatory, depending on the circumstances of each case and the jurisdiction in which it occurs.
8. Much of the theoretical work on predatory pricing was done during the 1970s, when academics began the long-running debate over the best way to detect it. During the 1980s, the rising popularity of “Chicago-school” economics largely stifled the debate because that school considered predatory pricing to be so rare and irrational that it was not worthwhile to devote much attention to it. That view prevailed until the work of “post-Chicago-school” academics invigorated support for the position that predatory pricing is neither so irrational nor so rare as had been previously thought, and competition agencies started to bring more predatory pricing cases.

9. Regardless of whether one believes predatory pricing is rare or not, if a company engages in it successfully, it will damage competition. On the surface, though, it seems odd that competition laws might be used to attack prices on the ground that they are not high enough. After all, the philosophy behind competition laws in general is that they are intended to promote competition, which is supposed to enhance consumer welfare by keeping prices lower than they would be if markets were more concentrated, collusive, or restrictive. Indeed, few consumers ordinarily believe that there is such a thing as a price that is too low. It is true that even successful predatory pricing improves consumer welfare in the short run, since the strategy involves unusually low prices at first. Predation, however, is a dynamic process, and when it succeeds, the resulting higher prices are detrimental to both consumers and allocative efficiency in the long run. If incumbent firms were allowed to absorb losses in order to undercut and eliminate rivals, then the benefits of competition would not be fully realised.

10. A key difficulty for enforcement agencies is that predatory pricing resembles legitimate competitive behaviour. It can therefore be extremely difficult to distinguish one from the other. A price cut in response to entry or the threat of entry is exactly what one would normally expect from an incumbent that had been enjoying more than a competitive level of profits. Over the years, many different tests have been devised to aid agencies and courts in sorting out predatory behaviour from tough competition. The major tests are described in the next section.

2.2. Tests for Detecting Predatory Pricing

2.2.1 Price-Cost Tests

11. The aim of price-cost tests is to discern whether a company is incurring losses that are rational only if they are part of a predatory pricing strategy. By comparing objective cost and price data, these tests do not directly address the more subjective question of whether a company intended to engage in predatory pricing, but rather they provide information about whether it is actually doing so. This objectivity is crucial because how an incumbent attacks its rivals is more significant in economic terms than whether it intended to do so.

12. For example, if a firm forces a competitor out of business by pricing such that the competitor must operate at a loss to meet that price, then it may be true that the elimination was intentional, that the firm intended to send a signal to deter potential entrants, and even that it wished to do these things so that it could achieve or maintain a dominant position. If that firm is more efficient than the competitor was, however, and it was therefore able to accomplish these goals simply by undercutting the competitor’s price

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3 Frank Easterbrook, “Predatory Strategies and Counterstrategies,” 48 University of Chicago Law Review 263 (1981) (“There is no sufficient reason for antitrust law or the courts to take predation seriously”).
while continuing to cover its own costs, then the outcome described above is consistent with normal competitive behaviour. On the other hand, if the firm priced below its own costs, then the competitive process was distorted and the firm may have expelled a more efficient competitor from the market.

13. What qualities are desirable in a price-cost test, then? Ideally, the cost benchmark would be set such that the firm could not possibly price above it and still manage to eliminate or deter competitors and potential competitors that are at least equally efficient. At the same time, care would have to be taken that the cost benchmark is not too high. “Too high” in this context means a rule that would force businesses to raise prices above the competitive level to avoid violating the law. In that situation, consumers, whose welfare the law is presumably intended to promote, might be paying higher prices than necessary because the law would protect less efficient firms from competition. Moreover, the more efficient firms would be collecting supra-competitive profits.

14. Most jurisdictions use some type of price-cost test when analysing predatory pricing cases. The agreement largely ends there, however, because different jurisdictions consider different measures of cost to be most appropriate for detecting predatory pricing. Furthermore, some jurisdictions use more than one cost measure, while others have not yet decided what the best measure is.

a) Cost Measures

15. The following measures are often mentioned as possible cost benchmarks:

- marginal cost (“MC”) is the cost of producing the last unit of output;

- average variable cost (“AVC”) describes how MC behaves, on average, over a given range of output. AVC is calculated by identifying those costs that vary with output, adding them together, and dividing the result by the total number of units produced;

- average avoidable cost (“AAC”) is the sum of all costs that a firm can avoid by not producing a certain quantity of output, divided by the total number of units not produced. The avoidable costs are defined as the variable costs and product-specific fixed, but not sunk, costs that were incurred to produce the given range of output;

- average total cost (“ATC”) is calculated by dividing a firm’s total costs – variable plus fixed, including common costs – by the total number of units produced. Common costs are fixed costs that support a number of activities or product lines. For example, the salary of a company’s receptionist is a common cost. It is an essential position, but no part of the salary is caused by any specific product alone.

b) The Areeda-Turner Test

16. In a 1975 article that stimulated great interest in predatory pricing, Areeda and Turner introduced what is now the most famous test for predation. They proposed that a price less than short run marginal cost is predatory, and that any price above that amount is not predatory. The rationale for this test is straightforward: in the theoretical state of perfect competition, market forces will force firms to price at

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MC. Accordingly, as long as a price is at or above that level, it cannot be deemed too low because that is the level that would prevail in the most competitive kind of market structure. Furthermore, as long as an incumbent’s price does not exceed that level, the price cannot exclude a competitor who is at least as efficient as the incumbent.

17. The authors were well aware that MC data is not easy to find, though. MC is more of a conceptual tool for economists than an easily measurable, empirical reality. Therefore, Areeda and Turner recommended using AVC as a surrogate.

18. Most of the criticisms levelled at the Areeda-Turner test can be grouped into either of two categories: 1) short run MC is not a good test because even though most prices below it are predatory, some prices above it can be predatory, too; 2) assuming that short run MC is a good test, AVC is often a poor substitute because it tends to fall below MC (and therefore underestimate it) at higher output levels, leading to false negatives when testing for predation. Another significant criticism is that the AVC standard favours defendants with high fixed and low variable costs, such as firms in the transportation and software sectors. In those industries, it is relatively easy for low prices to remain above AVC. Therefore, using the AVC test might allow incumbents to keep new entrants from recovering their (fixed) capital costs for a very long time, which in turn would deter entry.

19. Despite the criticisms, the Areeda-Turner test has probably had more worldwide influence on predatory pricing litigation than any other price-cost test has. Many courts and agencies seem to have taken the position that what the test may lack in accuracy is compensated for by the fact that it is relatively easy to use. Furthermore, the test is not without some substantive merit. A price that is persistently below AVC indicates that the firm is not even covering all of its variable costs, let alone its fixed costs. Usually, when a firm is experiencing such losses over time, it shuts down because continuing to operate would create bigger losses than going out of business would. Therefore, a firm that stays in business in those circumstances could be a predator (unless it has a legitimate justification).

c) The Average Total Cost Test

20. One of the drawbacks to using AVC in a price-cost test is that it fails to detect some forms of below-cost pricing. Not only can it underestimate MC, but it also overlooks prices that are above AVC yet below ATC. When pricing in that range of its costs, a firm is covering its variable costs but not all of its fixed costs. Therefore, the firm may be failing to charge enough to cover items like rent, interest payments, and depreciation. A price in this range will not inflict losses on an equally efficient competitor to the same extent that a price below AVC would, but holding price below ATC for a lengthy period can still cause financial damage to both the predator and its rival(s).

21. Consequently, some jurisdictions, such as the European Union, incorporate an ATC test in their predatory pricing analysis. Usually, the test is part of a framework that roughly resembles one first

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6 The reason for this divergence is that MC is an incremental measure, whereas AVC is an average. As output increases, diminishing marginal returns to the factors of production raise the cost of producing each additional unit of output. MC eventually crosses the minimum of the AVC curve and thereafter begins to pull AVC upward. AVC, however, cannot catch up to the more rapidly rising MC in the short run.


8 See Section 2.2.4 below.
proposed by Joskow and Klevorick. Those authors favoured a joint AVC-ATC approach in which prices below AVC are always deemed predatory, and prices greater than AVC but less than ATC are deemed predatory unless the defendant has a reasonable justification for the price.

22. The ATC test is not without drawbacks of its own. First, while it may seem that measuring ATC should be easy, it turns to be difficult – so difficult, in fact, that some economists have argued that accurately measuring ATC for a good sold by a multi-product firm is impossible. The basic problem is that when a firm produces several products, attributing common costs to a single product line is an arbitrary process. As William Baumol has observed,

\[\ldots\] Outside a textbook, there probably exists no such thing as a single-product firm, and all multiproduct firms have fixed costs incurred in common on behalf of two or more of their products. There is, however, no economically defensible way of dividing such costs up among the firm’s various products. As is well known, all methods for the allocation of common fixed costs are arbitrary.

Before the courts or regulatory agencies, ATC (fully allocated costs) are always manipulated to produce whatever answers are desired by the party that puts them forward. Moreover, as I show elsewhere, the amounts by which these contrived cost figures can easily be manipulated is [sic] enormous. Thus, though to economists it may seem obvious, for practitioners in the antitrust arena it is hardly redundant to suggest [that] any conclusion about the predatory character of a price that is based on a calculation of average total cost must be disregarded.

23. One might be tempted to solve the allocation problem by assigning shares of common costs to the firm’s different product lines according to the percentage of overall corporate revenue they each produce. The problem with this easy fix is that sometimes it will be clear in an ordinal sense that one business line uses a source of common costs more than another business line, but it will not be clear how the two compare in a cardinal sense. In other words, one may be able to tell which line is the heavier user, but not by how much. Thus it may be quite obvious that a relatively low revenue product line is using a certain common resource more heavily than a high revenue product line, but there might be no way to measure the difference. This might be the case with a receptionist’s services, for example. If the common cost is nevertheless allocated according to revenue, there will be a clear error in allocation, though it will not be measurable.

24. Another drawback to the ATC test is that pricing below ATC for some period of time may be a rational response to entry even if its result is not the elimination of competition. For example, after a new firm enters with a low price, an incumbent may experience a decline in demand such that marginal cost pricing allows it to cover its variable, but not all of its fixed, costs. As long as those costs remain fixed, it is rational for the firm to cover at least some of them if it can. In contrast, if it were to hold prices steady at the pre-entry level, the firm might suffer an even greater decline in demand, such that it was not even able to cover its variable costs. The possibility that below-ATC prices are non-predatory does not mean that all

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of them are, but it has led some well-known academics to conclude that they should be permitted because it is too difficult to sort them out.  

25. The use of AAC in price-cost tests has been gaining momentum in recent years. The AAC test is really a variant of the Areeda-Turner test. Under the AAC test, price is compared to the average of variable costs plus product-specific fixed, but not sunk, costs over a given range of output. The objective is to determine how much a firm would save by not producing a range of output.

26. One advantage of using AAC is that it is a better estimate than AVC of the true cost that a firm incurs when it produces output that is sold at an allegedly predatory price. When a firm increases output in a predatory campaign, it may have to incur more costs than just those that happen to vary with every unit of output sold, which the AVC test measures. Sometimes a predator will also incur substantial fixed costs when it increases its capacity to absorb extra demand. For example, a baker might have to buy another oven, or a tour guide might have to buy another tour bus. Those kinds of expenses are incurred step-wise, rather than increasing evenly with every additional cake or ticket sold. Thus, it can also be seen that by incorporating product-specific fixed costs, the AAC test blunts the criticism that the Areeda-Turner test is too easy to pass in high fixed-cost industries.

27. Alternatively, a predator might reallocate a fixed-cost input from one of its other product lines to the line in which it is carrying out its predatory plan. The avoidable cost concept captures that possibility, as well, which is appropriate when that input could have been used profitably where it was.

28. Another advantage of the AAC test is its flexibility. It can be used to study several dimensions of a firm’s pricing. For instance, it could be used to test the pricing of overall output for a product. In that case, the total revenues from sales of that product would be compared with the costs the firm would save if it completely withdrew the product from the market. The AAC test is equally capable of testing the pricing to a subset of customers, in which case revenues from sales of the product to those customers alone would be compared to costs that the firm would have saved by not supplying those customers.

29. Precisely what should be counted as an avoidable cost also depends, in part, on the time period considered. Ordinarily, the longer the time period, the larger the total and average avoidable costs will be. This is true because more and more sunk costs become avoidable costs over time. A contract may expire, 

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11 Phillip Areeda & Herbert Hovenkamp, Antitrust Law: An Analysis of Antitrust Principles and Their Application (2d ed. 2002), vol. 3, para. 735 (“The problem with all such strategies is not that we doubt their existence or even their anticompetitive consequences. Rather, identifying them in the particular case without chilling aggressive, competitive pricing is far beyond the capacity of any antitrust tribunal.”).


13 Firms engaging in predatory pricing strategies need to increase output for two main reasons. First, their lower pricing will stimulate overall market demand. Second, the predator must absorb the extra demand that was previously being supplied by its prey. See Section 2.2.2e) below.

for instance, or a buyer may eventually be found for an unusual piece of machinery. It is clear, then, that the AAC test becomes harder and harder to pass as the time period lengthens. The logical time period to consider, in turn, is that in which the allegedly predatory pricing occurred. The AAC test therefore becomes harder and harder to pass the longer the allegedly predatory prices cuts persist.

e) Above-Cost Prices

30. One possibility that has generated considerable debate recently is whether pricing can ever be considered predatory when the alleged predator is not pricing below any measure of its cost, but is nevertheless failing to maximise short-run profit. Essentially, the question is whether limit pricing should be unlawful. When using that strategy, an incumbent sets its price at a profitable level, but below the short-run profit maximising point, choosing a corresponding level of output that leaves just a bit too little residual demand for entry to be profitable (i.e., the entrant would not be able to recover its ATC at the prevailing price). By sacrificing some of its profit, the incumbent keeps entrants out and is able to earn at least some supra-competitive profit. This strategy harms consumer welfare when entrants would have become at least as efficient as the incumbent if they could have gotten a foothold in the market, gained experience and volume, and eventually lowered their operating costs.

31. To address the harm of limit pricing strategies, Aaron Edlin has proposed that incumbent monopolists should be prevented from responding to entry by cutting price substantially or making significant product enhancements until entrants have had an opportunity to become viable or perhaps even until the monopolist loses its dominant position. Einer Elhauge argued in response that a workable rule to stop above-cost predatory pricing does not exist, and even if it did, it would fail to yield a more competitive outcome.

32. Elhauge gets the better of this argument because Edlin’s rule encourages inefficient entry, forcing lower-cost incumbents to accommodate it despite uncertain results. It can be difficult for competition agencies (or anyone else) to make accurate predictions about whether entrants would have eventually been more efficient and viable. Furthermore, it is uncertain whether consumers are better off with an efficient incumbent who is forced to keep its prices high in the short term in order to encourage possibly inefficient competitors in the long term, who may nevertheless be eliminated, or with lower incumbent prices in the short term that deter entry by any firm that cannot immediately or quickly become as efficient as the incumbent.

33. In other words, it is hard to predict whether society would be better off with limit prices on goods produced by an efficient incumbent or with lower prices on goods produced by inefficient firms. In fact, it is not even clear that social welfare would be improved by moving from monopoly prices set by an efficient incumbent to lower prices set by inefficient producers.

34. Moreover, by making the attainment of a dominant position much less attractive, Edlin’s rule would remove some of the incentive for firms to compete vigorously in the first place. In the end, that

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could be far more harmful to competition, innovation and long-run consumer welfare than a limit-pricing strategy.\textsuperscript{19}

35. A significant problem with profit-maximisation tests in general is that determining whether a firm was pricing at the short-run profit maximising level can be very challenging. As one court observed, a profit-maximisation test “would require extensive knowledge of demand characteristics – thus adding to its complexity and uncertainty.”\textsuperscript{20} In contrast, from a consumer welfare perspective it is perfectly clear that limit-pricing is preferable to monopoly-level pricing. Thus, in the face of the uncertainties just mentioned, it seems better to allow limit pricing rather than to force monopolists to reduce consumer welfare further by maximising their profits. Consequently, provided the incumbent’s price stays above ATC, it is usually permissible to set a price below the short-run profit maximising level even if the motive is purely malicious.\textsuperscript{21}

2.2.2 Recoupment

36. Unlike price-cost tests, the recoupment test is not used to determine whether predatory pricing is actually occurring. Instead, this test assumes that predatory pricing is happening and asks whether it is likely to succeed in light of the characteristics of the relevant market, the predator, and its target(s). Specifically, the recoupment test aims to determine whether a company’s predatory pricing campaign would be likely to eliminate and deter competition, and whether it is likely that the predator will then be able to amass at least enough supra-competitive profit to recover the losses it sustained during the attack.\textsuperscript{22}

37. The recoupment test is based on the premise that the policy objective of competition law is to promote consumer welfare. If other objectives, such as the preservation of small competitors or minimising market concentration for its own sake, are seen as policy goals or factors contributing to some other (non-economic) type of consumer welfare, then the recoupment test has less importance. However, as a means of helping competition agencies and courts to ensure that they are targeting behaviour likely to harm consumer welfare, and that they do not inadvertently reduce that welfare, the recoupment test is quite valuable.

38. This point is clarified by considering that the recoupment of predatory losses necessarily involves harm to consumer welfare. Predatory losses can be recovered only by setting and sustaining a price higher than the price that would have been charged if the predatory attack had not eliminated or deterred competition. It is the above-competitive price that harms consumers. Thus, if the recoupment test indicates that there is little or no likelihood of recoupment, then predatory pricing would not only be irrational, it would be unlikely to harm consumer welfare. Indeed, in that case a predatory pricing campaign should actually boost consumer welfare for as long as the predatory attack lasts, with little or no danger of harm to consumers in the longer run. Therefore, under the logic of the recoupment test, even if a

\textit{See id. at 188 note 93.}

\textit{MCI Communications v. AT&T, 708 F.2d 1081, 1114 (7th Cir. 1983) (emphasis in original); see also Phillip Areeda & Herbert Hovenkamp, Antitrust Law: An Analysis of Antitrust Principles and Their Application (2d ed. 2002), vol. 3, para. 736c2 (“As a practical matter, the price that actually maximizes a defendant’s profits in the circumstances will seldom be knowable.”).}

\textit{But see Compagnie Maritime Belge, C-395/96 P, para. 97 (stating that “the mere fact that the aim of price competition was to drive a competitor from the market cannot render legitimate competition unlawful” but holding that it was unlawful for a defendant to reduce price to a level above its own costs but below those of a targeted entrant).}

company is pricing below cost, when recoupment is implausible the best course of action for the competition agency (and the courts) is to do nothing.

39. To put it another way, allegedly predatory prices can harm competition only if they cause rivals to exit, discourage them from entering, or discipline them into becoming price followers. That the low prices may be inconvenient to other competitors, or that they might harm competitors, is an insufficient basis to prohibit price cutting because all competitive behaviour inconveniences competitors and “harms” them in one way or another. The recoupment test helps to sort out the prices that are likely to harm not only competitors, but competition itself.

40. The recoupment test is intended to serve as a threshold inquiry. If it shows that predation is unlikely to eliminate or deter rivals, or that recoupment of losses is ultimately implausible, then this test enables agencies and courts to dismiss allegations of predatory pricing without having to conduct a price-cost test. This is quite useful because the process of determining whether prices are predatory based on their relationship to some measure of cost is often quite difficult.23 If the test shows that recoupment is likely, however, then it must be used in conjunction with a price-cost test to establish that the alleged predator actually is charging predatory prices.

41. Before examining the various factors that should be taken into account in a recoupment test, it is important to note that recoupment differs according to whether the predatory attack was launched against an existing competitor or against an entrant/potential entrant. In the former case, the target is a rival who has been exercising a downward influence on the predator’s price. After a successful predatory pricing attack eliminates or disciplines the pricing behaviour of the rival, the predator will raise its price above the pre-predation level. By doing so, it will eventually recover the losses incurred during the predatory period and earn even more, as well. There would, after all, be no reason to undertake this risky strategy if there were not supra-competitive profits to be gained through its success.

42. In the case of predation against an entrant or potential entrant, the predator lowers its price in order to make entry appear unviable so that the recent entrant exits and/or the potential entrant is deterred. If and when that strategy succeeds, the predator will raise its price back to the pre-predation level. It will not, in all likelihood, try to raise it above that level, for if it could do so profitably, it would have been pricing at that level before the entrant appeared. Thus, in this case, recoupment is not achieved through an ability to reap profits as never before, but through the restoration of a position that provides the previous level of supra-competitive profits.

43. Recoupment analysis takes into account a variety of conditions that contribute to the likelihood that a predatory pricing strategy will be successful. Not all of the conditions must be present to establish a likelihood of success.

a) Dominance or Market Power

44. Even in jurisdictions that do not use a recoupment test, this condition will probably be considered if for no other reason than that the competition laws in most member countries have a dominance or market

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23 The recoupment test is not without its critics, either, and some of them argue that forecasting whether a predator is likely to be able to recoup its losses is at least as difficult as selecting and measuring the most appropriate costs for use in a price-cost test. See M.L. Denger & J.A. Herfert, “Predatory Pricing Claims After Brooke Group,” 62 Antitrust Law Journal 541 (1994). However, even the critics do not suggest abandoning the recoupment test; they simply advocate conducting a price-cost test first.
power requirement that must be met before unilateral conduct can be deemed unlawful. It is not the purpose of this note to explore the different nuances of those thresholds. The important points here are simply that defendants in predatory pricing cases in most member countries must have a dominant position or market power (collectively referred to as “dominance” hereafter), or else be in the process of acquiring it, and dominance implies a higher likelihood of recouping predatory losses.

45. Having a dominant position makes recoupment more likely for a predator in two ways. The first way has to do with the fact that predatory pricing requires both a price decrease and an output increase. Price cutting alone will not work because the objective is to take market share away from rivals. If the predator cannot produce enough extra output to cover what was supplied by those rivals, then market demand at the predatory price will outstrip what the predator is able to supply. Furthermore, even if the predator is the sole producer in a market and is using predatory pricing to deter entry rather than to eliminate competitors, its price cuts will still stimulate additional demand that must be met. If the predator cannot produce enough to satisfy both that additional demand and any demand previously supplied by existing rivals, then existing and potential competitors will not only be able to make sales, but will be able to do so at prices above the level set by the predator. That is exactly what a predator would not want to happen.

46. Consequently, to produce the necessary additional output, the predator must have excess capacity. This is where it helps to be a dominant firm. The excess capacity required in a predatory campaign against existing rivals varies inversely with the predator’s market share, and dominant companies tend to have relatively high market shares. In other words, less excess capacity is required for a predator with a high market share than a predator with a low market share. For example, a predator with 80 percent of the market will need to expand only moderately to capture its rivals’ entire market shares.

47. In contrast, a firm with only 25 percent of the market facing three competitors of the same size would have a much more difficult time carrying out a predatory strategy. Putting aside demand elasticity effects, even if the firm doubled its output, it would be able to take only 25 percent more of the overall market share from the other three firms. That extra amount will most likely come from the three rivals proportionally, rather than from a single one. Consequently, unless this small predator can expand greatly and take over the entire demand previously met by its competitors, its attacking power will be diluted.

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24 An exception must be noted, however. Some nations also rely on “resale-below-cost” laws (which do not necessarily have market power thresholds) to punish what is considered to be predatory pricing. See Section 2.4.

25 In some countries, such as the U.S., it is sufficient that there be a willful acquisition of market power as a result of anti-competitive conduct, or that there be an attempt to acquire market power with a dangerous probability of success. This is a desirable trait in a competition statute intended to cover predatory conduct because predators are not necessarily dominant when they begin their predatory campaign, but they will acquire a dominant position along the way if the strategy is successful. There is an anomaly in this respect in some other jurisdictions’ laws, which require that the defendant already be dominant at the time of the predatory conduct. Some commentators have noted the importance of this difference. See Speech delivered by Philip Lowe, Thirtieth Annual Conference on International Antitrust Law and Policy, Fordham Corporate Law Institute, 23 October 2003, pp. 2-3 (commenting on Article 82); Geoff Edwards, “The Perennial Problem of Predatory Pricing,” 30 Australian Business Law Review 170 (2002), 196, 197, 199 (arguing that, for this reason, s. 46 of Australia’s Trade Practices Act 1974 is “ill-suited to address predatory pricing conduct”).

26 This effect is caused by the price elasticity of demand. See Section 2.2.2d).
48. Suppose that one of the competitors is so weak that the small predator succeeds in eliminating it from the market. The distributional problem occurs again. The exiting firm’s market share will probably not all go to the predator; instead, it will likely be divided among the three remaining firms.

49. The second reason dominant firms are more likely to be able to recoup predatory losses is that, by definition, such firms operate in markets with entry barriers. As explained in the next section, entry barriers are essential to recoupment.

b) Barriers to Entry and Re-entry

50. Entry and re-entry barriers are part of the analysis of dominance and thus will be considered as a matter of course in nearly all predatory pricing cases. These barriers are essential if a predator is to have any hope of recovering the losses it will incur in a predatory strategy. Once it drives its rivals out, or deters a potential entrant, the predator needs to raise its price high enough to earn the supra-competitive profits that will justify its predatory losses. Ordinarily, those profits attract entrants, which tend to drive prices down to the normal, competitive level. In a market with high entry barriers, though, the predator is shielded from the threat of entry, so it can raise its price without having to worry so much about competition.27

51. Re-entry barriers are equally important. If it is easy and inexpensive for a defeated rival to regroup and resume its business a few months later, when the would-be predator has raised its price, the predator’s recoupment period will probably be short-lived. Re-entry barriers exist, for example, when it is difficult and expensive for a firm that has left the market to repair the damage done to its reputation when it exited. Alternatively, it may be difficult for some firms to rehire the specialists who lost their jobs when the firm went out of business, or to find new ones to replace them.

52. When considering entry and re-entry barriers in a predation case, competition agencies should pay attention not only to the likelihood of entry, but to the time that will be necessary to accomplish it. If entry is likely but will take several years, for example, then a predatory pricing strategy could still be profitable.

53. At this point it may seem reasonable to think, because most relevant competition laws have a built-in dominance requirement, which also necessarily calls for an analysis of entry and re-entry barriers, that it does not matter whether there is a separate recoupment test or not. This is not the case, however, because a dominant position and entry barriers alone are not enough to establish that recoupment is likely. Several other structural and behavioural features of the market and its participants have to be weighed.

c) Relative Financial Strength

54. Predatory pricing is a financial war of attrition. To win it, a predator not only has to be financially strong in general, it has to be stronger than its opponents in particular. The more cash reserves a predator has and the cheaper its access to capital is relative to that of its rivals, the more likely it is to survive and succeed in its predatory campaign. On the other hand, if the predator has a weak balance sheet with low cash reserves and it faces relatively expensive terms of credit, and if its rivals are willing and able to invest more money in a price war than the predator is, then the predator is less likely to succeed. In fact, it cannot succeed in those circumstances unless its other costs are lower than its rivals’ costs, in which case it probably would not have resorted to predation in the first place.

27 There is no clearly established consensus on the definition of entry barriers. Some regard them as costs necessarily incurred by new entrants that incumbents did not have to bear when they entered. Others view entry barriers as anything that permits incumbents to charge above-normal prices without attracting entry.
55. An interesting feature of predatory pricing is that the closer a firm gets to eliminating its rivals, the more expensive getting rid of them becomes. This point follows from the fact that the predator is losing money, by some measure of cost, on every unit of output it sells. As it takes more and more market share away from its failing competitors, the predator incurs losses on more and more units of output. The predator must have the financial staying power and determination necessary to fund all of its losses and finish the war.

d) Low Price Elasticity of Demand

56. This characteristic is not essential, but it does make predatory pricing more likely to succeed for two reasons. First, it reduces the amount of excess capacity required in a predatory attack. In this sense it is similar to dominance or market power, but here the concern is whether the predator can absorb the extra market demand stimulated by its price cuts, rather than whether the firm can satisfy the demand previously supplied by its competitors. The lower the price elasticity of demand, the less excess capacity a predator must have in order to satisfy the new market demand generated by the predatory prices.

57. Second, a low price elasticity of demand also facilitates recoupment because demand will decline relatively less when the firm raises the market price. A high elasticity of demand, in contrast, would mean that even if the predator succeeded in raising price to a monopoly level, it might lose so much demand that the magnitude of its profits might not be sufficient to cover its predatory losses.

e) Excess Capacity

58. For reasons already mentioned, excess capacity is virtually a prerequisite for a predator. The predator must be able to absorb all of the new demand created by its price cuts, and in the case of predation against existing rivals, the predator must also be able to absorb the rivals’ sales. If it cannot do both of those things, demand will exceed the predator’s output and prices will have to rise, which will take pressure off of the rivals and allow them to survive, or at least to survive longer.

59. It is especially noteworthy that dominant firms do not necessarily have excess capacity. If they have little or no excess capacity, and are incapable of acquiring some quickly, then predation is probably implausible. Thus it is not true that recoupment tests are essentially built into the dominance standard that most competition laws have.

60. One option for a capacity-constrained predator may be to purchase its competitors’ assets, if there are any existing competitors. But the more dominant the predator is, the more likely this strategy is to run into difficulty with the competition agency’s merger review process. That, in turn, will likely bring unwanted attention to the predatory campaign even if the merger itself would otherwise be permissible. Thus, acquiring a rival’s assets is not always an attractive option.

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28 This term refers to the percentage change in quantity demanded caused by a 1% change in price. Highly elastic demand, for instance, would mean that a 1% drop in price would cause, say, a 10% increase in the quantity demanded. Inelastic demand, on the other hand, would mean that the same drop in price would cause, say, only a 0.5% increase in the quantity demanded.

29 This remains true even if the acquirer makes a failing firm defence. The agency will naturally examine why the target firm is failing, and if it is failing because of the acquirer’s predatory strategy, then the acquirer will still face the agency’s scrutiny—with respect to both the acquisition and the predatory pricing.
f) Market Share Trends

61. Examining market share trends is elementary in recoupment analysis. If the shares did not change during the period of alleged predation, or if the alleged predator actually lost market share during that period, then recoupment would appear to be impossible (or, if the alleged predation is ongoing, recoupment would at least appear to be unlikely). On the other hand, for example, if the alleged predator’s market share fell and its rival’s share rose prior to the alleged predation, and that trend reversed itself during that period, recoupment would be more plausible.

g) Brand Loyalty

62. This factor is not essential, but it does increase plausibility. The more brand loyalty the incumbent has, the less costly is predatory campaign will be. This is so because, in order to take sales away from its rivals, the predator will not have to lower its price as far as it would have had to if it enjoyed less brand loyalty.

h) Relative Efficiency

63. The more efficient the incumbent is relative to its rivals, the less expensive (and thus easier) it will be to conduct a predatory campaign. Conversely, the less efficient the incumbent is relative to its rivals, the more expensive a predatory campaign will be. One might wonder whether an incumbent would ever find it desirable to adopt a predatory pricing strategy if it is relatively efficient compared to its rivals. Information is often imperfect, however. The incumbent may not realize that it has an efficiency advantage. Furthermore, if it is in a hurry to get rid of its rivals, the incumbent may want to speed up the process of wearing its competitor down. Still, an incumbent’s efficiency advantage will often be sufficient, in the long run, to vanquish a rival even without resorting to below-cost pricing. Ironically, this means that it is much easier for an incumbent who least needs to adopt a predatory scheme to afford it and make it work than it is for an incumbent who would probably face eventual extinction by a more efficient rival. In fact, the more an incumbent “needs” to predate, the less likely it is to succeed (holding other considerations constant) because it will be necessary to make price cuts that go deeper and deeper below its costs to eliminate its more efficient competitor(s).

i) Reputational Effects

64. Acquiring a reputation for being willing to absorb losses over time in order to eliminate rivals and discourage potential entrants can significantly increase the likelihood of recoupment for a predator. First, a predatory reputation may have lasting effects on the market in which the predatory attack is carried out. If a firm’s predatory pricing strategy succeeds in eliminating rivals, and any potential entrants to that market believe that the predator would employ the same strategy again, the potential entrants will be less likely to enter. As a result, the predator may actually be winning several battles at once when it defeats a rival in the present. Its ability to reap supra-competitive profits may therefore extend farther into the future than would be the case if there were no reputational benefit. This does not mean that reputational effects make recoupment plausible in all predatory pricing schemes. In combination with other factors, however, a convincing reputation as a predator does make recoupment more likely.  

65. Furthermore, a predatory reputation could be even more helpful to a business that operates in multiple markets. In this situation, the effects of notoriety gained in one market may reverberate throughout the firm’s other markets. The predator may then be able to reap the rewards of predatory pricing in multiple markets while incurring the costs in only one. This is a rather potent theoretical concept because it means that adequate recoupment does not have to come from the market in which the predation occurred. Predatory losses may never be recouped from the market in which they took place, yet because of multi-market reputational effects, the strategy may still be perfectly rational. Note, however, that this scenario depends on the incumbent not having to incur more predatory losses in its other markets because if it did, then those losses would have to be recouped, too.

66. Reputational effects are not easy to measure, but they can at least be taken into account in a qualitative manner. They are, in fact, showcased prominently in the recent post-Chicago school literature that has helped to revive concerns that predatory pricing can be a sensible strategy.\(^{31}\) To date, however, courts have largely ignored or rejected theories based on these effects.\(^{32}\) This may not be very surprising, since the theory’s effects are hard to verify quantitatively. Even at a qualitative level, if plaintiffs are allowed to count all of a multi-market defendant’s markets as sources of recoupment, it seems that only a very weak case would not pass the test.

j) Price Discrimination

67. If the incumbent is able to offer its predatory price only to those customers who are seriously considering buying a rival’s product, rather than having to implement the predatory price across all of its output, then the cost of the predatory strategy will be minimised, which not only makes it easier to finance but lowers the break-even point in the recoupment process.

k) Cross-Subsidisation

68. If a firm can fund its predatory losses in one market with supra-competitive profits from another market, then its chances of sustaining predatory prices long enough to eliminate and deter rivals are increased.

2.2.3 Predatory Intent

69. One controversial area in predatory pricing analysis is the value of evidence showing that the defendant had predatory intent. Some jurisdictions, such as the European Union, expressly incorporate intent in their predation analysis (along with price-cost tests), whereas others, such as the United States, are more sceptical toward intent as an indicator that predatory conduct is occurring or is likely to harm competition. Proponents of using intent evidence in predation cases tend to support their position by pointing out that business managers, not government agencies or judges, are in the best position to determine whether a predatory pricing scheme would be likely to eliminate competition and ultimately be profitable or not. Since these managers are knowledgeable, rational actors, any evidence showing that they intended to carry out a predatory plan or harm a competitor is more reliable than guesswork by outsiders about whether recoupment is likely.

\(^{31}\) Bolton, et al. (2000).

\(^{32}\) The concept of reputational effects was at least treated respectfully, in dictum, in one U.S. case. See Advo, Inc. v. Philadelphia Newspapers, Inc., 51 F.3d 1191, 1196 (3d Cir. 1995) (finding that reputational effects are applicable in “a limited number of special situations” and that the plaintiff had not alleged any such special circumstances).
70. On the other side of the fence, opponents of using predatory intent evidence tend to dismiss harsh-sounding language in memos and business plans as indistinguishable from the typical, but innocuous, corporate chest-thumping or cheerleading that is part of good, tough competition:

Firms ‘intend’ to do all the business they can, to crush their rivals if they can. . . . Entrepreneurs who work hardest to cut their prices will do the most damage to their rivals, and they will see good in it. . . . Almost all evidence bearing on ‘intent’ tends to show both greed-driven desire to succeed and glee at a rival’s predicament. Firms need not like their competitors; they need not cheer them on to success; a desire to extinguish one’s rivals is entirely consistent with, often is the motive behind, competition. . . . Intent does not help to separate competition from attempted monopolization and invites juries to penalize hard competition.\(^{33}\)

71. One possible explanation for the disagreement over intent derives from the fact that some jurisdictions use juries in competition law cases and some do not. As Judge Easterbrook’s quote above suggests, juries may be more susceptible to being misled by intent evidence than judges are. Therefore one might expect that intent evidence would be frowned upon in the United States, where juries are used in some cases, and readily accepted in the European Union, where they are not.

72. Even where juries are used, and despite the criticism above, when there is evidence of a specific intent to engage in predatory pricing, as opposed to merely general ill will toward competitors, such evidence probably should be weighed, since it shows that at least the defendant itself expected the scheme to work.\(^{34}\) It is submitted, however, that the analysis should not end there. In other words, it should not be enough to prove only predatory intent and below-cost pricing.

73. Ultimately, the question competition agencies and courts face in competition law cases is whether they should intervene or not. If the correct policy objective is to stop and punish all attempts by dominant firms to engage in predatory pricing, then it makes sense to pursue all dominant firms that fail a price-cost test and an intent test, without specifically considering whether the predatory plan really will work. If the correct policy objective is to promote consumer welfare by protecting competition, however, then there needs to be more assurance that competition will be harmed than just the confident assertions of a defendant who is losing money. In other words, there needs to be a recoupment test.

74. First, business managers are far from flawless. It is not unusual for business plans to fail. As we will see below in the discussion of the Aberdeen Journals case, companies may believe they can subdue competition with a predatory pricing strategy and yet be completely wrong. The predator could easily have made a mistake about market conditions, the resiliency or sheer resolve of its competitor(s), or its own ability to sustain a money-losing price war. After all, predatory pricing would not be considered such a risky strategy if it were easy to execute.

75. Second, if the presence of predatory intent is an element of the test for predation, then an absence of proof of such intent suggests that the defendant should be exonerated. This could lead to undesirable

\(^{33}\) A. A. Poultry Farms, Inc. v. Rose Acre Farms, Inc., 881 F.2d 1396, 1401-02 (7th Cir. 1989) (Easterbrook, J.; see also Richard Posner, Antitrust Law: An Economic Perspective 190 (1976) (“Especially misleading here is the inveterate tendency of sales executives to brag to their superiors about their competitive prowess, often using metaphors of coercion that are compelling evidence of predatory intent to the naive”).

\(^{34}\) Furthermore, if a defendant makes a showing that its seemingly predatory behaviour should be excused because of a legitimate business justification, then predatory intent evidence should be allowed to give plaintiffs an opportunity to refute that showing. See Section 2.2.4.
outcomes for competition and consumer welfare, since a well-advised company might execute a successful predatory attack without leaving a telltale paper trail.35

76. Third, allowing liability based on price-cost and intent evidence alone encourages private litigation (where private suits are permitted). It is questionable whether any legitimate policy aim is served by encouraging lawsuits from defeated competitors who believe they were bullied but cannot show any effect on competition.

77. In any event, if an agency is looking for evidence that an alleged predator intended to adopt a predatory pricing strategy, it will wish to consider the following things:

- **Below-cost price cuts that are targeted toward rivals, as opposed to across-the-board price changes.** For example, if a firm operates in several geographic markets but implements price cuts in the only one in which it faces competition, that behaviour is at least consistent with predatory intent. Alternatively, if it decreases its prices in all its geographic markets, that suggests a more innocuous motive, such as that the firm’s costs have declined and it is legitimately adjusting its prices to maximise profits.

- **Attempts to acquire the target company.** If the alleged predator has tried to acquire the target firm in the past, or is trying to do so while the alleged predation is occurring, this may be an indication of predatory intent. Having failed to get rid of its rival through a merger, the predator may be resorting to predation. Alternatively, it may be attempting to weaken the target firm via predatory pricing, so as to drive the acquisition cost down.

- **An unusual history of price movements consistent with predation.** The timing, duration and extent of price cuts by the incumbent may help to establish predatory intent. The typical pattern to look for in the alleged predator’s prices is a decrease that lasted long enough to eliminate or deter competition (or is ongoing) and, unless the predatory campaign is still taking place, a price increase back to the pre-predation level (in the case of predation to deter entry) or above that level (in the case of predation to eliminate an established competitor). On the other hand, price histories may reveal that an industry is cyclical, and that the allegedly predatory prices merely reflect that the bottom of the cycle has been reached. Pricing is seasonal in some industries, for example.

- **Direct evidence of intent.** Obviously, if an investigation turns up documents or testimony indicating that high-level officers within a company purposefully engaged in predatory pricing, this will be helpful in establishing predatory intent.

2.2.4 Legitimate Business Justifications

78. This topic is related to predatory intent, in a sense, but legitimate business justifications (“LBJs”) are used to exonerate defendants, not condemn them. An LBJ exists when behaviour that otherwise fails predatory pricing tests should be excused because of special circumstances that render the conduct reasonable. No matter what test has been used to detect predatory pricing, the analysis will be incomplete unless it considers any plausible LBJs because there are valid, even pro-competitive reasons why firms occasionally price below cost. “[I]t is hard to imagine a firm that has never found it expedient or even

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35 See Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 232 (1st Cir. 1983) (Breyer, J.) (noting that under an intent-based predation test, firms might refrain from describing the motives and consequences of their actions, thereby thwarting the test).
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."

79. Typically, the burden of establishing an LBJ falls on the alleged predator. To make its case, the company will need to show that it was pricing below cost for legitimate, non-predatory reasons. It must be able to support the conclusion that it would have set the same prices even if doing so would not have harmed competition. Specifically, the company should have to show either that circumstances forced it to price below cost, or that its prices were part of a normal business practice involving a brief period of losses. Furthermore, if the company makes that showing, even critics of predatory intent evidence would probably agree that it is appropriate for an agency to use any such evidence it has to rebut the proffered LBJ.

80. A wide variety of circumstances may constitute LBJs. The following list is representative, not exhaustive.

a) Product Introductions

81. Temporary below-cost prices are sometimes nothing more than part of a reasonable effort to break into a market and establish a new brand. Provided the prices do not remain below cost long enough to harm competition, and that the promotional pricing does not occur repeatedly, such pricing is rational even though it is not profit maximising in the short run. "Promotional" below-cost pricing by a firm in a market in which it is already dominant, however, should not be permitted.

82. Promotional pricing is particularly likely to occur in network effects markets, where a new entrant must compensate customers for the fact that it does not yet have a strong network, or pay them for helping to establish one. The firm’s early investment in attracting customers is recovered over the longer term when the firm has a larger market share. Unfortunately, it will often be difficult to distinguish innocuous below-cost promotional pricing that is necessary to gain viability from predatory pricing that winds up tipping the entire market and eliminating more efficient competitors. In fact, one of the relatively recent developments in economic theory that has helped to turn the tide against Chicago school scepticism about the existence of predatory pricing concerns network effects.

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37 A recent example of a product introduction LBJ (technically, a service introduction in this case) was described in a 29 April 2004 press release from the U.K. Office of Fair Trading. A bus company began service in a new geographic area and was accused of predatory pricing. Although the company’s prices “were low enough in comparison to its costs to raise questions about predation,” the OFT found that the company had not infringed the Competition Act because compelling evidence showed that the company was merely attempting to establish a “more secure commercial basis” in the new area and that it neither intended to, nor believed it could, drive a competitor out of business. Thus the OFT concluded that the conduct in question was legitimate competition, and that consumers had benefited from a period of low prices without any weakening of competition. See “First Edinburgh Buses Not Predatory,” www.oft.gov.uk/News/Press+releases/2004/75 -04.htm.

38 A network effects market is one in which the value of a good or service to a potential customer depends on the number of customers who already use that good or service. One consequence of a network effect is that the purchase of a good by one person benefits others who own the good – a common example is purchasing a telephone. By doing so, a person makes other telephones more useful.

83. It turns out that predatory below-cost pricing can be shown to be a perfectly rational, profitable strategy in network effects markets, whether the predator is already a monopolist who is fighting off potential entrants, or it is an aspiring monopolist trying to eliminate its competitor(s). The most famous example is Microsoft’s browser war with Netscape, in which Microsoft priced its product at zero (among other tactics) to eliminate Netscape. Not surprisingly, though – and consistent with the concept that there should be an exemption for some promotional pricing behaviour – the theoretical work also shows that below-cost pricing strategies in network effects markets are sometimes welfare-enhancing rather than harmful.

84. The key point is that in such markets below-cost pricing may be necessary to establish critical mass. In fact, it may be the only way a firm can survive in what will turn out to be a winner-takes-all situation. Some models show that firms in network effects markets will price below cost even if they face no competitors or potential competitors. That means that their behaviour should not be called predatory because it cannot be said that their pricing is rational only because it will eliminate competition. If competition authorities were to intervene against such behaviour, they might thwart network development and thereby harming consumers. Moreover, even if the market did develop, if there are strong network effects then in the end there is likely to be only one winning firm anyway. Taking all of these factors into account, ten Kate and Nielsen conclude that the wisest choice is to let this severe form of competition determine for itself who will survive.

b) Loss Leading

85. Sometimes a company may price one or more of its products below cost in order to entice customers to buy additional products sold by the company at higher profit margins. This is known as a loss leader strategy. For example, a grocery store may run an advertisement offering orange juice at a price below cost, reasoning that the ad will attract customers who are likely to buy other, higher margin items once they are in the store. Loss leading should be permitted as long as it is not used to destroy a competitor (or potential competitor) who sells only the product that the incumbent is pricing below cost, and thereby to reduce competition in that market.


41 United States v. Microsoft, 253 F.3d 34 (D.C. Cir. 2001). Interestingly, Microsoft’s recoupment came from preserving its monopoly in a different product market, not from ultimately raising its price in the browser market. Microsoft knew that if it allowed Netscape to remain a popular browser, Netscape would have been a threat to Microsoft’s operating system monopoly.


43 Id. at 111-112.

c) Systems Pricing

86. This strategy can be an effective way of increasing overall sales and profits when there are demand complementarities among two or more of the company’s products. Personal computer printers are often sold at relatively low prices, for instance, when the manufacturers also sell print cartridges that go with them and the margins on the cartridges are much higher. This tactic, called systems pricing, is a form of price discrimination that enables the manufacturer to earn greater revenues from customers who will use the printer more than others and thus are willing to pay more for the cartridges. Price discrimination has indeterminate effects on consumer welfare. A below-cost price on one component of a system may be part of a competitive pricing structure. As with loss leading, if an alleged predator can show that its systems pricing is not being used to destroy a competitor who sells only the product that the incumbent is selling below-cost, and thereby to destroy competition, then systems pricing should be permitted. In any case, systems pricing is ordinarily easy to distinguish from predatory pricing because a genuine systems pricing strategy should remain in effect as long as the products are on the market. In contrast, a predatory pricing strategy usually involves an obvious period of low prices followed by higher, recoupment-level prices on a single component in the system.45

d) Obsolete inventory

87. Sometimes pricing below cost may be necessary to clear out older products and make room for new stock. In general, this should be permissible.

e) Industry Downturn

88. Relatively sudden decreases in demand can create excess capacity that may cause firms to price below cost even though they have no intention to engage in predatory pricing. This is the case of a “sick industry.” Firms in such markets may decide to stay in business and absorb losses for a while. In doing so, however, they are not looking forward to a period of monopoly-level pricing; they are simply trying to survive in the hope that demand will increase in the future. Over time, if demand does not recover, some firms will leave the market in order to cut their losses, resulting in a realignment of capacity with demand. Thus, below-cost prices in a sick industry are probably not predatory, but are part of the market’s normal corrective process.

f) Cyclical Industries

89. Demand is cyclical in some industries, and firms may need to sell below cost during the slumps to maintain customer relationships, avoid shutdown and re-start costs, and/or storage costs.

g) Adjustment to a New Entrant

90. Large-scale entry can reduce each incumbent’s share of demand rapidly, thereby creating excess capacity and leading to the same situation as an industry downturn.

h) Learning Curves

91. If there is a steep learning curve for participants in an industry, a firm may decide to hold its price below its present cost in an effort to sell more units and thus work its way down the learning curve more quickly. This behaviour is actually pro-competitive when a learning curve is clearly present and prices are not held below cost long enough to harm competition. If new firms in such industries were not permitted to price below their initial costs, they might never remain competitive long enough to lower their costs and become viable.

i) The “Meeting Competition” Defence

92. Whether a dominant firm’s below-cost prices may be excused when they match, rather than undercut, a competitor’s price is yet another controversial topic related to predatory pricing. The “meeting competition” defence (“MC defence”) was developed under U.S. law in the context of discriminatory pricing under the Robinson-Patman Act, but it has also been applied in Sherman Act predatory pricing cases. In the U.S., courts have ruled that “[a] company should not be guilty of predatory pricing, regardless of its costs, when it reduces prices to meet lower prices already being charged by its competitors,” and that “to force a company to maintain non-competitive prices would be to turn the antitrust laws on their head.” More recently, a different U.S. court rejected the idea that the MC defence is available to defendants in Sherman Act cases, setting up a conflict among the circuit courts.

93. In Europe, the Commission and the Community Courts have not specifically ruled on the MC defence in a predatory pricing case. The ECJ has stated more generally that if a dominant firm is attacked, it may take reasonable and proportionate steps to protect its own commercial interests. In the United Kingdom, however, Bellamy J. rejected it in a judgment of the Competition Commission Appeal Tribunal, reasoning that dominant firms have a special responsibility not to diminish competition and must protect their commercial interests only by “reasonable and proportionate” means.

94. In Canada, the defence appears to be accepted. In Boehringer Ingelheim v Bristol-Meyers Squibb, the court decided that a below-cost price that merely matches a competitor’s price and goes no lower is non-predatory.

95. From an economic standpoint, the decisions accepting the MC defence do not appear to be well-reasoned. The key question in determining whether a price is predatory has nothing to do with its relationship to competitors’ prices. Instead, the question is whether the price is below the alleged predator’s costs, regardless of whether the price “merely” met a rival’s price.

47 *ILC Peripherals v. IBM*, 458 F. Supp. 423, 433 (N.D. Cal. 1978), *affirmed, Memorex v. IBM*, 636 F.2d 1188 (9th Cir. 1980); see also *Richter Concrete v. Hilltop Concrete*, 691 F.2d 818, 826 (6th Cir. 1982) (“it is not anticompetitive for a company to reduce its prices to meet lower prices already being charged by competitors”).
48 *United States v. AMR Corp.*, 335 F.3d 1109, 1121 n.15 (10th Cir. 2003).
50 *Napp Pharmaceutical Holdings Ltd v Director General of Fair Trading*, Case No. 1001/1/1/01, paras. 342-343 [15 January 2002].
Suppose a new entrant is more efficient than the incumbent and therefore undercuts the latter’s price. What if the entrant was counting on being able to continue undercutting the incumbent in order to maintain the demand it needed to operate efficiently? In other words, suppose that the entrant cannot reach its minimum efficient scale unless it has the demand it captures from the incumbent when the incumbent is pricing high enough to cover its own (higher) costs. If the incumbent is permitted to respond by lowering its price below its costs to match the entrant’s price, then the entrant will be prevented from gaining the minimum sales volume it needs, and would have had but for the incumbent’s below-cost pricing. Society is worse off if the more efficient competitor is forced to exit.

Another logical drawback to the MC defence is that it cannot take differences in quality and reputation into account. Thus, while an incumbent may be matching an entrant’s price, it is still doing much more than merely “meeting” the competition if its product is of higher quality or is more trustworthy in the minds of consumers than the unknown entrant’s product is. It would be difficult indeed for a court to take such differences into account. Although such exercises have been attempted, they have the appearance of being arbitrary.52

2.3 Approaches to Predatory Pricing in a Sampling of Member Jurisdictions

2.3.1 European Union

The current approach to predatory pricing in the E.U. is a blend of price-cost tests and an intent test, based on Article 82’s proscription against abuse of a dominant position. The approach was first set forth by the European Court of Justice (“ECJ”) in the AKZO decision.53 In that case, the ECJ held that prices below AVC are presumed to be illegal, prices above AVC but below ATC are illegal when coupled with intent to eliminate a competitor, and prices above ATC are conclusively legal.

The holding in AKZO suggests that prices below AVC are always unlawful, leaving no room for a defendant to offer LBJs. 1996’s Tetra Pak II decision confirms that interpretation.54 Later decisions, however, state that the AKZO presumption is rebuttable “by showing that such pricing was not part of a plan to eliminate its competitor.”55

The European Commission has refined the AKZO approach by issuing a special notice regarding the cost measure that it will use in certain industries.56 The notice explains that the AKZO framework may be too lenient in “network” industries, such as telecommunications, in which pricing at the AVC level may still be predatory due to relatively high fixed, common costs among several product lines. The notice

52 See the discussion of the Germania decision in Section 3.3.


54 Tetra Pak International v Commission (Tetra Pak II), C-333/948 [1996] ECR I-5951, para. 41 (“prices below average variable costs must always be considered abusive”).

55 Opinion of Advocate General Fennelly, Compagnie Maritime Belge Transports v Commission, C-395-960 & C-396/96P [1998], para. 127; see also Aberdeen Journals v Office of Fair Trading, [2003] CAT 11, para. 357 (despite the apparently peremptory wording of . . . AKZO . . . and Tetra Pak II . . ., we do not exclude the possibility that, exceptionally, a dominant firm may be able to rebut the presumption of abuse”).

states that the Commission will therefore use an average incremental cost measure (similar to average avoidable cost, but including common costs) instead.\textsuperscript{57}

101. A recoupment test is not currently required in the E.U. In \textit{Tetra Pak II}, the ECJ ruled that there is no need to prove that an alleged predator had even a “realistic chance” of recouping its losses, let alone a likelihood of doing so. The decision states that “[i]t must be possible to penalise predatory pricing whenever there is a risk that competitors will be eliminated.”\textsuperscript{58} This reasoning contrasts with the rationale behind the recoupment test, and that contrast may reflect different views about the purpose of competition laws. As stated earlier, the recoupment test is grounded on the premise that the primary objective of competition laws is to promote consumer welfare. Under that view, it is of no consequence that a firm’s unilateral conduct may eliminate a competitor so long as the elimination of that competitor does not result in economic harm to consumers. The ECJ’s statement, on the contrary, shows concern for the fate of competitors who may be affected by a dominant firm’s below-cost pricing, regardless of whether their elimination would affect consumer welfare.

102. That same concern for competitors can be seen in the 1998 \textit{Compagnie Maritime Belge} decision. In that case, the \textit{AKZO} elements were not met because the defendant was not pricing below ATC. Nevertheless, the ECJ held that under Article 82 it was abusive for a dominant defendant to adopt a strategy of reacting to entry by cutting prices, regardless of whether the prices remained above cost, when 1) the price cuts were reactive and selective; (2) the reduced prices matched the entrant’s prices; (3) the price cuts reduced the defendant’s profits compared to what they would have been at the previous prices; and (4) the defendant’s purpose was to eliminate the entrant.\textsuperscript{59}

103. Significantly, the Court in \textit{Compagnie Maritime Belge} acknowledged the risk that condemning above-cost pricing could shield inefficient rivals from the full effects of legitimate competition. The Court still held, however, that there was abuse in this case because the selective price cuts were aimed at eliminating an entrant and thereby eliminating competition.

104. It is clear that the ECJ was substantially influenced by the defendant’s intent to eliminate competition. The difficulty with this is that every rational firm aspires to eliminate competition. Every firm would like to be free of competitors and potential competitors so that it can gain a dominant position and reap monopoly profits. There is no certain harm in the mere intention to eliminate a competitor. What matters is how a firm goes about trying to do that. Does it do so in a way that harms consumer welfare in the long run or not?

105. Einer Elhauge has criticized \textit{Compagnie Maritime Belge} on four grounds. First, attacking above-cost price cuts is unwise because it pays for an uncertain long-term effect (the survival of relatively inefficient firms) with a guaranteed short-term loss (the loss of the defendant’s lower pricing). Restricting such price cuts may wind up increasing prices and harming consumer welfare in the majority of cases.

\textsuperscript{57} That measure was used in \textit{Deutsche Post AG}, in which the Commission found that Deutsche Post had infringed Article 82 by pricing parcel services below cost. 2001/354/EC, 5 May 2001, O.J. L125/27. Because \textit{Deutsche Post} is a fidelity rebates case and that topic was covered in a previous roundtable, it is not discussed here. \textit{See OECD, “Roundtable on Loyalty and Fidelity Discounts and Rebates,” DAFFE/COMP(2002)21.}

\textsuperscript{58} \textit{Tetra Pak II}, C-333/94 P [1996] ECR I-5951, para. 44.

106. Second, restricting selective above-cost price cuts will often penalise efficient pricing behaviour. In many markets, incumbent firms can maximise profits and output only by charging more to customers that value the product more highly, thus making them bear a greater proportion of common costs. In such markets, selective discounts to customers on the margin will augment output and welfare. Third, restricting above-cost price cuts will reduce the pressure on rivals and potential entrants to become more efficient, which will raise costs and decrease quality for society. Finally, these adverse effects are aggravated by implementation difficulties that are an inevitable consequence of trying to regulate firm pricing, output and responsiveness to entry.60

107. Predatory pricing policy in Europe is at an important point in its evolution. The Commission is currently reviewing its policy on the abuse of dominance – including predatory pricing – to determine how its policy could be made more effective.61 Meanwhile, the Court of First Instance is due to issue a decision in the Wanadoo predatory pricing case, in which the Commission went so far as to “investigate[] the possibility of recoupment, without using it as a key element in the final decision.”62 Furthermore, recoupment analysis is beginning to show up in the Member States’ decisions. In the State Railways case, the Swedish Market Court explored the likelihood of recoupment.63 Very recently, in the private AOL v. Wanadoo case, the French Competition Council rejected the plaintiff’s predatory pricing claim, noting that although the defendant seemed to be pricing below cost, it was steadily losing market share while several new entrants had gained share, indicating that the market is competitive.64

108. Some commentators have argued that recoupment should be part of the predatory pricing analysis used by the Commission and the European courts.65 Their arguments will gain weight if private plaintiffs begin to bring more predatory pricing cases before national courts in Europe. In the U.S., where the vast majority of predatory pricing claims are brought by private plaintiffs, one function of the recoupment test is to weed out frivolous and abusive claims. In Europe, as long as the Commission brings most of the predatory pricing cases, that problem is not very worrisome. If that changes, however, then the case for a recoupment test will become more formidable.

2.3.2 United Kingdom

109. The U.K. has its own competition law, the Competition Act 1998, but the legal analysis of predatory pricing in the U.K. follows the precedents set by the ECJ in AKZO and Tetra Pak II. The elements of the U.K. analysis are therefore the same as those of the E.U. analysis. The Aberdeen Journals

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62 Id. at 6; Wanadoo, COMP/38.233 (16 July 2003), appealed to the European Court of First Instance, T-340/03 (pending).
64 Decision 04-D-17, 11 May 2004, paras. 68, 71.
decision is an apt example. In that case, the publisher of a free, weekly newspaper ("the Independent") complained to OFT that another publisher, Aberdeen Journals, was selling advertising space in its free weekly newspaper at below-cost prices. OFT opened an investigation to determine whether Aberdeen Journals had abused a dominant position.

110. The Director General of Fair Trading ("DGFT") found that Aberdeen Journals did have a dominant position in the relevant market. In reaching that conclusion, DGFT conducted an assessment of entry barriers in the newspaper market. DGFT took multi-market reputational effects into account by recognising that an incumbent could raise entry barriers in several of its markets by developing a predatory reputation in one of them. Notably, the defendant publisher was active in several geographic markets. DGFT's assessment of dominance was not phrased in terms of recoupment analysis, but it could easily be viewed as contributing to that end. Market power, entry barriers, and reputational effects are all major factors that affect recoupment. They are not, however, the only considerations that should be weighed in a full recoupment analysis.

111. Next, DGFT determined that Aberdeen Journals had held its prices below ATC, and sometimes below AVC, with a handful of exceptions, for 45 months. It further found that the defendant had intentionally priced below ATC in an effort to eliminate the Independent. Aberdeen Journals failed to proffer an objective justification, so DGFT ruled that it had abused its dominant position and, accordingly, imposed a fine.

112. It is worth pondering what might have happened if the facts of this case had been subjected to a recoupment test. Would it have been adequate that the defendant had a dominant position, that there were high entry barriers, and that it appeared that the defendant could benefit in multiple markets from a predatory reputation earned in one market? The most troubling fact, from a recoupment standpoint, is that after roughly four years of below-cost pricing, the targeted publisher was still in business and had shown no signs of giving up. Consumers of advertising space were therefore enjoying quite a lengthy period of low prices with no apparent detriment, or danger of detriment, to their long-run welfare.

113. On the other hand, the finding that the defendant could obtain a strong, multi-market reputation for fighting entry means that further analysis might have solved that problem. The decision's discussion of reputational effects ended there, though, which was proper given that the analysis was addressing dominance, not recoupment. If it could have been shown, though, that supra-competitive profits would likely have been obtained in other markets as a result of Aberdeen Journals' predation against the Independent, and that those profits would have been large enough to compensate for the defendant's predatory losses, then the recoupment test would have been passed. But because that likelihood was neither proved nor disproved, it is not as clear as it could be whether consumers were helped or harmed by the Aberdeen Journals decision.

114. Predatory pricing policy in the U.K., like that at the E.U. level, seems to have arrived at an important node in its evolution. In a recent speech, John Vickers, Chairman of the OFT, stated, in the context of a discussion of a theoretical model in which a ban on selective price cuts would have ambiguous effects on welfare and consumers, that "a rule against selective price cuts could often be bad for consumers

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67 Aberdeen Journals, paras. 145-149.
68 Aberdeen Journals, Table in para. 181 (entry entitled “Review of Aberdeen Independent by Mr. Ezzat”).
in contested markets, and sometimes detrimental to consumers overall.”69 Chairman Vickers also noted that the law on abuse of market power in Europe “could now develop in either of two broad directions, with emphasis increasingly either on form or on economic effect,” and he advocated the latter approach.70

2.3.3 New Zealand

115. One of the most recent predatory pricing decisions issued by any nation’s highest court concerns a case brought in New Zealand. *Carter Holt Harvey Building Products Group Limited v. Commerce Commission* is notable, for purposes of this paper, because it shows that a) the recoupment test is gaining international momentum, and b) the same may be true of the meeting competition defence.71 The case stemmed from a price war in New Zealand’s insulation market. The defendant was a major wood fiber products manufacturer. Its subsidiary, INZCO, responded to the entry of New Wool Products (“NWP”), a manufacturer with a superior, wool-based product, by releasing its own wool-based product. The price of INZCO’s new product was higher than NWP’s, though, and INZCO continued to lose market share. Eventually, INZCO reduced its price by 50 percent, sending it below average variable cost. Sales of NWP’s product then fell sharply, and it complained to the Commerce Commission.72 The Commission filed a lawsuit alleging that the defendant’s predatory pricing strategy violated Section 36 of the Commerce Act 1986.73

116. The Privy Council took no issue with lower court findings that the defendant was in a dominant position and that it implemented its price cut in order to prevent or deter NWP from competing, or to eliminate it. The Council also accepted lower court findings that INZCO priced below its AVC. It held, however, that this was not enough to conclude that INZCO’s conduct violated the Commerce Act. There must be evidence that the defendant somehow *used* its dominance for a prohibited purpose, and use – in the context of a predatory pricing case – means price-cutting “with a view to” recouping losses by raising prices without fear of losing market share.74

117. The Privy Council determined that there was no evidence that INZCO’s pricing was implemented with a view to being able to charge supra-competitive prices in the future. Its reasoning at this juncture takes a surprising turn. Earlier in its decision, the Council had observed that, in light of other established facts, even if the defendant’s predatory pricing strategy had succeeded in eliminating NWP, another wool-based product similar to NWP’s probably would have been introduced within a short time.75 That fact

70 *Id.* at 23.
72 *Carter Holt Harvey*, paras. 11-20, 42-43.
73 At the time the events in *Carter Holt Harvey* took place, Section 36(1) provided that “No person who has a dominant position in a market shall use that position for the purpose of a) Restricting the entry of any person into that or any other market; or b) Preventing or deterring any person from engaging in competitive conduct in that or in any other market; or c) Eliminating any person from that or any other market.” Section 36 has since been amended, for the purpose of harmonisation with Australian law, to prohibit taking advantage of market power.
74 *Carter Holt Harvey*, paras. 53, 60.
75 *Id.*, para. 21.
might have played a larger role in the decision because it seems to show that entry barriers were low and that recoupment was therefore implausible.

118. Placing its emphasis elsewhere, though, the Council fashioned the equivalent of a meeting competition defence for INZCO. It found that the defendant’s pricing “was a response to competition in an area of a market which it dominated but where it had nevertheless been shown to be vulnerable.” The decision continues, “The price level had been set by NWP, and no one could sell a product comparable to [NWP’s] at a higher price and be competitive. Without the offer of a comparable product . . . INZCO was at risk of losing its market share[.]” Earlier, the decision states that “[t]he obvious response, in a truly competitive market, was to cut the price of [INZCO’s product] to a level that was competitive.”

119. In a truly competitive market, INZCO would have eventually been displaced by the more efficient NWP, or else INZCO would have had to improve its own efficiency. Thus, although it may have been an obvious response, it does not seem evident that cutting and sustaining a price below AVC in order to fend off a more efficient rival should be lawful – unless there is no likelihood of recoupment. A disquieting aspect of *Carter Holt Harvey* is that even though it holds that a recoupment test is necessary, it never really addresses the defendant’s prospects of recoupment. Instead, the Privy Council ruled that, because the defendant lowered its price to meet the competition of a low-cost entrant, and because the defendant would have continued losing market share if it had not done so, the defendant’s actions were merely aimed at preserving its share and were therefore permissible.

120. It is worth noting that the defendant’s below-AVC prices had been in place for seven months when management became aware of the Commission’s investigation and altered its pricing. It should also be noted that NWP had ceased production while INZCO’s low prices were in effect. Thus it is not clear from this part of the decision that INZCO could not have eventually elevated its prices back to their pre-entry level, regained its original market share, and thereby recouped its losses.

121. In any event, the decision is perfectly clear that a recoupment test is required under New Zealand law in predatory pricing cases. In this regard, New Zealand’s approach is now consistent with Australia’s.

2.3.4 Australia

122. Australia is another country whose highest court recently issued a predatory pricing decision. In fact, it was the High Court’s first statement regarding an allegation of predatory pricing. In *Boral Besser Masonry Ltd v Australian Competition and Consumer Commission*, the High Court ruled that the recoupment test is mandatory. In addition, the decision highlights the anomaly mentioned above that some competition laws do not seem well-equipped to catch predators who are not dominant at the time they carry out their predatory campaign, but acquire dominance later as a result of their predatory actions. Rather, such laws seem to be effective only when the predator can be said to be able to execute a successful predatory strategy because it was dominant in the first place.

76 *Id.*, para. 68. This is an interesting conclusion. Ordinarily, one would expect that when a firm can be characterised as “vulnerable,” when lower-cost entry has already occurred, and when the court has found that even if the new entrant were eliminated, another entrant probably would have appeared within a short time to take its place, then the firm would not be considered dominant.

77 *Id*.

78 *Id.*, paras. 16-20.

79 See note 25 above.
123. In *Boral*, it was alleged that the defendant had violated Section 46 of the Trade Practices Act 1974 by setting the prices of its concrete masonry products below their avoidable cost of production for 30 months in order to eliminate a more efficient new entrant, C&M. The ACCC argued at an advanced level, contending that Boral recognised that its rival’s ability to fund a price war by borrowing in capital markets did not match Boral’s own ability to do so, and that Boral desired to benefit from gaining a predatory reputation that would deter entry in the future.

124. The case turned on whether Boral would be able to recoup its predatory losses once C&M had been eliminated. The trial court had determined that Boral lacked the market power necessary for recoupment because structural barriers to entry in the relevant market were too low. On appeal, the Full Court of the Federal Court accepted the argument that a showing of recoupment was not necessary under Section 46. It is sufficient, that court ruled, to show that a defendant had the ability to price below avoidable costs for an extended period and to eliminate a competitor, regardless of whether the firm also lacked the ability to raise prices high enough to recoup losses. The High Court reversed that decision:

> 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 price 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.

125. One would like to have seen a phrase such as “or afterward” at the end of that quotation, which would have indicated that Section 46 could capture conduct by a predator who acquires substantial market power as a result of its predatory behaviour. That was not possible, however, because Section 46 is predicated on the defendant firm already having substantial market power at the time of the conduct in question. Justice McHugh was well aware of this problem but, unless and until the law is changed, even the High Court cannot solve it.

2.3.5 United States

126. The United States is one of the jurisdictions that have not yet decided which measure of cost is best to use in price-cost tests, at least not at the Supreme Court level. In *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, the Court declined to adopt a specific cost measure and ruled instead that a plaintiff “must prove that the prices complained of are below an appropriate measure of its rival’s costs.” In addition, the Court established the requirement that a predatory pricing plaintiff must prove that there is a dangerous probability that the defendant will recoup “its investment in below-cost prices.”

127. Implicit in the Court’s approval of the general concept of using price-cost tests is the rejection of the idea that above-cost prices can ever be deemed predatory. In the Court’s view, predatory pricing requires pricing below the defendant’s costs not because prices at or above cost would necessarily guarantee an absence of anticompetitive pricing, but because that standard leaves intact the crucial role of price-cutting as a legitimate means of competition. In other words, the Court made a compromise, knowing that its ruling would allow some conduct that could have been classified as “predatory” to go unpunished, but deciding that it was more important to ensure that the antitrust laws themselves did not chill reasonable, competitive conduct.

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80 *Boral*, Judgment of Justice McHugh.
81 *Id.* ("S46 is ill drawn to deal with claims of predatory pricing under these conditions.")
128. Prohibiting price cuts that result in above-cost pricing would trade a clear, present benefit to consumers for uncertain future benefits, and it is preferable to encourage prices to move closer to efficient, competitive levels, despite some risk that they could have gotten even closer. Of course, that same point could be used to defend below-cost prices, and indeed the Court recognized that, at least in the short term, “[l]ow prices benefit consumers regardless of how those prices are set.” But the Court also made the distinction that unlike below-cost pricing, low but above-cost pricing may exclude a competitor simply because of “the lower cost structure of the alleged predator, and so represents competition on the merits.” Finally, attempting to identify anticompetitive above-cost pricing may be “beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price cutting.”

129. Regarding recoupment, Brooke Group relied on the earlier Matsushita decision, which imposed the recoupment requirement on predatory pricing plaintiffs because “[t]he success of any predatory scheme depends on maintaining monopoly power for long enough both to recoup the predator’s losses and to harvest some additional gain.” Picking up on that theme, the Court further explained its insistence on proof of a likelihood of recoupment:

Recoupment is the ultimate object of an unlawful predatory pricing scheme; it is the means by which a predator profits from predation. Without it, predatory pricing produces lower aggregate prices in the market, and consumer welfare is enhanced. . . . [U]nsuccessful predation is in general a boon to consumers.

That below-cost pricing may impose painful losses on its target is of no moment to the antitrust laws if competition is not injured: it is axiomatic that the antitrust laws were passed for the protection of competition, not competitors[.] 87

130. The scarcity of successful predatory pricing lawsuits in the U.S., despite the relatively high number of claims brought there, suggests that the current tests in that country may be too harsh. Not only have plaintiffs had a difficult time satisfying the recoupment test, they have also struggled with the Areeda-Turner test. Although the latter test has influenced virtually every American predatory pricing case since the authors wrote their 1975 article, seven years passed before a plaintiff managed to satisfy a court that the test had been met. Furthermore, since 1993’s Brooke Group decision, no predatory pricing claim has been successful. This has been due, in large measure, to the influence of Chicago-school thought. With post-Chicago school scholarship gaining at least a mention in recent decisions, however, plaintiffs’ fortunes may begin to change.

83 509 U.S. at 223.
84 Id.
85 Id.
87 Brooke Group, 509 U.S. at 224 (emphasis in original).
88 See D&S Redi-Mix v. Sierra Redi-Mix and Contracting Co., 692 F.2d 1245 (9th Cir. 1982).
2.3.6 A Pragmatic Approach to Predatory Pricing Based on Promoting Consumer Welfare

131. In view of the theories, literature, and jurisprudence discussed above, some suggestions may be made about analysing predatory pricing cases.

- **Use Average Avoidable Cost in Price-Cost Tests.** As is already widely agreed, there should be a price-cost test. Its purpose should be to determine whether an alleged predator is pricing in a manner that could enable it to exclude an equally or more efficient competitor. Average avoidable cost is the predatory pricing benchmark of choice for most economists today.\(^{90}\) For that reason, as well as reasons discussed above, it is the recommended measure here, as well.

- **Use a Recoupment Test.** In light of Australia’s *Boral* decision, New Zealand’s *Carter Holt Harvey* decision, established U.S. law, and early indications that recoupment may become a more frequent part of the European Commission’s analysis, there already seems to be an international trend in favour of the recoupment test. In fact, the trend appears to be substantially stronger today than it was in 2000, when scholars first began to notice it.\(^ {91}\) For reasons already discussed, it is also recommended here.

- **Consider Legitimate Business Justifications.** It should be possible for a defendant who fails the price-cost and recoupment tests to escape condemnation if it can establish that there were special circumstances that render its pricing reasonable. A proffered justification can be legitimate only if the firm would have set the same prices even if doing so would not have harmed competition. Therefore, the company should have to show either that circumstances forced it to price below cost, or that its prices were part of a normal business practice involving only a brief period of losses. If competition agencies have contrary evidence showing that the defendant’s intent was actually predatory, then the agencies should use that evidence in rebuttal.

- **Do Not Recognise the “Meeting Competition” Defence.** The meeting competition defence is neither economically sound nor workable in practice without being arbitrary. It should not be allowed. Instead, the agency’s inquiry should focus on the relationship between the defendant’s own prices and costs.

2.4 Resale-Below-Cost Laws

132. Having reviewed the basic theory and some of the law on predatory pricing, it is appropriate to address the specialised laws on below-cost retail pricing that some countries have. These laws do not replace, but rather coexist with the more general competition law governing the abuse of a dominant position. The resale-below-cost statutes do not necessarily require other elements of proof (besides a retail price below the overall wholesale costs paid by the retailer), such as evidence of a dominant position or predatory intent, though some do. For example, Germany’s Act Against Restraints of Competition (“AARC”) prohibits a business with “superior market power in relation to small and medium-sized competitors from offering goods or services not merely occasionally below its cost price, unless there is an objective justification.”\(^ {92}\) This provision seems at least to resemble the analysis in certain predatory pricing frameworks, given that it considers the relationship of price to cost, the degree of the defendant’s

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\(^{92}\) Act Against Restraints of Competition, Section 20(IV)(2).
market power, and possible justifications. As it has been applied, however, the AARC is even stricter than
the stern predatory pricing standards used in Article 82 cases.

133. In December 2002, the German Supreme Court ruled that retailer Wal-Mart had violated the
AARC by setting the price of certain food items below its purchase cost. Wal-Mart was involved in a price
war with two major competitors. Eventually, Wal-Mart lowered its price on sugar below its purchase cost.
It also held its milk prices steady despite a sudden spike that pushed costs above those prices.

134. First, the Court held that under the AARC, it did not matter whether there was any harmful effect
on competition. The Act requires only that the defendant have “superior” market power, that it priced
below cost, and that there be no objective justification. The Court then determined that Wal-Mart had the
superior market power required by the AARC. Superior market power in relation to small and medium-
sized competitors, however, is very different from dominance. The AARC does not inquire whether a
defendant has superior market power in relation to large, established competitors, two of which Wal-Mart
was confronting. That latter fact alone would probably prevent Wal-Mart from being considered dominant,
and thus would put its pricing beyond the reach of Article 82.

135. Finding that Wal-Mart’s prices were indeed below its cost, and that there were no objective
justifications, the Court upheld an earlier decision ordering Wal-Mart to increase its prices so as to avoid
driving smaller shops out of business.

136. It is difficult to rationalise this decision on consumer welfare grounds since there was no finding
that competition was harmed or likely to be harmed. The Court very clearly based its decision on the
finding that Wal-Mart’s conduct might have harmed smaller competitors. The policy objective of the
AARC therefore seems to be to insulate small competitors from the effects of below-cost pricing, even if
harm to small competitors would not necessarily mean harm to competition, and even if the below-cost
pricing was therefore beneficial to consumers.

137. Title IV of France’s competition law contains even stronger controls on below-cost retail pricing
than the AARC does. Title IV nominally concerns “transparency, practices that restrict competition, and
other prohibited practices.” Like Germany’s law, however, it is closer to a fair dealing statute because it
addresses practices that do not necessarily harm competition in order to protect small businesses. One
provision imposes penalties for setting retail prices below purchase cost, which is defined as invoice price
plus taxes and transport costs. There is no need to show superior market power, dominance, any
likelihood of exclusion, or any effect on competition whatsoever. There are exceptions for changes in
season, style, or upstream price levels. Small resellers are allowed to meet the price of another seller in the
same area, but only if the other seller’s price is legal. Furthermore, prices may be cut for food products
that are about to spoil, but the lower price cannot be advertised outside the store. Again, it is difficult to
justify this law on consumer welfare grounds because it prevents consumers from enjoying certain low
prices even when those prices would not have damaged competition.

138. Another example is Ireland’s Restrictive Practices (Groceries) Order of 1987, which prohibits
selling groceries at prices below the net invoice prices paid for the goods. Like its counterpart in France,
this law does not consider any market structure conditions or effects on competition. The Irish
Competition Authority has spoken out in favour of repealing the Act, arguing that it prohibits legitimate

loss-leading behaviour and that it enables upstream distributors to set minimum resale prices downstream. As of this writing, however, the Order remains in effect.94

3. Predatory Foreclosure in the Airline Industry

139. There were five different airline predation cases around the world in 2002 and 2003.95 Each of them involved very similar allegations of predatory conduct: an incumbent, confronted with an entrant offering lower fares, lowered its own fares and increased its capacity in an effort to eliminate or discipline the entrant. The outcomes of these cases, however, differed markedly. This makes the 2003 airline cases quite useful for studying the implications of several different approaches to predation.

3.1 The American Airlines Case

140. In United States v. AMR Corp., the government alleged that American Airlines (“AA”) had violated the Sherman Act by expanding its capacity on routes that low cost carriers (“LCCs”) had entered, such that the incremental costs incurred in the expansion were not covered by the incremental revenue it added. Summary judgment for AA was affirmed on appeal on the bases that the government had not presented valid measures of incremental cost, and AA had not priced below its route-wide average variable costs.96 The case is significant because the court a) treated a predatory capacity expansion claim in exactly the same manner as a predatory pricing claim; b) was willing to consider newer theories about the appropriate costs to use in price-cost tests, even though it found that those costs were not correctly calculated in this case; and c) refused to apply the meeting competition defence.

141. AA carried about 70 percent of domestic passengers at Dallas/Fort Worth International Airport (“DFW”), one of its biggest hubs. LCCs, who generally have lower costs than the major carriers, had begun to make inroads on some routes departing from or arriving at DFW by undercutting AA’s fares. At first, AA responded to these entrants by matching their fares on a limited number of seats. But when it began to sense that an LCC might be winning enough business to form a hub of its own at DFW, AA targeted the LCC’s route, adding many more fare-matching seats by bringing in more planes – and in some cases larger planes – from other routes in AA’s system. AA’s CEO knew this strategy “would definitely be very expensive in terms of AA’s short term profitability[.]. If you are not going to get them out then no point to diminish profit.”

142. By pursuing its capacity-expanding strategy on certain routes, AA ignored its own planning models, which had previously shown that such a plan would be unprofitable. In each case, the evidence showed, the competing LCC was unable to establish a presence, opted to move its operations, or ceased


95 One of the matters, Australian Competition and Consumer Commission v. Qantas, involved allegations that Qantas had misused its market power on a certain route after Virgin Blue Airlines had entered. This case is not discussed here because the ACCC ended its enforcement action after determining that, during the time since the action began, the airlines market had changed and competition had been enhanced. See ACCC Press Release, “Qantas Airlines Matter Discontinued,” 21 November 2003, available at www.accc.gov.au/content/index.phtml/itemId/402657/fromItemId/378016

96 335 F.3d 1109 (10th Cir. 2003).

operating altogether. Once the competitor was no longer a threat, AA returned to its former strategy by reducing capacity and raising fare prices until they were comparable to the former levels.98

143. The government’s argument focused on the exclusionary effect of AA’s capacity expansion rather than its pricing per se. Essentially, what allegedly killed competition was not just that AA matched the entrants’ fares, but that AA inundated the market with available seats at those fares. Facing so much oversupply in the affected routes, the LCC’s lost volume and consequently could not survive.

144. Furthermore, what made the inundation unlawful, according to the government, was that it cost AA more than it generated in revenue, and it was rational only because AA expected it to eliminate competition, thereby enabling AA to recover its losses later. That recoupment was plausible because AA hoped to benefit from a predatory reputation not only on the routes where it had added the excess capacity, but on other routes where its predatory reputation would deter competition.

145. The government’s description of AA’s money-losing plan was crafted so as to discourage application of the Areeda-Turner test, which would have compared all of the variable costs (and none of the fixed costs) with all of the revenues across the entire supply of seats on the routes in question. Instead, the government wanted the court to compare the costs and revenues that were associated only with the incremental capacity that AA added on those routes as part of its allegedly predatory strategy. In other words, the government wanted to use an avoidable cost test.99

146. The district court was not prepared to take that unfamiliar step, so it chose to apply the Areeda-Turner test over the entirety of AA’s operations on the relevant routes. Under that test, it found AA’s actions to be lawful and granted summary judgment for AA.100

147. The appellate court was unreceptive to the government’s attempt to focus on the illegality of AA’s capacity expansion, as opposed to its price cuts. It held that “prices and productive output are two sides of the same coin,” and that “these actions must be analyzed in terms of their effect on price and cost. Thus, . . . the government must meet the standards of proof for predatory pricing cases established in Brooke Group.”101 However, the court did open a new door for the government by holding that AVC is not the only possible appropriate measure of cost in all cases. It then turned its attention to four incremental cost measures proposed by the government without criticising the general concept of using an incremental cost measure. This suggested – but did not state outright – that the court found the principle of examining only the allegedly predatory range of output to be acceptable.

148. At this point things began to go badly for the plaintiff, as the court proceeded to find flaws in each of the four proposed incremental cost measures. Each of them was based on data from AA’s own accounting system. In a nutshell, two of the tests used cost accounts that allocated 97 to 99 percent of AA’s total costs down to the individual flight level. These were rejected on the basis that they included some costs that would not have been avoidable even if AA had abandoned the entire route. The other two tests used cost accounts that allocated only 72 percent of AA’s total costs down to the flight level. One

98 AMR, 335 F.3d at 1112.
100 AMR Corp., 140 F. Supp.2d at 1199, 1202.
was rejected because it amounted to a short-run profit maximisation test. The other was rejected because it contained four arbitrarily allocated variable common costs that the appeals court apparently found on its own, without the help of either the defendant or the trial court.\footnote{See Greg Werden, “The American Airlines Decision: Not with a Bang but a Whimper” (September 2003), U.S. Department of Justice Antitrust Division Working Paper No. EAG 03-8, available at http://ssrn.com/abstract=446262, 8.}

149. Clearly, it made no difference to the appeals court that AA had relied on the cost measures in its accounting system to make strategic decisions. What mattered to the court was simply whether the government’s proposed cost measures accurately reflected average avoidable cost.\footnote{AMR Corp., 335 F.3d at 1119-20.} Finding that none of them did, it relied on the uncontested evidence that AA’s prices never fell below AVC and therefore affirmed the trial court’s order granting summary judgment.

150. There was one other bright spot for the government. The district court had ruled that even if AA had priced below cost, it would still have granted summary judgment because AA had merely met the prices of its competitors, not undercut them. The appellate court disapproved that ruling, deciding instead that the meeting competition defence is inapplicable in the context of a monopolisation claim.\footnote{AMR Corp., 335 F.3d at 1021 n.15.}

151. Intuitively, the outcome in \textit{AMR} seems misguided from an enforcement perspective. AMR had a roughly 70 percent market share in the relevant market. It lost money by adopting a plan that had no chance of being profitable unless it eventually eliminated entrants, and it did eliminate them even though they were more efficient than AMR. Finally, AMR raised its price and reduced its capacity after its rivals exited. Yet, in the end, the fact that AMR’s conduct never resulted in a price below AMR’s overall AVC enabled it to prevail. This case exemplifies the level of difficulty that exists in bringing a successful predation case in the U.S. today.

152. On the positive side, \textit{AMR} shows that at least one appellate court in the U.S. is willing to consider newer thinking on predation analysis. The court acknowledged that “recent scholarship” has shown that predation can be profitable, “especially in a multi-market context where predation can occur in one market and recoupment can occur rapidly in other markets.” Furthermore, the court’s careful attention to the AAC test suggests that it might have validated the government’s claim if there had not been a quirky problem with the cost data.

153. There was no such problem in the next case.

3.2 \textit{The Air Canada Case}

154. Canada has taken an unusually precise legislative approach to predation in the airlines industry. Special regulations (the “Airline Regulations”) were adopted in 2000 because of concerns about Air Canada’s ability to abuse market power when it became, by far, the largest domestic airline due to its acquisition of Canadian Airlines. The new regulations made it unlawful for an airlines company to operate or increase capacity at fares that do not cover the avoidable cost of providing the service.\footnote{Regulations Respecting Anti-Competitive Acts of Persons Operating a Domestic Service (the “Airline Regulations”), paras. 1(a) and (b); see \textit{Commissioner of Competition v. Air Canada} (2003), 26 C.P.R. (4th) 476, [2003] C.C.T.D. No. 9 (Competition Tribunal), para. 21.}
155. In *Commissioner of Competition v. Air Canada*, Canada’s Competition Tribunal was called upon to decide whether Air Canada had violated the Airline Regulations and section 79 of the Competition Act by engaging in behaviour virtually identical to the conduct at issue in the *AMR* case.\(^{106}\) It was alleged that Air Canada had responded to the entry of two LCCs on some routes with a blended strategy of matching the entrants’ fares and increasing capacity in a manner that did not cover the avoidable cost of operations on the affected routes. The Tribunal split the proceedings into two phases and so far has ruled only on the issue of whether Air Canada failed the AAC test on two sample routes.\(^ {107}\)

156. First, the Tribunal held that the appropriate increment of output to examine in the avoidable cost test is an individual, one-way flight, as opposed to examining an entire route.\(^ {108}\) This is the same approach that the plaintiff in *AMR* was advocating.

157. The Tribunal also held that avoidable costs consist of the variable costs, and the product-specific fixed costs that are not sunk, which can be avoided by not producing the good or service in question.\(^ {109}\) In identifying which costs are avoidable, the issue of redeployment opportunities came up. Essentially, the question is whether the fact that a resource could have been profitably redeployed to another flight following the cancellation of a given flight renders any of the costs associated with that resource avoidable. For example, if the aircraft, pilots and flight crew on a cancelled flight can be profitably reallocated to other flights (including newly scheduled ones), then are their wages avoidable?\(^ {110}\) After finding that Air Canada has many such opportunities for profitable redeployment of its resources, the Tribunal answered that question in the affirmative.\(^ {111}\)

158. The government took the position that all of Air Canada’s costs, except those that can be characterised as overhead, are avoidable within a time frame of three months. It also took the position that income known as the “beyond contribution” or as “follow-on” revenues should not be included in the calculation of Air Canada’s revenues for purposes of comparing them with avoidable costs.\(^ {112}\) Instead, according to the government, such income could be considered in a later analysis of legitimate business justifications. The Tribunal agreed with both positions, though it shortened the time frame to one month.\(^ {113}\) By agreeing to include all of the non-overhead costs, the Tribunal seems to have taken a different approach from that of the *AMR* court, which rejected one of the plaintiff’s proposed tests because it included arbitrarily allocated common costs.

159. The beyond contribution is a means of taking into account the demand complementarities present in the hub and spoke systems used by major airlines. A passenger may buy a ticket, for example, that takes

\(^{106}\) Section 79 concerns abuse of a dominant position.

\(^{107}\) Because some aspects of this case are still pending, the discussion here will be limited to a neutral summary of the Tribunal’s decision.

\(^{108}\) *Air Canada*, paras. 155-165

\(^{109}\) *Air Canada*, para. 76.

\(^{110}\) Note that this is not a question of profit maximisation. It is simply a question of whether, by cancelling a flight, the defendant could have shifted the resources made idle by that cancellation to an activity that earned any positive amount of profit (without necessarily earning the maximum profit possible).


\(^{112}\) *Air Canada*, para. 35.

\(^{113}\) *Air Canada*, para. 337.
her from A to C via hub B, where she switches onto a different aircraft. She has paid only one fare, but there are two routes on her trip. Flying from A to Hub B is a way for the airlines company to consolidate traffic and offer service to C. In other words, if it were not for the company’s ability to provide a flight from A to B, it might never have been able to attract a passenger going to C because there might not be enough volume for the company to justify direct flights from A to C. Thus, a measure of the conceptual profit from the B to C flight is attributed to the A to B flight (and vice-versa).114

160. Ultimately, the Tribunal found that Air Canada had operated or increased capacity at fares that did not cover its avoidable costs on two routes.115 It will be interesting to see whether the avoidable cost measure gains acceptance by Canadian courts in predation cases arising in other industries, as well.

3.3 The Germania Case

161. The analysis in this case was completely different from those used in AMR and Air Canada, and shows a more activist posture by both the competition agency and the courts. The Germania decision reflects an uncommon willingness to force incumbents to make room for entrants and to dictate the terms of that accommodation with precision.

162. When Germania Fluggesellschaft mbH (“Germania”) entered one of Lufthansa’s routes with a much lower one-way fare of 99 euros, Lufthansa responded with a 100 euro economy fare, which it eventually raised to about 105 euros. Unlike American Airlines and Air Canada, Lufthansa did not raise its capacity. After reviewing a complaint from Germania, the Federal Cartel Office (“FCO”) concluded that Lufthansa had abused its dominant position because its economy fare did not cover its average total costs. Later, the Düsseldorf Court of Appeals affirmed.116

163. When it calculated Lufthansa’s ATC, the FCO included foregone revenues as a cost component. The interesting thing about this step is that the foregone revenues were calculated based on the theory that by offering a reduced fare, Lufthansa was losing money because some passengers who would have paid the higher fare would now prefer the economy fare. This concept is quite different from the foregone opportunities that were considered in the Air Canada decision, which concerned the prospect of deploying resources more profitably on other routes. Under the Germania approach, Lufthansa was penalised for failing to charge all that the market would bear. Furthermore, this method appears to have a double-counting effect against the defendant. Not only were revenues reduced when customers who would have paid full fares paid economy fares instead, but the FCO increased its approximation of the defendant’s cost by the same amount, as well.

164. The FCO concluded that Germania needed to take some passengers away from Lufthansa in order to survive. It further concluded that Lufthansa’s nearly matching fare, in combination with its superior quality (in the form of frequent flier miles, free newspapers, and higher flight frequencies, reputation, etc.), was preventing Germania from doing that. In other words, even though Lufthansa’s fare was slightly higher, in effect it was still undercutting the new entrant.

114 Beyond contributions were taken into account by both parties in AMR.
115 Air Canada’s failure of the AAC test, however, has not yet resulted in a finding that Air Canada had abused a dominant position. Other elements, including dominance and a practice of anti-competitive acts, would have to be established at the Phase Two hearing.
The FCO then implemented a remedy designed to ensure that Germania was able to compete. Monetary values were assigned to each of Lufthansa’s differentiated services, based on the perceived value of those services to customers, not on their actual costs. Ultimately, the FCO decided that, in order to be comparable to Lufthansa’s offering, the Germania flight had to cost 35 euros less. It therefore ordered Lufthansa to keep its fares at least 35 euros above Germania’s, up to a maximum of 134 euros each way, for two years.

On appeal, Lufthansa relied heavily on the meeting competition defence, and the Düsseldorf Court of Appeals agreed that it is applicable in abuse of dominance cases. Nevertheless, it ruled that in this case, despite the fact that Lufthansa’s fares were nominally higher than Germania’s, the defence could not be claimed. The court agreed with the FCO that when Lufthansa’s differentiated services were taken into account, Lufthansa had actually undercut Germania’s fare. The Court of Appeals also approved of the remedial concept of quantifying Lufthansa’s higher quality, but was not satisfied with the FCO’s calculation. It therefore adjusted the differential figure from 35 euros to 30.5 euros.

This decision suggests that the FCO and the Court of Appeals were following a policy based on the principle that more competitors are always better for competition, regardless of the means taken to ensure their survival. By using the most aggressive of all cost measures (ATC) in its price-cost test, counting price cuts as opportunity costs, and assigning values to differentiated services,118 the Germania analysis makes it difficult for incumbents to do anything other than accommodate entrants, regardless of whether they are more efficient. Moreover, by pegging the remedy to Germania’s entry price without inquiring whether it could have been profitably lowered (and still covered Germania’s costs), consumer welfare could be harmed. Other LCCs, with this analysis in mind, could enter other routes at prices well above their own costs, but below Lufthansa’s, in the hope that they will be similarly shielded from Lufthansa’s competition.

### 3.4 The Spirit Airlines Case

This decision is noteworthy because it used the more conventional AVC test rather than the AAC test, and because it refused to allow the meeting competition defence. Mirroring the allegations in AMR and Air Canada, Spirit Airlines sued Northwest Airlines, alleging predatory capacity expansion and pricing on two routes involving Northwest’s hub in Detroit.119 Spirit, an LCC, had begun service on the two routes by undercutting Northwest’s fares. The latter responded by adding new capacity and matching Spirit’s low fares on a number of seats. Subsequently, Spirit exited the routes, whereupon Northwest reduced its capacity and raised its fares.

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117 After the FCO issued its decision, several other LCCs entered the market for a number of domestic routes in Germany, causing fares to decline. That led Lufthansa to implement a new fare system for all of its domestic flights, not just for those routes in which it is not dominant. This development suggests that Lufthansa’s fare reduction on the Germania route in question may have been due to legitimate competition, not a predatory strategy. The FCO appears to have reached the same conclusion, because in September 2003 it set its decision aside and settled the matter with Lufthansa while part of it was still pending before the Düsseldorf Court of Appeals. See Ulrich Quack & Rüdiger Schütt, “Lufthansa/Germania: German Federal Cartel Office Takes Tough Approach,” ABA Section of Antitrust Law Spring Meeting Course Materials, 31 March 2004, p. 962.

118 Morrison has argued that this approach is likely to be inaccurate, arbitrary and difficult to administer. William Morrison, “Dimensions of Predatory Pricing in Air Travel Markets,” 10 Journal of Air Transport Management 87, 92 (2004) (“using a demand-based valuation of the [incumbent’s] additional services requires that the competition authority is able to uncover the distribution of consumer preferences over the particular bundle of services offered . . . Serious errors in this calculation could occur[].”)

One of the defences Northwest claimed was the meeting competition defence. The court soundly rejected it on the basis that it would allow a predator to price below its own costs in order to match a rival, even if the rival were more efficient and pricing at what was, for it, a profitable level. Therefore, the court reasoned, to allow the defence would be to allow exactly the kind of predatory conduct that the law aims to prevent. Furthermore, in contrast to Germania, the Spirit Airlines court had no confidence in its ability to determine whether Northwest had really “matched” Spirit’s fares or not, given the differentiation between services offered by the two airlines.

Nevertheless, the court granted summary judgment to Northwest. Deeming AVC to be the most appropriate measure of cost, it found that there had been only one month in which the defendant did not pass that test – even when Northwest’s “beyond contribution” revenues were not taken into account. Yet there is something unsatisfying about this analysis.

By adopting the AVC test, the court had reduced plaintiff’s chances of success substantially compared to what they would have been under the AAC test. First, the court was comparing Northwest’s route-wide revenues and costs, rather than just the incremental figures related to the flights Northwest had added. If Northwest was flying relatively more empty seats on the newly added flights, then performing the price-cost calculation across all of its flights on the relevant routes may have helped it to disguise losses it was incurring on the added flights alone. Second, by using AVC rather than AAC, the court was not taking any product-specific fixed costs into account. Thus, the AVC test may have been comparing higher revenues and lower costs than the AAC test, which naturally works to the disadvantage of the plaintiff.

3.5 Lessons From the Airlines Cases

There are a few observations that can be made based on this review of the airlines cases. First, different jurisdictions remain divided about which cost measure to use. There is sometimes no clear standard of choice even within a jurisdiction, as illustrated by the different tests considered in the U.S. cases AMR and Spirit Airlines.

Second, casting a complaint in terms of “predatory capacity expansion” rather than predatory pricing does not change the basic framework of analysis. Courts still apply price-cost tests as in a predatory pricing case. Emphasizing the capacity expanding aspect of the defendant’s strategy may, however, help to focus the court’s attention on the incremental segment of output that is allegedly losing money. In other words, characterising the incumbent’s behaviour as predatory capacity expansion encourages the use of the AAC test. That test helps to prevent predators from hiding their predatory conduct in the route-wide averages measured in AVC and ATC, which take into account the more profitable segment of output that existed before the allegedly unprofitable capacity expansion. There is no reason this approach could not, or should not, be used in predation cases in other industries.

Third, the AAC test seems conceptually sound, but a consensus has not been reached on what costs are avoidable and what costs are not. That much is clear from a comparison of AMR and Air Canada. Similarly, there does not appear to be a common view yet on whether beyond contribution revenues should be considered.

Finally, some jurisdictions still allow the meeting competition defence in predation cases, while others have seen through it and refuse to apply it.
4. Other Forms of Non-price Predation

4.1 Introduction

There is quite a large variety of conduct that could be labelled “non-price predation,” including bundling, tying, refusals to deal, refusals to license intellectual property, predatory innovation, pre-emptive investments, etc. Covering all of those subjects comprehensively in a note that also strives to provide a thorough background on predatory pricing is not practicable. Instead, this paper has singled out predatory capacity-building because that conduct figured prominently in the airlines cases. In that context, the analysis turned out to be much the same as it is for predatory pricing. To provide a sense of the nature of other types of non-price predation conduct, a few additional subjects are discussed briefly here. It is suggested, though, that non-price predation should be addressed in a future roundtable if the subject generates sufficient interest.

4.2 Raising Rivals’ Costs

Raising rivals’ costs (“RRC”) is a powerful form of non-price predation, but it did not receive much attention in economics literature until the early 1980s. A predator employing an RRC strategy attempts to disadvantage its competitors by increasing their costs. Sometimes the predator will have to increase its own costs in order to execute this strategy, but not always. The strategy will be profitable if the predator succeeds in raising the market price by more than it raises its own average total cost (assuming a steady level of output).

RRC is usually a more appealing strategy than predatory pricing because RRC can inflict damage on a competitor without necessarily requiring that the incumbent incur losses itself. Furthermore, the recoupment phase occurs at roughly the same time the RRC strategy is put into effect, rather than at some uncertain point in the future. For these reasons, some commentators have stated that “the RRC analyses . . . make clear that cost-raising and exclusionary strategies should be the predominant antitrust concern about a dominant firm’s behaviour.” On the other hand, RRC is not always an available option, whereas anyone can at least attempt a predatory pricing strategy.

Like predatory pricing, RRC is not necessarily harmful from a consumer welfare standpoint. It harms competition only if it enables the predator to charge a supra-competitive price. But unlike predatory pricing, RRC does not lend itself to intuitively obvious methods for detecting competitive harm, such as price-cost and recoupment tests. Some competition authorities have specific guidelines that cover conduct involving raising rivals’ costs. Canada’s Competition Bureau, for example, has given notice that it will view an act by a dominant firm as an abuse if that act raises rivals’ costs or reduces rivals’ revenues for a predatory, exclusionary, or disciplinary purpose. There is, however, no specific process in the Canadian guidelines for ascertaining whether there has been (or will likely be) any harmful competitive effects from the dominant firm’s RRC strategy. Instead, there are many examples of RRC strategies that would be viewed as anti-competitive acts. Unless and until there is a consensus among economists on a general test for detecting harmful RRC strategies, Canada’s approach seems advisable.


4.3 Exploiting Information Asymmetry

Sometimes the incumbent in a market has an informational advantage over potential entrants due to its greater experience and established contacts with suppliers and customers. This advantage flows in two directions, i.e., the incumbent might not only have better access to market information, but it might also be viewed as a more reliable source of information than newcomers are. This creates the potential for incumbents to create fear, uncertainty and doubt in the minds of others – including potential entrants, customers, and investors or creditors – regarding the feasibility of profitable entry. For example, an incumbent might send misleading signals about market demand and its own costs to deter competitors or make it harder for them to raise capital. In addition, an incumbent might spread doubt among customers about an entrant’s viability or quality.

Product announcements were challenged in several older cases that collectively illustrate the challenges that an agency would face in trying to develop guidelines in this area. In some cases, the plaintiff complained that an announcement violated antitrust laws because it was made too far in advance of the actual release of the new product. In others, plaintiffs complained because the announcements were not made far enough in advance of the product release. The courts were being asked, in effect, to define the permissible time period in which companies may announce their new products. Drawing a parallel to predatory pricing analysis, a court would somehow have to decide whether the timing of the announcement would have differed if the defendant had believed there was no possibility of harming competition by making the announcement at that time (or at all).

Unfortunately, firms choose the timing of their product announcements for all sorts of plausible reasons, some of which may be competitive and some of which may not. Furthermore, some of the reasons will push the firm to announce earlier, and some will influence the firm in the opposite direction. For example, it is possible that, by announcing a product early, an incumbent intends to damage an entrant by encouraging buyers to wait until the incumbent’s new model is released. At the same time, the incumbent may simply wish to alert companies who produce complementary goods far enough in advance for them to develop new products that work with the incumbent’s product. Or the incumbent may wish to keep its new

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127 Berkey Photo, Inc. v. Eastman Kodak Corp., 603 F.2d 263 (2d Cir. 1979); ILC Peripherals Leasing Corp. v. IBM, 458 F. Supp. 423, 436 (N.D. Cal. 1978).
product a secret for as long as possible because it wants to produce and sell all the complementary goods itself. Such conflicting possibilities have led some scholars to give up on a rule and conclude that any timing of a product announcement should be presumed lawful.\footnote{Janusz Ordover & Robert Willig, "An Economic Definition of Predation: Pricing and Product Innovation," 91 Yale Law Journal 8, 53 (1981).}

5. Conclusion

185. Current economic theory, if not actual corporate behaviour, leaves little reason to believe any longer that predation rarely or never occurs. It is a serious threat to competition and consumer welfare that warrants scrutiny from competition agencies and courts, albeit very cautious scrutiny. Even though scholars have advanced the discourse over the past several years, they have yet to devise a generally applicable, simple set of rules that distinguishes harmful predation from legitimate competition. Unless agencies proceed quite carefully when considering possibly predatory conduct, therefore, they may inadvertently discourage welfare-enhancing competitive behaviour.

186. This paper has sought to clarify the basics of the ongoing debate on predation, to describe recent trends in enforcement approaches around the world, and to make recommendations as to what presently seem to be the most sensible ways to test for predation under the premise that competition laws are intended to promote and protect consumer welfare.