PREDATORY PRICING: PARADOX OR CHALLENGE FOR COMPETITION POLICY?¹

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Abstract: This paper is an overview of the predatory pricing and the main competition challenges regarding this issue. The aim is to provide a framework for understanding predatory pricing and to discuss how to manage different opinions about tests, standards, and costs for policy makers. The paper starts with a conceptual overview of predatory pricing and the main theories in this field. We also discuss standards and tests proposed in the literature for identifying predatory pricing, with a short benchmarking of the types of costs appropriate in different cases.

Key words: predatory pricing, relevant cost

JEL classification: L11, L40, D4

1. Introduction

In this paper we try to prove that predatory pricing is a challenge for competition policy. Generally, low prices are associated with higher consumer and social welfare. From this point of view predatory pricing may appear a paradox: why competition authorities are concerned with situations where a firm charges “too low” prices? The answer is the mechanism of predatory pricing. A big firm sets so low prices that competitors quit the market and after that the predator will raise the prices and recoup losses. The concern for competition policy is not the low price in the first period, price that is good for the consumers, but the high price in the second period, when the incumbent will have significant market power. Competition policy will protect the competition not the competitors, its aim is to prevent monopoly and abusive practices. Edlin (2010) explains why predatory pricing and competition policy in predatory pricing are based on sacrifice. Sacrifice theories observe that in predatory pricing the firm sets a price below cost; this reflect a sacrifice, and sacrifice raises the question – “what for?”. One possible answer is that the sacrifice was suffered “to exclude competition”, and if this is the answer, then an antitrust problem emerges.

There are many definitions of predatory pricing. Motta (2009) notes that predatory pricing occurs when a firm sets prices at a level that implies the sacrifice of profits in the short-run in order to eliminate competition and get higher profits in the long-run. This definition, contains two main elements for the identification of predatory behavior in practice: first, the existence of short-term loss; second, the existence of enough market power by predator so that it can reasonably expect to be able to raise prices so as to increase profits in the long-run once a rival or more rivals has been driven out of the market. Gavrilă and Gavrilă (2008) define predatory price as an extremely low price, below average variable cost. Selling price below average variable cost is considered predatory pricing only if there is a dominant position and is promoted for a long period of time. In Romanians’ authors view, there is predatory pricing if: competitors left the market; those who intend to enter the market quit the project; the incumbent firm has significant losses that can’t be attributed to external factors; after the competitors has been driven out of the market, price increases to recover previous substantial losses.

Predatory pricing could be a business strategy designed to create or maintain a monopoly position. In the short run, during the price war, consumers enjoy low prices. But consumers end up paying monopoly prices in the long run. If the predator’s discounted long-run monopoly profit exceeds its short run profits sacrifice during the price war, the consumers’ discounted long-run loss will exceed the gain that consumers enjoy during the price war. All things considered consumers would be better off and the market would be more efficient if the target firm survived rather than being eliminated in a price war.

Edlin (2010) considers that successful predation requires: (1) low prices – price must be sufficiently low to tempt the rivals to exit (generally below AAC) or otherwise to chasten them; (2) credibility – the threat must be credible that the predator will keep prices low until rivals exit; (3) no re-

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entry – re-entry or new competition must be sufficiently delayed that the predator can recoup its losses from predation.

Predatory pricing presents a policy dilemma for antitrust (Elzinga and Mills, 2005). The conduct of a predator during a predatory pricing episode looks a lot like vigorous competition, so its hard to distinguish an instance when low prices are sustainable and pro-competitive from an instance when low prices are unsustainable and seek to persuade the target firm that its commercial success are poor.

2. Theories of predatory pricing

Among the most influential articles in predatory pricing were McGee’s article *Predatory price cutting: The Standard Oil (NJ) Case*, published in Journal of Law and Economics in 1958, and Areeda and Turner article *Predatory Pricing and Related Practices under Section 2 of Sherman Act*, published in Harvard Law Review in 1974 (Motta, 2009; Utton, 2008; Edlin, 2010; Anderson, 2003; etc.). McGee criticized the idea that a firm is interested in predatory pricing, arguing that a large firm will suffer greater losses when the price is low, and also, the small firm can re-enter on the market when the price rise. McGee’s position was equally sustained and criticized in the literature. Vickers (2009) mentioned the arguments of “Chicago School” which argues that a competition policy which tries to stop low pricing risks to promote inefficient competitors and to harm consumer interests. Moreover, Mc’Gee’s arguments are sustained by “Chicago School”, showing that predatory pricing is rare and less profitable. “Post – Chicago” economists have proved that price predation is not only plausible, but profitable, especially in a multi-market context where predation can occur in one market and recoupment can occur rapidly in other markets.

Motta (2009) disagree with McGee’s conclusions, and makes the following arguments: bigger loses of the dominant firm can be avoided if predatory pricing is used only on the markets where the firm has some interests to make the competitors to exit - this reduce the costs of predation strategy; re-entering the market can be very costly, the small firm cannot return very easy on the market; if the incumbent preyed successfully once, this will probably affect other firms which want to enter the market. McGee’s most important argument is that small competitor has limited resources (a “small pocket”) comparing to the predator (which has a “deep pocket”) and will be unable to survive long enough.

Recent theories solved the problem: predatory pricing is a phenomenon that can be explained only in the context of imperfect information. Edlin (2010) shows that many economists pointed out a fact: firms have asymmetric fundamentals (cost of production or finance or discounting) and asymmetric information about these costs. The predation makes perfect sense if the firm with high cost may cut price in an effort to convince entrants that it has low costs and the competitors should therefore exit.

Recent models of predatory pricing are based on asymmetric information and games theory. There are three main types of models (Motta, 2009): reputation models, signaling models, financial market models of “deep pocket” predation.

In global economy it is possible to assist at predatory pricing on external markets, in order to make the domestic firms to leave the market. This type of behaviour is close to dumping, but is not identical. Elzinga and Mills (2005) explain that competition policy has the same purpose in both cases: to protect the domestic firms. The original intention of anti-dumping policy was very similar to that part of antitrust which aimed to protect competition from the abusive behavior of dominant firms. Thus, an anti-dumping action would be aimed at a foreign firm which entered the domestic market at a very low price with the intention of driving domestic firms out, acquiring market power, and than raising prices in the domestic market to monopoly or near monopoly levels. In other words in its original formulation the policy was designed to prevent the domestic competition from being undetermined by predatory dumping. Willig (1998) mentioned by Elzinga and Mills (2005) identifies five categories of dumping: market expansion dumping, cyclical dumping, state trading dumping, strategic dumping and predatory dumping.

Predatory dumping aims to destroy competition in the importing country by sacrificing short-run profits and then to raise prices to monopoly levels to recoup previous loses. Successful predatory dumping is bad for the world economy. The long term losses to consumers in the importing countries outweigh their short-term gain from the initially low prices, like in all predatory pricing strategies. Anti-dumping actions would fail if antitrust criteria to establish predatory pricing were employed instead of trade policy criteria.

Heyes (2009) notes some important contributions (Klaasen and McClaughlin, 1996, Salop and Scheffman, 1983) at non-price predation. Predatory pricing theory focuses on conduct that lowers revenues. Alternatively, a firm can induce its rivals to exit the industry by raising their costs. The market
predatory cost-raising strategies more likely to be attractive to the dominant firm when: (a) market demand is comparatively inelastic; (b) the strategy in question has a more pronounced impact on the relevant cost conditions of the fringe firms than the dominant firm. A cost increasing strategy is more credible if embedded in legislative or regulatory requirements. For that, rules against predatory pricing and dumping might be natural weapons for non-price predator.

3. Standards and tests in predatory pricing

Until Areeda and Turner’s article (1974) numerous complaints (77) about predatory pricing were settled favorably in US. This article has set a standard based on average variable cost, and after that only 8 complaints about predatory pricing have been admitted.

More recently, theories of predatory pricing try to set some standards and tests, generally accepted for identifying predatory pricing. We will present few positions on this issue, and will analyze them.

Elzinga and Mills (2005) propose a three steps test for determining predatory pricing:

1. define the relevant market and determine whether the defendant firm could exercise monopoly power in this market;
2. determine whether the defendant’s prices in the relevant market were below an appropriate measure of costs (the authors accept Areeda – Turner test, with price below the average variable cost, $P<AVC$);
3. “recoupment test” – defendant could charge monopoly prices high enough and long enough after disposing of the target rival.

The first step is very important because the real economy is based on a multi-market system, the dominant position doesn’t have to be global. Price discrimination on this multi market system is possible, and the test has to look only at the relevant market. The third step is the most challenging point. We think is hard to measure the predator’s capacity to recoup losses and to determine the exact time needed to this.

Elzinga and Mills (2005) mentioned that a number of economists pointed out that an established, dominant firm could reduce its price below that offered by an entrant but still above its marginal cost (Scherer, 1976; Williamson, 1977 and Baumol, 1979). It could then not be caught by the Areeda – Turner rule and yet the entrant may be unable to survive at the reduced price now offered by the incumbent. Limit pricing models essentially arrive at this result: incumbent firms can price strategically to ensure that the demand available to the entrant firm is insufficient to allow them to do better than break even. Many limit pricing models assume that a potential entrant could in principle attain the same cost levels as the incumbent. Other commentators have been concerned with the possibly more realistic cases where the existing dominant firm has a series of cost advantages over potential entrants.

Motta (2009) says that two elements should be stressed from predation mechanism: (a) the sacrifice of short-run profits; and (b) the ability to increase prices in the long run by exercising market power once predation has been successful. He proposes to have a two-tier test of predation:

1. Analysis of the industry to determine the degree of market power of the dominant firm. If the firm is not dominant, we cannot say that is a case of predatory pricing; if the firm is dominant, proceed with the second phase:
2. Analysis of the relationship between price and costs:
   - A price above average total costs should definitely be considered lawful, without exceptions.
   - A price below average total costs but above average variable costs should be presumed lawful.
   - A price below average variable costs should be presumed unlawful, with the burden of proving the opposite on the defendant.

The first point is similar to the test proposed by Elzinga and Mills. The ability to increase prices after the small firm left the market depends of the market power. It is possible for a non-dominant firm to price below the cost, but this will not harm the competition or the consumer. The reasons for this behavior could be: the existence of switching costs – most consumers would be locked-in with the dominant firm, and only a significant price cut might convince many of them to address another seller instead; the presence of network externalities; learning curves and economies of scale; product complementarities with another market.

The market power test should catch only dominant firms, and not just any oligopolistic firm that has some market power. The existence of dominance should refer to the period when the first allegedly predatory episode starts, not at some later dates.
In 2008, International Competition Network conducted a research through Unilateral Conduct Working Group (UCWG, 2008). Based on the responses of agencies and non-governmental advisors (NGAs) covering thirty-five jurisdictions, the UCWG examined specific practices on predatory pricing. Respondents are divided with regard to whether the alleged predatory pricing must occur in the market in which the firm holds a dominant position or substantial market power. For eleven agencies that responded, to be unlawful the alleged predatory pricing must occur in the market in which the firm holds a dominant position or substantial market power. By contrast, seventeen agencies responded that the dominant firm also may be found liable for predation in other markets in which it lacks dominance and substantial market power. We can explain this kind of approach by reputation models.

Sacrifice of short-run profits is analyzed through price – cost relationship. It could be acceptable for a dominant firm in some market situation to price below the average total cost, but in Motta’s view, pricing below average variable cost is not acceptable.

Looking at predatory pricing paradox – we have to have competition policy measures to diminish the risk of too low prices, Vickers (2009) mentioned that have been advanced three principles, or tests, to distinguish anticompetitive conduct from competition on the merits – the sacrifice test, the as-efficient competitor test, and the consumer harm test. Anyway, there remains plenty of scope for argument over (a) the relevant cost concept; (b) how to measure the cost; (c) the role, if any, for evidence on intent; (d) whether or not separate proof of recoupment should be required; (e) what scope should be allowed for justifications of below-cost pricing.

Edlin (2010) presents three potential standards for identifying predatory pricing: the sacrifice standard - price-cost test based on sacrifice theory requires that either price and cost be measured by inclusive measures; equally efficient competitor standard - a price-cost test to prevent the exclusion of equally efficient competitors, by contrast, requires that price and cost be measured by inclusive measures; a consumer betterment standard for monopolization and predatory pricing.

Perrot (2008) proposes an effects-based approach, relied on two pillars: first a sacrifice test and second a microeconomic analysis.

4. Appropriate measure of costs in predatory pricing

Almost all the tests propose a test on price – cost relationship to identify the predatory pricing. The next question is which is the most appropriate measure of cost? We find the following costs:

- Marginal Cost (MC) – Areeda and Franklin consider marginal cost the most appropriate measure of cost in predatory pricing from a conceptual point of view, since a firm that sets price below marginal cost would not maximize the short – run profits;
- Average Variable Cost (AVC) – is the most common measure used for cost-price test;
- Average Incremental Cost (AIC) - Bolton et al. (2000) define average incremental cost as per unit cost of producing the added output to serve the predatory sales. Incremental cost is a better standard than either average variable cost or full cost because it most accurately reflects the costs of making the predatory sales.
- Average avoidable cost (AAC) consists of the costs that can be avoided by not producing any given number of units divided by that number of units. In UCWG study is mentioned the Canadian authority, which uses an avoidable cost test in determining whether prices are predatory on the basis that a firm selling at prices that do not cover its avoidable costs will not be profit-maximizing unless there is an expectation that its pricing policy eventually will create or enhance the firm’s market power. Canada considers avoidable costs to be all costs that would be avoided if the firm chose not to produce or sell the relevant product(s) during the period of time the firm engaged in its alleged predatory pricing policy.
- Long run average incremental cost (LRAIC) – is the sum of the variable and product-specific fixed costs divided by the number of the units produced. LRAIC has been used in addition to other measures to analyze costs of multi-product firms when some costs cannot be uniquely attributed to a particular product. Some agencies consider LRAIC an appropriate benchmark, in particular for industries characterized by high fixed costs and low variable costs, such as telecommunications or postal.

When analyzing predatory pricing cases in all countries prices must be below costs for predation to occur. We can also take into account some or all of the following factors: recoupment of losses, competitive effects, predatory intent, and justifications and defenses.
Edlin (2010) extend the discussion to marginal revenue; it can be seen as an inclusive notion of price; it includes revenue effects. So, the alternative way to measure sacrifice is to talk about an inclusive notion of revenue that includes the lost revenue on inframarginal units, and the limitation to costs tests is not enough in predatory pricing.

5. The frequency of predatory pricing

The question about the frequency of predatory pricing appears very often in the literature. Edlin (2010) quotes Frank Easterbrook (1981) who says that “predatory pricing is like dragons – everywhere in the literature and nowhere in the world”. The perfect competition almost excludes predatory pricing. Real world economics shows that symmetric costs, symmetric information, decreasing returns of scale, and no switching costs, are rare. Once one deviates from these assumptions, we are seeing that price cuts can be anticompetitive and we asked how frequently they can be.

In UCWG study, during a period of ten years, responding agencies brought approximately twenty-four cases in which predatory pricing violation was established and have initiated at least five times as many investigations in which predatory pricing was alleged but no violation was found (UCWG, 2008).

In Romania, there are several complains about predatory pricing, but they have not been admitted by Competition Council (Decision no.174/2004 – cable television, Decision no.46/2005 – cable television, Decision no.11/2010 – energy market). Although the competition law interdicts predatory pricing, all cases were considered irrelevant for this issue considering there wasn’t a dominant position on the relevant market. Looking at these decisions, we can say that the conditions for predatory pricing considered in Romania are: the existence of dominant position on relevant market; the intention to make the competitor to exit the market; the existence of a consumer’s prejudice.

Time is a very important aspect in predatory pricing. There are studies that show the need for an appropriate timing and suggest some policy options to reduce the time of the investigation. Eckert (2002) analyzes the factors that influence the length of time required for the analysis of an allegation of predation. The necessary time depends both on the legal framework and on the detailed microeconomic analysis required. The antitrust process in a case of predation can be broken down into two broad stages: the data collection and analysis stage, and the legal proceedings. The time required for data collection and analysis is at least important as the time for legal proceedings, although this would likely depend on the nature of industry. Accordingly, Eckert (2002) suggests some policy options to reduce the time costs of the economic analysis: (1) one suggestion has been that the enforcement of laws or regulations dealing with predation in certain industries be handled by industry-specific agencies. This might reduce the time based on specialized knowledge of the cost and pricing practices in certain industries, the existence of regular monitoring of market characteristics; (2) another suggestion for specific industries would be requirements of data availability. By requiring, through law or regulation, that firms in particular industries keep certain records of their costs and price structures, one could potentially reduce the time required for data collection; (3) some proposals for reform focused not on the speed of existing economic analysis, but on abandoning the two stage economic analysis (the recoupment analysis and the cost-based test) in favor of a different economic test.

6. Conclusions

Why should we care about predatory pricing? Is predatory pricing a competition policy issue? We demonstrate in this paper, using the most recent and the most relevant opinions in this field that predatory pricing is not a paradox, it is a challenge. The competition problem related to predatory pricing is not the low price during the predation, but the high price during a period without competition or with less intense competition.

7. References


