swiss economics

The more economic approach to predatory pricing

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Agenda

- **Legal framework and recent case law**
- **The economics of predatory pricing**
- **The fallacy of the more economic approach**
- **Predation and mergers**
- **A feasible framework to pursue predatory pricing**
- **Conclusion**

Legal framework for predatory pricing

European approach

- Context: A dominant firm has a special responsibility not to harm competition
- EU: Unlawful exclusionary conduct of firms which hold a dominant position (Art. 102 TFEU)
- Switzerland: Unlawful practice by dominant undertakings (Art. 7 CartA)
- In both constituencies, ex ante dominance has also the function of an intervention threshold

US approach

- Context: Prevention of a monopolization by unlawful means
- If a firm reaches a monopoly position with legal means, it is free to exploit it; ex ante dominance is not an issue

Recent cases of predatory pricing

Switzerland

- No conviction since the introduction of the new Cartel Act (1995)

European Union

- Several cases involving the leverage of market power (Akzo, Tetra Pak II, Deutsche Post, GlaxoSmithKline)
- Several cases in network industries with a strong incumbent (Deutsche Post, Wanadoo, Intel, Post Danmark II)

United States

- No convictions since the Brooke ruling of the US Supreme Court (1993)

Economics of predatory pricing I

Early economic theories based price-cost benchmarks

- Prices below a certain cost-benchmark (e.g. Average Avoidable Cost AAV) are considered to be predatory
- No strategic explanation (rationality implicitly assumed)

Chicago critique

- Predatory pricing is like a dragon: everywhere in the literature and nowhere in the world (Easterbrook, 1981)
- Predatory pricing is not a rational business strategy
- A merger between the predator and the prey would be more profitable
- Below-cost pricing can be pro-competitive

Economics of predatory pricing II

Predatory pricing as a dynamic process of intertemporal price discrimination

- In a first period, a firm (the predator) offers very low prices and deliberately incurs losses
- In a second period, the predator recoups its losses from the first period
- There is a causal link between low prices in the first and profits in the second period

Economics of predatory pricing III

Theories of rational predation

- **Signalling models** (Milgrom & Roberts, 1982)
  Predator signals low cost $\rightarrow$ ability to compete fiercely
- **Reputational models** (Kreps & Wilson, 1982)
  Predator builds up a tough reputation $\rightarrow$ willingness to compete fiercely
- **Financial market models** (Holmström & Tirole, 1997)
  Predation influences the prey's lender's expectation of future profitability
- **Learning-by-doing models** with multiple equilibria (Besanko et al. 2014)
  Low prices allow for learning and competing for a market
- **Economies of scale models** (Fumagalli and Motta, 2013)
  Predation prevents efficient entrants from reaching sufficient economies of scale

1 ½ settings of rational predation with dominance

Leverage market power to another market (1)

- With reputation and signalling effects, predation in one market exerts an externality on other markets
- No requirement of ex ante dominance in the market of recoupment

Prevent market entry in network industries (½)

In network industries with strong economies of scale, an incumbent undercuts prices in order to prevent a smaller but efficient competitor from achieving the needed economies of scale

- Inconsistency between the incumbent's dominance and the market's contestability

→ Exactly the settings of recent cases in the EU

Economics of predatory pricing – implications

Implication of new economic theories

- Predatory pricing can be rational under specific circumstances; especially if information is incomplete or asymmetric
- Rule-based / per se approaches are not appropriate
- Assessment of effects and strategic intents is necessary in order to discern predation from competition on the merits
- Ex ante dominance is often not required for rational predation – only ex post dominance (for recoupment)
- For an ex ante dominant firm, predation is often not a rational strategy

→ **Divergence between economic theory and antitrust enforcement of predatory pricing**

The more economic approach to predatory pricing

General direction of the more economic approach: More flexible rules of reason rooted in economic theory

- Economic effects instead of price-cost rules
- Causality: conduct must be very likely to foreclose rival
- Rationality based on consistent economic theory

Aligning economics and competition law

Bolton, Brodley and Riordan (2000)

- Aim: modern approach to predatory pricing in the US after the Brooke ruling
- Method: new means to assess effects and causality
- Success: no change in enforcement

Niblett, Gans and King (2004)

- Aim: abolishing the dominance condition in Australian antitrust legislation
- Method: structural market power instead of dominance
- Success: adjustment of legislation in 2007 – "substantial share of the market"

De la Mano and Durant (2005)

- Aim: applying economic theory to the analysis of predatory pricing as an example for the implementation of the more economic approach
- Method: three-step structured rule of reason (sacrifice, potential foreclosure, recoupment)
- Success: no noticeable influence on predatory pricing cases in the EU

Applications of the more economic approach

Guidance by EU Commission 2009 relating to predatory pricing

- **Sacrifice**: Average Avoidable Cost (AAV); shortfall in short term revenues due to predation compared to alternative conducts
- **Possibility** of anti-competitive **foreclosure**: as efficient competitor test
- **Recoupment**: Quantification not necessary, self-evident for a dominant firm
- Possibility of strategic considerations along modern economic theories

Development in the US (Brooke ruling 1993)

- Required **proof** that a predator could **recoup** its losses **because** of the additional market power

The fallacy of the more economic approach I

Most theories of rational and harmful predation do not require dominance

- A dominant firm can raise prices above the competitive level anyway. Why take the risk of a predatory strategy?
- Predation to prevent market entry is only rational if a substantial part of the market is contestable
- Harm to competition and consumers results especially if a non-dominant firm becomes dominant (i.e. if there is a change in the market structure)

→ Economic analysis makes detection of harmful predation less likely: dominance and rationality of predation are often mutually exclusive

→ Systematic underenforcement

The fallacy of the more economic approach II

Economic effects of predatory pricing is hard to assess because they occur with delay

- At the time of antitrust enforcement, effects are not yet apparent (ex ante evaluation of ex post effects)
- The ability to recoup is the result of the exclusionary conduct. The dominance criterion prevents a thorough analysis of the possibility of recoupment
- Without analysis of recoupment, differentiation between harmful predation and competition on the merits by a dominant firm is not possible
- Economic effects and the causal link between conduct and possible harm to consumers can only be established theoretically and by ex ante validation of the underlying assumptions

→ No need to quantify recoupment according to EC guidance

→ Overenforcement if recoupment is considered self-evident

→ Underenforcement if recoupment has to be proven

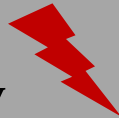
The fallacy of the more economic approach III

Predatory pricing as an exclusionary abuse of dominance

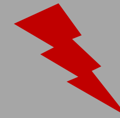
Conduct
Pricing below cost

More economic approach

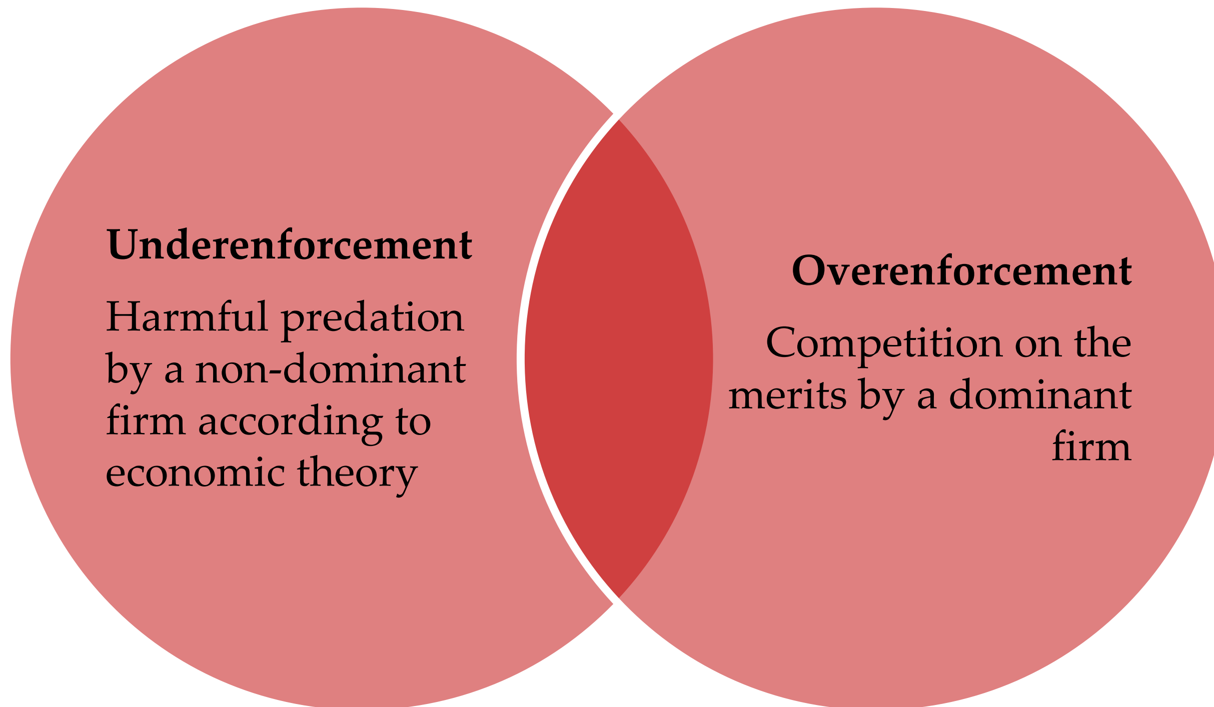
Causality / Rationality



Effect
Exclusion
Recoupment



The fallacy of the more economic approach V

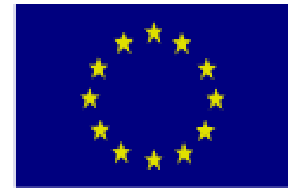


→ **Two main issues:**

- **Context of dominance**
- **Intertemporal effects**

The view of DG Competition members

Predation:



Dominance

Recoupment

OVERENFORCEMENT:

- Identity of the prey (distant rival?)
- Firms leave, but assets stay
- Capacity constrained dominant firm

Ok

UNDERENFORCEMENT

- Predation to acquire dominance
- Reputation is the entry barrier

Source: Damien Neven, Chief Economist DG Competition & Miguel de la Mano, Member of the Chief Economist's Office, Further steps towards an effects-based approach (2006)

Predatory pricing and mergers

There are close links between mergers and predatory pricing

- No ex ante dominance required, intertemporal effects
- Similar business logic and anticompetitive effects
  - Gain of the market share of a competitor
  - Prevention of the loss of market share to a potential competitor
- Substitutes: in order to gain market share (or not lose it), a firm can either merge or predate
- Complements: predation to merge

→ **Why are mergers and predatory pricing treated differently?**

A feasible framework to pursue predatory pricing I

In order to align economic theory and antitrust enforcement, predatory pricing should be separated from the exclusionary abuse of a dominant firms, especially in terms of:

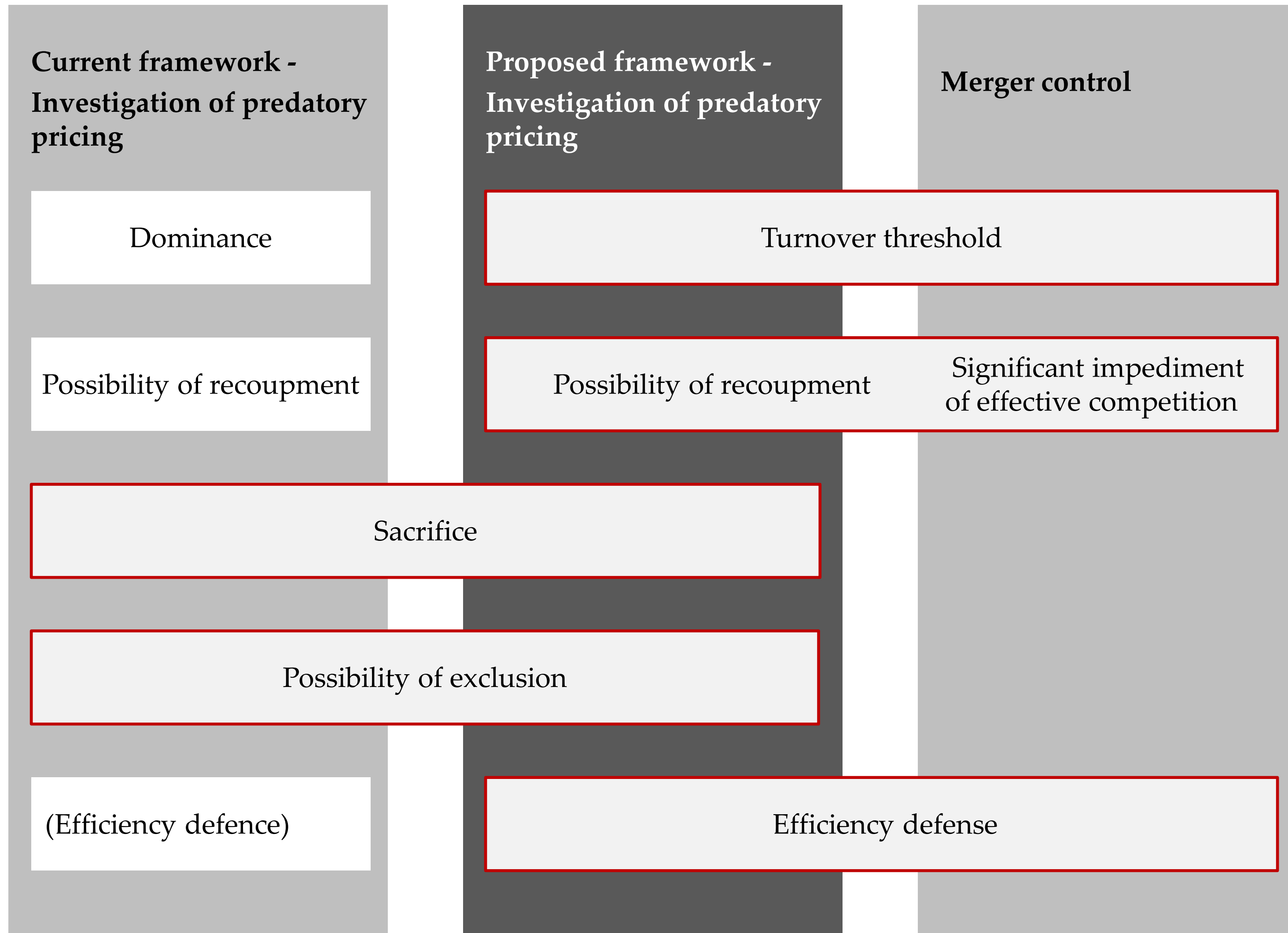
- Intervention criteria
- Economic effects (recoupment) of predatory pricing

→ Because of the analytical and procedural similarities, the analytical tools and the intervention thresholds may be borrowed directly form merger control

Detection of predatory pricing should be conducted within the current framework

- Sacrifice (incremental cost > incremental revenue)
- Possibility of exclusion (e.g. as efficient competitor test)

A feasible framework to pursue predatory pricing II



A feasible framework to pursue predatory pricing III

Legal alignment of predatory pricing and mergers

- Abandonment of the dominance criterion (mergers are not only investigated if one firm is already dominant)
- Introduction of a turnover threshold as intervention criterion (a firm needs a certain capacity to keep up a predatory strategy and harm competition)

→ Broadening of the special responsibility doctrine

Procedural alignment of predatory pricing and mergers

- Analysis of recoupment along well established procedures of merger control
  – Would a merger between the predator and the prey raise competition concerns?
  – Ex ante evaluation of ex post market structure: standard procedure
  – Elasticities, entry barrier, incentives for entry after predation etc. can be borrowed directly from merger control
- Institutional efficiency defense like in merger cases

Conclusion

Gap between economic theory and the legal framework for the pursuit of predatory pricing

- Requirement of dominance
- Harm of predatory pricing

→ Gap became apparent with a more economic approach

Predatory pricing could be separated form ex ante dominance

- Detection of exclusionary abuse within the current legal framework
- Analysis of economic effects and intervention thresholds borrowed from merger control

Advantages of this approach

- Consistent economic analysis possible
- Increased legal certainty as firms, layers as well as authorities are used to assess merger of two firms

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