Master’s thesis

Exploring Predatory Pricing: The Line between Legal and Illegal Price Setting

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Introduction

Enlargement of the EU, globalisation, possibilities of merging with other firms give more opportunities for firms to survive. In some cases even more market power could be obtained and abused. Seeing as liberalisation and deregulation have taken place, there are more incumbents facing new entrants. As the fight for market share is taking on a new dimension with firms using a wealth of tactics, it cannot be excluded that some may want to resort to, among other things, to predatory pricing. The key question is whether current legislation will be able to defend those encumbered by major market players using predatory pricing techniques. In light of all tactics that price predation may involve is current legislation able to defend all possible sufferers, including customers? If the answer is in the negative, then how to draw the line between legal and predatory pricing? Seeing as firms may well employ different strategies that are more advanced in comparison with those formerly used isn’t it high time that present day legislation was changed to reflect present day firms’ likely thinking? The thesis answers these questions, but the main problem, namely that of drawing the line between price predation and illegal price setting is its core consideration.

An analysis is made of both current legislation in terms of predatory pricing, and future one - the one that should intuitively be enforced, as I suggest, to be able to forbid new possibilities of killing off competitors. The analysis involves breaking down price predation as opposed to predation as a whole, which is a far broader topic. That is why, such issues as all abuses of dominance (exclusionary practises) are not discussed. Although a price predator may want to use these in connection with pure predatory pricing tactics, I decided not to delve into them as I would have to write a few volumes. That is why, the thesis is only devoted to artificially separated cases of price predation.
I have struggled through with finding the best ways of solving the problem I undertook the task of solving, and in the end I arrived at a method leading to a full detection both of price predators using ‘old tricks’, and those advanced such as influencing one’s views through strategic actions. However, it took me quite time to arrive at a new method of detection - part of the blame could be assigned to my considering first present current views, and present legislation. But results were rewarding since enabled me to see present day laws’ imperfection that I later tried to eliminate in the last chapter.

In solving the problem I thought it of great importance to include in the analysis the current US and EU legislation that proscribes price predation. This is done mainly for two reasons. To investigate which of the standards provides more protection against price predation; the second one to present what the current EU and US legislation have to say about these issues. A scan of both systems is to answer the question of how to guard against likely price predators of whatever descent. I chose the two systems because I consider the US the greatest competitor of the European Union.

In the first chapter is where I discuss such important issues as the current legislation and determinants of fair prices. I put forward Article 81 and 82, and the New Merger Regulation that came into force on 1st May 2004. Corresponding US documents follow the EU ones. Moreover, at the close of the first chapter I consider economic aspects of price setting as I think that these factors, besides legal ones, are taken into consideration by firms willing to compete whatever business environment they choose to operate in. Becoming aware of the current state of affairs is my only goal in this chapter, which later helps me to concentrate on current legislation’s weak points.

The second chapter is purely informative in a sense that it provides one with an understanding of such important issues as dominance, relevant market and abuse of dominance.
Introduction

It is my opinion that without becoming aware of these matters any analysis of the problem as the one I am trying to solve would be fruitless since the substantive issues that I selected are an integral part of every predatory pricing analysis.

The third chapter role’s is crucial to drawing the line between legal and illegal price setting. In the beginning I start by defining this complex phenomenon. Afterwards, I introduce standards both the EU and US courts put forward as these help to distinguish predatory from competition enhancing behaviour.

It appears that” Brooke Group (1993) uses recoupment as the primary standard for predatory pricing cases”¹ in the US, while on the other side of the Atlantic, attention is focused on prices below average variable cost, present market power and intent to eliminate².

However, no matter which standard is used and no matter which element of proof is taken into account, the analysis of predatory pricing is likely to fail to explain predatory pricing in today’s turbulent, dynamic environment as it is based on neoclassical price theory³. Stringent assumptions about parties motivated exclusively by profit maximization, possessing perfect knowledge, and acting rationally are all too restrictive in breaking down contemporary firm’s behaviour and render it impossible to explain predatory pricing in full⁴, let alone exclude from the market game all present day predators.

Moreover, as much of the current assessment of predatory pricing has been dominated by price cost comparisons, and is heavily influenced by assumptions made by Areeda and Turner⁵, the result is loopholes that, as I suggest, should be eliminated by changes to the current legislation.

² Speech by Philip Lowe - Director General DG Competition,” How Different is EU Antitrust? A Route Map for Advisors,” ABA 2003 Fall Meeting, Brussels, 16 October 2003.
Another section is where I suggest that for the problem to be solved new enactments have to be put into effect since, as I think, it is adjusted set of laws that will help to draw the much desired line. From this point a road to a proposition of new legislation is long, but the proper one. First, I concentrate on current analysis enlisting its weak points, and then introduce a new approach that helps to encumber at best most present day predatory pricing tricks and at worst point out the areas where they may be expected. The new approach is based on information asymmetry, complexity of the market and new consumer welfare notion, and entwines the concept of planning into present day legislation that is still based on sound economic theory. A list of possible strategies follows. These enable to depict why current standards presented earlier are at a loss to explain present day phenomena that are conspicuous, but undetectable by the US and EU standards. Finally, at the close of the chapter is where I begin to draw the line. However, as this could only be achieved by legislation that encompasses both old and new observations I undertook the task of constructing new set of rules as these are absent today. In doing so I assumed that since there are loopholes the new laws will inevitably be constructed to eliminate them, and that new testing mechanisms will be a reflection of the future legislation. That is why, I first propose a future mechanism of detection called ‘an interface approach’ and then through backward induction gather what the new laws should be like. The thesis ends with conclusions as to where this border line is.
Chapter I The Guardians and Determinants of fair prices

The role of this chapter is to introduce standard documents to which courts presently refer to when deciding whether a certain practice violates the law. I present European legislation that is likely to catch predatory pricing cases followed by American ones mostly concerned with the issue of price predation. This presentation is accompanied by an enumeration of economic issues that each predator must be aware of when setting their prices. The same economic issues are looked into by courts.

1.1. Article 81

Article 81 of the EC Treaty prohibits a large number of agreements between undertakings that may significantly lower competition levels. Article 81 forbids “all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States, and which have as their object or effect the prevention, restriction or distortion of competition within the common market”. The threat to competition, according to Article 81(1), may be posed by those agreements that:

(a) Directly or indirectly fix purchase or selling prices;
(b) Limit or control production, markets, technical development, or investment;
(c) Share markets or sources of supply;
(d) Apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
(e) Make the conclusion of contracts subject to acceptance of supplementary obligations which have no connection with the subject of the contracts.

Any agreement, any decision or any concerted practice, which includes these prohibited elements, is invalid unless it contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, says Article 81(3).
In other words, agreements, decisions and concerted practises caught by Article 81(1) which satisfy the conditions of Article 81(3) of the Treaty shall not be prohibited. In addition such agreements cannot impose on the undertakings restrictions which are not indispensable to the attainment of the above-mentioned objectives.

1.2. Article 82

Another guardian of competition is Article 82 of the EC Treaty. It says that:

“Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market insofar as it may affect trade between Member states.”

The abuse it mentions may be:
(a) Directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions;
(b) Limiting production, markets or technical development to the prejudice of consumers;
(c) Applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
(d) Making the conclusion of contracts subject to acceptance of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of the contracts.”

It appears from the Article that for an abuse of a dominant position to exist, first it must be established that a dominant position exists, then that this dominant firm has engaged into an abusive behaviour. The abusive behaviour does not necessarily have to concern one undertaking; two or more companies’ actions can also be caught by Article 82 as it says of “any abuse by one or more undertakings...”

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1 This section is based on Article 81.
Lastly, Article 82 does punish any abuse of a dominant position, but leaves both the creation and the existence of market power intact. If one looks at the text of the Article 82, it is clearly written that it is any abuse and not dominance that shall be prohibited. In other words, if a firm builds market power through innovation, better R&D or marketing strategies, this is allowed. Being better because of its own superior set of attributes is perfectly legal, but using this set to the detriment of consumers is forbidden, according to Article 82. This in turn is quite opposite to the US legislation that prohibits firms from the wilful acquisition of monopoly power\(^4\). Views as to what is better are very differing, but my view is that, even though predatory price is a “symptom” of monopoly power, the latter cannot be eradicated as it may be accompanied by offsetting advantages to the economy (such as efficiency), and is based on legal patents (the courts will not break up the monopoly firm). In such cases, if the symptom (predatory pricing) is bad in itself, then the symptom should be treated directly.

1.3. The EC Merger Regulation\(^5,6\)

Before adoption of the Merger Regulation, mergers could only be controlled by applying Articles 81 and 82 to those cases where a merger was deemed to strengthen a dominant position, which was seen as inadequate method of control.\(^7\)

As Articles 81 and 82 are not sufficient to control all operations which may prove to be incompatible with the system of undistorted competition, the Merger Regulation is supposed to apply to those concentrations that may significantly impede effective competition in the common market. The Regulation also introduces an authorisation

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\(^3\) This section is based on Article 82.


\(^6\) This section draws heavily on the text of the Merger Regulation.

procedure with strict time deadlines. Each project of concentration has to be reported to the Merger Task Force (MTF) within seven days of the agreement of the public bid. After this notification the MTF has one month to carry out the first round of investigation. It is here that the MTF can decide to allow the merger or that the merger raises serious doubts. In the latter case the MTF has another four months during which it will deliberate merger’s possible effects. In the end, there are three outcomes. The merger may be allowed, prohibited or given the green light but subject to certain conditions.

The fixed timetable to which merger investigations are conducted is widely seen as one of the main advantages of merger inquiries over inquiries under Articles 81 and 82. Firms and the markets know quicker whether a merger can be carried out, which minimises the uncertainty, the possible loss to consumers, and the costs involved.

As the market became bigger and more complex due to the enlargement of the EU, and the completion of the internal market, major corporate organisations-mergers, able to decrease competitiveness of the EU, may emerge. The Merger Regulation’s task as a guardian of sound competition is to preserve the existence or growth of the competition likely to be endangered by such concentrations.

By offering a framework for the assessment of whether a concentration significantly impedes effective competition, the regulation is able to assess the mergers. In doing so the Regulation applies the following principle, namely that “a concentration, which creates or strengthens a dominant position as a result of which effective competition in the common market or in a substantial part of it would significantly impede the competition, should be declared incompatible with the common market”. To enable control of all mergers suspected of competitive distortions, the Regulation proposes its own mechanism helpful in finding the culprit.

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9 The interesting feature is that the Regulation considers mergers whose joint market share is less than 25% either in the common market or in a substantial part of compatible with the common market. In other words, only those concentrations whose market share is above 25% might violate the regulation and damage the competition-author’s note.
10 See footnote 2.
The following issues need to be checked by the Commission in discussing a takeover’s effects on the market: (1) the need to maintain and develop effective competition within the common market, (2) the structure of all markets concerned, (3) the actual or potential competition from undertakings located either within or outside the community; (4) the market position of the undertakings concerned and their economic and financial power, (5) the alternatives available to suppliers and users, their access to supplies or markets, (6) any legal or other barriers to entry, (7) supply and demand trends for the relevant goods and services, (8) the interests of the intermediate and ultimate consumers, and (9) the development of the economic progress.

If the merger of two or more previously independent undertakings or parts of undertakings (definition of concentration as given by the Regulation) may lead to distortions of the competition, then the concentration will be declared incompatible with the common market, as it does raise serious doubts as to the influence on the competition.

In this way the Merger Regulation prevents the creation or strengthening of a dominant position.

This is similar to Article 82’s focus on the abuse of a dominant position: if a merger leads to significant market power (equivalently, a dominant position), then one should expect the concentration to exercise that market power (equivalently, abuse a dominant position). Such a view is logical since a merger that creates or strengthens its market power is likely to lead to an increase in price of its products and services. Moreover, this view is in accordance with section 2 of the Sherman Act that does not allow anything to come into being that at a later stage may damage the competition.

1.4. The Sherman Act-Sections 1 and 2

The act clearly states that: “Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among several States, or with foreign nations, is declared to be illegal. Every person who shall make any contract or

11 This section draws heavily on the Sherman Antitrust Act of 1890, 15 U.S. Code § 1 and 2.
engage in any combination or conspiracy hereby declared to be illegal shall be deemed
guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding
$10,000,000 if a corporation, or, if any other person, $350,000, or by imprisonment not
exceeding three years, or by both said punishments.”

The second section then follows:” Every person who shall monopolize, or
attempt to monopolize, or combine or conspire with any other person or persons, to
monopolize any part of the trade or commerce among the several states, or with foreign
nations, shall be deemed guilty of a felony, and, on conviction thereof shall be punished
by fine not exceeding $10,000,000 if a corporation, or, if any other person, $350,000, or
by imprisonment not exceeding three years, or by both said punishments, in the
discretion of the court.”

The first act states that every contract, combination, or conspiracy in restraint of
trade is illegal; the second act forbids both the very creation and the existence of
monopolies; alls subject to a monetary penalty.

**1.5. The Clayton Antitrust Act**

The Clayton Act restricts mergers between companies. Section 7 of the Clayton
Act prohibits mergers and acquisitions where the effect may be to substantially restrain
competition, or to tend to create a monopoly:

“No corporation engaged in commerce shall acquire directly or indirectly, the whole or
any part of the stock or other share capital of another corporation engaged also in
commerce, where the effect of such acquisition may be to substantially lessen
competition between the corporation whose stock is so acquired by the corporation
making the acquisition, or to restrain such commerce in any section or community, or
tend to create a monopoly of an line of commerce.

The Clayton Act also specifies a number of illegal practices that either
contribute to or result from monopolization. It outlaws commercial practices such as, for

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12 This section is based on the Clayton Act of 1914, 15 U.S. Code sections 12-27.
instance: Price discrimination, exclusive dealing contracts and tying arrangements or price cutting below cost to eliminate competitor.

Section 2 concerns price discrimination:
"It shall be unlawful to discriminate in price between different purchasers..., where the effect of such discrimination may be to substantially lessen competition or tend to create a monopoly, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination." However, as the section unfolds the whole story, price discriminations generally are lawful, particularly if they reflect different costs of dealing with different buyers or products.\textsuperscript{13} By making "allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods" [of production], there is a good chance of not being caught by this section.

Section 3 of the Clayton Act forbids sale on agreement not to use goods of competitor:
"It shall be unlawful for any person engaged in commerce, in the course of such commerce, to lease or make a sale or contract for sale of goods, wares, merchandise, machinery, supplies, or other commodities, whether patented or unpatented, for use, consumption, or resale, or fix a price charged therefor, or discount from, or rebate upon, such price, on the condition, agreement, or understanding that the lessee or purchaser thereof shall not use or deal in the goods, wares, merchandise, machinery, supplies, or other commodities of a competitor or competitors of the lessor or seller, where the effect of such lease, sale, or contract for sale or such condition, agreement, or understanding may be to substantially lessen competition or tend to create a monopoly.”.

According to Section 3a prohibits tying arrangements and price cutting to eliminate competitors:
"It shall be unlawful for any person to be a party to, or assist in any transaction of sale, or contract to sell, which discriminates against competitors of the purchaser, in that, any discount, rebate, allowance, or advertising service charge is granted to the purchaser

\textsuperscript{13} Price discrimination also might be used as a predatory pricing tactic - setting prices below cost to certain customers - to harm competition at the supplier’s level - author’s note.
over and above any discount, rebate, allowance, or advertising service charge available at the time of such transaction to said competitors in respect of a sale of goods of like grade, quality, and quantity.”

It shall also be unlawful”to sell, or contract to sell, goods in any part of the United States at prices lower than those exacted by said person elsewhere in the United States for the purpose of destroying competition, or eliminating a competitor in such part of the United States; or, to sell, or contract to sell, goods at unreasonably low prices for the purpose of destroying competition or eliminating a competitor.”

In other words discrimination in rebates, discounts, or advertising service charges and underselling in particular localities is subject to penalties.

### 1.6. Determinants of price

The prices we pay for the products that satisfy our wants include a number of elements responsible for how much we are charged. These could be: 14(1) demand, (2) costs, (3) product life cycle and (4) the competition.

The quantity of a product that will be bought (one’s demand) sends a message to the seller, who after including in his analysis both the costs involved in the production and the demand sets the prices. As the products differ from each other, and as they may have lots of substitutes and their durability differs from the competitor’s products, the consumer may be very sensitive to price increases. In other words, the elasticity of demand says a lot to the producer about how much he can charge. The more unique the product, the higher the price, the more substitutable or interchangeable the products, the less we are likely to pay and more easily switch to different brands.

As the seller’s intention is to make a profit, the price of the products must guarantee that the profit is achieved; that is that total revenue decreased by total costs (fixed and variable) will be a positive or a zero value15. A loss can be attained, but “it

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15 When total revenue - total costs = 0, then a firm neither attains a profit nor incurs a loss- author’s note.
The Guardians and Determinants of Fair Prices

has to be smaller than the firm’s fixed costs\textsuperscript{16}. The firm will produce despite its loss because all variable costs as well as some portion of the fixed costs can be paid out of revenue.

The situation gets out of control when the price is below average variable costs: “At any price below minimum average variable costs the firm will minimise losses by closing down”\textsuperscript{17}. In other words, producing below average variable costs is not possible in the short run.

In the long run the situation does not look any different: “The entry of firms attracted by huge profits in the sector, and the exodus of inefficient ones let the price reach the level of average cost.”\textsuperscript{18} Thus, in the long run the price will oscillate around average cost levels at worst, or will be above them at best. The latter outcome depends on whether barriers of entry will make it impossible for others to enter.

Product’s life cycle serves as another indication of prices. At the very beginning of the product’s existence its price tends to be high as the firms tend to recover their R&D costs quickly\textsuperscript{19}. Then, the price decreases because high-cost firms are eliminated. The old age products’ prices also are low as there are not many people willing to buy them\textsuperscript{20}.

The major factor affecting price is probably competition\textsuperscript{21}. The more firms enter the market; the lower the price of the products can be expected as the incumbent firms compete for customers through delivering more innovative products. Their production costs usually are lower and therefore manufacturers can charge less than competitors. The fewer competitors, the fewer innovations, which results in inefficiencies and consecutively leads to higher prices\textsuperscript{22}.

\textsuperscript{17} S. L. Brue, ibid., p. 451.
\textsuperscript{18} S. L. Brue., ibid., p. 459.
\textsuperscript{20} The prices may rise dramatically if the product moves into the speciality good category. See footnote above.
\textsuperscript{21} D. Mercer, supra note 14, at p. 417.
The objective of the chapter has finally been attained as it got us one step closer to understanding where the present-day line between predatory and legal price setting lies. The role of the legislation described is of utmost importance in this respect. The big question, however, is whether these days this legislation provides enough defence against modern predators.

Although European legislation and that of the US differ greatly in that the former allows the growth of monopolies and the latter proscribes their existence with the Merger Regulation acting as an exception to the rules of the first system, they are at a loss to explain present day phenomena that modern day predatory pricing involves. The acts do not contain anything that involves planning and strategic moves that modern predation is based on. The sound economic theory is not any better. It is not concerned with prices above average price levels that could be predatory. For this reason it needs to be adjusted.

In other words, the documents do not allow for a more dynamic approach suggested in the last chapter. However, prior to its unfolding, the second chapter discusses substantive issues that any discussion of predatory pricing cases cannot take place without.

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22 Massimo M., supra note 8, at p. 46.
Chapter II Substantive issues

Every predatory pricing litigation must involve at least the establishment of the three issues discussed in this section of the thesis. Dominance is a crucial one as predators in order to both set prices, and as I suggest later in the thesis, to manipulate their preys must have enough market power to do so.

Relevant market is of utmost importance since it leads to the establishment of dominance. The output of the predator in a total number of products is a common standard.

Lastly, abuse of dominance is used to say that an undertaking has been behaving badly. The presentation of the set of elements is needed as it paves the way for drawing the new line between legal and predatory pricing. By defining these concepts one can better understand current predators, foresee their moves and single them out.

2.1. Dominance

As the EC Treaty does not define the concept of dominance, I will try to create the best working definition that I shall be referring to while discussing predatory pricing related issues across the thesis.

The fact that there is not a one generally accepted, accurate definition issued by a competent body, e.g. the Commission or any other EU institution, gives rise to complications and creates the ground for speculations on what dominance is. However, it also gives an opportunity to present a more precise definition that could serve as a guide for future analysis of dominance.

Let us commence with the first definition formulated in the European Court’s *Michelin* judgement in which dominance means:¹

“A position of economic strength enjoyed by an undertaking which enables it to hinder the maintenance of effective competition on the relevant market by allowing

it to behave to an appreciable extent independently of its competitors and customers and ultimately of consumers”.

The definition is clear, but has its drawbacks. It fails to explain what both to prevent effective competition and to behave independently means. Moreover, it does not explain how the two issues relate to each other. Interestingly, no firm can act to an appreciable extent independently of its consumers or customers. This is because, I think, the products of each firm are a response to clients’ needs, and every product must at least satisfy those wants. That is why, the existence of a firm that supplies what it wishes without respecting its customers is more the stuff of a science-fiction literature rather than real life cases.

Acting independently of its competitors is a more probable indicator of dominance, but not a good one since every firm’s residual demand curve, even that of a dominant firm is affected by the presence of competitors. Moreover, as each firm, a dominant included, has its demand curve with elasticity different from that of any competitor, it is not possible that these curves look the same. In other words, the existence of two firms with the exact demand curves is impossible, and that means that there has to be an interaction between them. This interaction, rather competition arises because each firm has different attributes that determine the price elasticity of demand of each of them.

As the above definition appeared to be meretricious, the concept of dominance has recently been equated with significant market power, for example, in its recent “Framework Directive” and in its guidelines on the Competition Act 1998 the UK OFT states that:

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5 Guidelines to the Competition Act, para 2.10 of Assessment of Market Power (OFT 415).
“An undertaking is unlikely to be dominant if it does not have substantial market power”.  

Now the task of establishing dominance boils down to setting up a framework for deciding significant market power, which is more problematic. In doing so I will put forward a few parameters that will proffer some help in establishing substantial market power. The list of parameters was proposed by Simon Bishop and Mike Walker. They enumerate five indicators of market power:7 (1) The number of competing suppliers of the same products, market shares and concentration, (2) barriers to entry, (3) barriers to expansion, (4) product differentiation, and (5) the nature of the oligopolistic interaction between firms.

It needs to be said that market power cannot be judged on the basis of only one of the above indicators, and that a thorough analysis included the mentioned elements has to be carried out.

The first parameter on the list, the market share, could be misleading if the verdict as to any firm’s dominance had to be reached solely on this criterion8. Although most dominant firms that might be suspected of exclusionary behaviour have high market shares, one has to bear in mind that the situation where the market is abundant in the firm’s products does not necessarily imply that this firm is dominant. A case in point is a situation where barriers to enter the market concerned and barriers to expansion are very low and the threat of entry frustrates the firm’s plans to dominate.

To be more certain as to one’s dominance there is a need for a second and third parameter, namely barriers to entry and barriers to expansion.

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6 Market power is defined as the ability of a firm or a group of firms to raise price, restrict the output above the level that would prevail on a competitive market, and thereby enjoy increased profits from the action - author’s note.
7 S. Bishop, M. Walker, supra note 3, at p. 52.
8 The European Court of Justice has held that a market share over 50% can be considered to be so large that except in exceptional circumstances such an undertaking could be presumed to be dominant (Engineering and Chemical Supplies v AKZO UK Ltd [1982] 1 C.M.L.R. 273; 1981 O.J. L374/1); The Commission has stated that a dominant position exists when a firm has a market share greater than 40%, although it cannot be ruled out for undertakings with a lower market share (European Commission, 10th Report on competition Policy (1981); The Merger Regulation sets the threshold at 25% (The EC Merger Regulation No 139/2004).
Substantive issues

The likelihood of dominance is higher, if there are more barriers or fewer ones but more difficult to surmount. These barriers could range from financial resources, patents and know-how through technical superiority\(^9\), a strong brand image\(^10\) to significant sunk costs\(^11\).

Let us now assume that a firm has a very high market share and that both barriers to entry and barriers to expansion are very high. Is this firm dominant?

Still, the answer is no. What about **product differentiation**? If there exist a few firms that can easily produce and quickly increase the number of output of substitutes that satisfy customers’ wants, no dominant firm can be dominant in the long run; and the short term huge profits will attract more competitors selling more and more substitutes even with better attributes. A good example taken from the real life is the existence of different makes of jeans. Levi’s is not dominant even though it spends a lot of money on advertising.

As for the fifth indicator there are firms that while on the look out for possibilities of increasing their sales and consequently market power resort to **oligopolistic interaction**. The joint dominance, whether between two or more firms, no matter whether it is tacit or explicit, is as dangerous to the competition forces as if it were enjoyed by one firm willing to dominate the market. That is why, all cunning firms choosing to jointly dominate the market will be met with the same fate, namely a monetary penalty. A good example of collective dominance detrimental to consumers is in *Gencor/Lonrho v Commission* where the latter stated:\(^{12}\)

“It appears that the main effect of the merger is the increase in the market power of the merged entity. Even if there were synergies, the Commission finds that they would not be to the advantage of the consumers since the operation will create a jointly dominant position in the platinum and rhodium markets and form an obstacle to competition in

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\(^9\) Case C-53/92 P Hilti.

\(^{10}\) Case 27/76 United Brands.

\(^{11}\) This enumeration is not exhaustive as there could be more barriers—author’s note.

those markets. The result of the operation would be the creation of a dominant duopoly, as a result of which effective competition would be significantly impeded”.

The quote shows not only that collective dominance in the case of Gencor/Lonrho was dangerous, but also that any benefits from the merger do not constitute a justification if either consumers or the competition forces are endangered. Both Gencor and Lonrho lost their case as the concentration was declared incompatible with the common market. Today it would violate Article 2(3) of the Merger Regulation\textsuperscript{13}:

“A concentration which would significantly impede effective competition, in the common market or in a substantial part of it, in particular as a result of the creation or strengthening of a dominant position, shall be declared incompatible with the common market”.

A reiteration as to what constitutes a significant market power in the case of concentrations is present in the Merger Regulation itself. In Article 2(1b) it is written that in making the appraisal of concentrations, the Commission shall take into account:”

The market position of the undertakings, the alternatives available to suppliers and users, their access to supplies and markets, any legal or other barriers to entry, supply and demand trends for the relevant goods and services, the interests of the consumers, and the development of technical and economic progress”. Although differently formulated the list is a reformulation of the indicators of market power I mentioned earlier, that is why I shall not describe each element.

Having regard to the above discussion, it will be best if I adopted the following definition of dominance:

**Dominance describes a situation in which a firm (or a group of firms) has substantial market power that influences the competition forces in such a way that its clients suffer as a result of this firm’s (or a group of firms’) actions.**
Substantive issues

It is to be underlined that any analysis of dominance has to be carried out with the help of the five criteria mentioned so that an elimination of the firm that is not dominant will not take place. Not doing so may result in a distortion of competition and harm to consumers since a competitor that is not dominant may be eliminated. That is why, to eliminate the risks of this a reference to all indicators of dominance should be made so that a correct finding of the culprit will ensue.

Finally, one has to bear in mind that the list of the criteria is not exhaustive, and can be widened by other criteria specific to the type of activity performed by an undertaking concerned. For example, in telecommunications, it would be wise to consider the exclusionary effect of government licences that may limit the number of competitors in a particular market.

2.2. The Relevant market

The relevant market concept is a very important one as it enables to establish whether a firm or group of firms is guilty of exerting a substantial impact on the competition. By identifying substitute products or services, which may pose a threat to other firms, one delineates the relevant market. This allows to count market shares that each firm has, and describe the market concentration, which in turn enables to analyse the market power discussed earlier.\(^{14}\) Although the relevant market concept serves as an intermediate tool in a competitive analysis, no investigation of dominance could take place without it.

It is in the Commission’s Notice that its vital role is defined:\(^{15}\)

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\(^{14}\) Market power is a function of market shares, the number of competing suppliers of the same products, barriers to entry, barriers to expansion, product differentiation and the nature of the oligopolistic interaction between firms-author’s note.

\(^{15}\) Commission Notice on the definition of the relevant market for the purposes of Community competition law, OJ 1997 C372.
“Market definition is a tool whose purpose is to identify in a systematic way the competitive constraints that the undertakings involved face. The objective of defining a market in both its product and geographic dimension is to identify those actual competitors of the undertakings involved that are capable of constraining their behaviour and of preventing them from behaving independently of any effective competitive pressure.”

Having regard to the above quote, the relevant market contains all those substitute products and regions which provide a significant constraint on the products and regions of interest.

The Notice speaks of three constraints: Demand substability, supply substability and potential competition.” The assessment of demand substitution entails a determination of the range of products which are viewed as substitutes by the consumer,” according to the Notice. “Supply substitution means that suppliers are able to switch production to the relevant products without incurring significant additional costs or risks in response to small and permanent changes in relative prices”. The third source of competitive constraint, potential competition, does not need clarification.

Another observation to be made from the above quote is that a relevant market has two dimensions: the product market and the geographic market dimension. The product market dimension considers which products provide an effective competitive constraint on the products made by the relevant market players:

”A relevant product market comprises all those products and/or services which are regarded as interchangeable or substitutable by the consumer.”

The relevant geographic market dimension emphasises mutual constraints of firms co-existing in the same market:

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17 Section 6 of both Form A/B with respect to Regulation 17 and Form CO with respect to Regulation 4064/89.
The relevant geographic market comprises the area in which the undertakings concerned are involved in the supply and demand of products or services, in which the conditions of competition are sufficiently homogenous and which can be distinguished from neighbouring areas because the conditions of competition are different in those areas.”

Whereas the question of why to define the market was easy to answer, the next one - how to define it, is more complicated. In doing so, the Commission focuses on the following factors approach set out in the Notice.

To the factors considered when defining the product market belong:¹⁹ (1) physical characteristics of the product/service, (2) intended end-use, (3) product prices, and (4) consumer preferences.

In effect, the above factors are used by the Commission to establish whether the products are substitutes, in other words to assess the price elasticity of demand. If, on the basis of the analysis, the Commission finds that the demand curve for one product is more elastic than for another, then the products cannot be reasonably substitutable for another, since they have different attributes, prices and are differently perceived in the eyes of the customers.²⁰ If this is the case, then the products belong to separate relevant markets and the producers cannot constrain each other’s behaviour.

A good example is in Volvo/Scania v Commission²¹. The latter defined separate markets for trucks of 5 to 16 tons and 16 tons and over saying that the two products cannot be substitutes as they are technically different; they have different attributes, and cannot be used for the same end use. On that basis, it would be appropriate to define 16 ton trucks

¹⁸ See footnote 16.
¹⁹ See footnote 17; Notice on the Relevant Market, point 7.
²⁰ I assume that if the demand curves for two products look almost the same, then the products are close substitutes. In an extreme case, where the two curves look the same, the two products would be copies of each other, which is impossible since products differ from each other. Moreover, products characterized by more elastic demand curves are not the ones that one could suspect of being supplied by a monopolist since he would loose too much after the slight price increase of his products- author’s note.
²¹ Volvo/Scania, OJ 2001 L 143/74.
as another relevant market, said the Commission. As for the price factor, the amount of money we pay is an important factor in evaluating whether products are substitutes.\textsuperscript{22} If similar products sell at widely different prices in the same geographic region, they are unlikely to be close substitutes, and define separate markets.\textsuperscript{23} Thus, similar products sold at different price levels, such as soft drinks and spring water belong to different markets.\textsuperscript{24} If a small increase in prices would cause consumers to switch to alternatives, these interchangeables must be included in the relevant product market.\textsuperscript{25} However, substitutes must be excluded in cases of barriers, such as a need for different cooling equipment.\textsuperscript{26}

To be sure about how the consumers perceive the products or their characteristics, the Commission contacts consumers to obtain information on their views on substitutability.\textsuperscript{27} The rule is that distant substitutes have less of a chance of belonging to the same relevant market than close substitutes.

When defining relevant geographic markets, the Commission considers the factors that can be summarised under the following headings: \textsuperscript{28}(1) regional differences, (2) product prices, (3) consumer preferences and (4) transport costs.

According to the relevant geographic market definition two products cannot belong to the same market if conditions of competition are heterogeneous in the two markets. That is why, different marketing strategies in different geographic markets (regional differences); significant price differences between two geographic areas; particular consumer lifestyles, language and culture (consumer preferences), and significant

\textsuperscript{23} Tetra Pak I, D. Comm., 1980 OJ L 272/27.
\textsuperscript{24} Nestle/Perrier, 1992 OJ L 356/1.
\textsuperscript{25} United Brands, 1978 ECR 207, paras. 32-33.
\textsuperscript{26} Tetra Pak/Alfa-Laval, 1991 OJ L 290/35.
\textsuperscript{27} Commission notice, supra note 15, point 33.
\textsuperscript{28} Bishop S., Walker M., supra note 3, at p. 113.
\textsuperscript{29} Hoffmann-La Roche, ECJ 1979 ECR 461, para 22.
\textsuperscript{30} Thorn/EMI/Virgin Music, D. Comm., 1994 OJ L 364/1, point 47.
transport costs\footnote{Continental Can, ECJ 1973 ECR 215, para. 35; geographic limits between 150 and 300 kilometres for transporting large cans and between 500 and 1000 kilometres for transporting smaller cans.} are all reasons why competitors’ products from outside the region belong to a separate market.

It is indisputable that the definition of the market should be a function of the two types of markets I have just described, that is the relevant product market and the relevant geographic market. For the purpose of my thesis let me introduce the following definition of the market that draws on the above observations:

A relevant market is a set of substitutable or interchangeable products made and sold within a given, distinguishable area, where there are competitive constraints that producers present in that market face.

It is to be emphasised that products and/or services that could readily be put on the market by other producers without significant costs or by potential competitors at reasonable cost and within a limited time span also need to be taken into account.

2.3 Abuse of dominance

The concept of abuse itself has not been defined yet. For example, Article 82 does not attempt to provide a definition of abuse, but instead lists examples of abuse, videlicet: (1) directly or indirectly imposing unfair purchase or selling prices, (2) limiting production, markets, or technical development to the detriment of customers, (3) applying different conditions to equivalent transactions with other trading parties; and (4) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

Although by listing examples, one may have a vision of what abuse is, still, it is better to work out a definition rather than enumerate samples taken from real life stories.
In all above instances put forth there are two issues that intertwine the four points, namely the existence of at least two parties, and occurrence of improper treatment or expressed differently a change of the inherent purpose of dominance to the detriment of the abused and to the advantage of the abuser. This is somewhat similar to a game, where one side is doomed to failure, while the other has to win no matter what.

The last conclusion and the comparison I made are based on the quote from a duel between the Commission and Hoffmann-La Roche. The first said that:

”An objective concept relating to the behaviour of an undertaking in a dominant position is such as to influence the structure of a market (the game) where, as the result of the very presence of the undertaking in question (abuser), the degree of competition is weakened and which, through recourse to methods different from those which condition normal competition (change of the purpose of something), has the effect of hindering the maintenance of the degree of competition still existing in the market (outcome of the game) or the growth of that competition.”

One issue that has not been addressed, and which in my opinion, is vital to the concept of abuse, is the existence of fear that the hypothetical abuser will carry out its threat that it has given either directly or indirectly to the abused. If the threat can be neglected, because the hypothetical abused firm knows that the abuser does not have enough power, then there could only be talk of an unlucky attempt to frighten rather than abuse one’s dominant position. If the given threat scares off the rival however, the abuse is observable, able to be detected and should be punishable. It is not as the current legislation does not catch modern price predation cases where the firms want to enter the market. Recall the Commission’s statement above. This body does not include in the analysis likely entrants, which calls for a change to the current legislation.

Having regard to the above observations let me put forward the following definition of abuse modified in a way that it catches every cases of abuse:

32 Hoffmann-La Roche, Case 85/76 (1979).
Abuse of dominance is the corrupt practice, existence of which compromises the quality of the competition in the market, where at least one party (the abused) is successfully frightened by no matter what kind of threat given no matter how by the firm with substantial market power.

It is to be underlined that abuse of dominance is subject to a monetary penalty and is regarded as an offence that aims at destroying the existing competition. The examination however should be widened by the inclusion of possible entrants, the analysis of which seems to miss out on today.

The survey of the three issues, namely dominance, relevant market power and abuse of dominance is completed. Dominance that can be regarded as a market power is a function of a set of elements that help to point out a dominant predator. Relevant market power is a tool for establishing the dominance. Here a scan of a geographic and product markets is required. Such issues as regional differences, product prices, consumer preferences and transport costs, and substability are dealt with.

Abuse of dominance has been widened to include not only present players but also the future ones-an element the inclusion of which will lead to a more thorough understanding of the wealth of possible abuses that are to be observed today. That combined with the guardians described in the first chapter will help eliminate underinclusiveness embedded in the current thinking.

The next chapter’s role is to draw the line between legal and illegal price setting today. The crucial steps forward include an assumption about information asymmetry and consumer welfare. However first I present current thinking and then propose my own standard for evaluating the suspected behaviour. The chapter ends with a proposition of the new legislation.
Chapter III Predatory Pricing

This chapter’s role is to draw the line between legal and illegal price setting. This goal is attained, but the way towards it is a long one. The starting point is a definition of the concept. Presentation of possible strategies that current legislation does not catch is also made. However, prior to that a review of the current thinking together with a suggestion as to reflections on it ensues. The key features of the new approach are discussed. The border line examination is enriched with a list of possible defences.

3.1. Defining the concept

What is it about predatory pricing that we do not like? The answer seems to lie in the following quote:

“Predatory price cutting is specifically designed to kill off or repress rivals of the seller, or at least bring them to terms. This is the case of competition to establish monopoly, where, if successful, there is an eventual reduction of the market alternatives at the primary level.”

According to the above citation there are two much hated issues about price predation, namely driving the rivals out of the market or binding their hands, and the consequential reduction in the number of products delivered to the market. Similarities are to be found in the following quote by Sheffet who, while depicting the concept, implies the existence of purported strategies that are to be found in today’s firms’ behaviour. She said that:” An aggressive firm may also attempt to lower a rival’s profits through price predation. In this case, a firm sets its prices low enough and for a sufficient time period to disadvantage its rival in some way”. The word aggressive evokes images of firms fighting for market shares and employing different strategies - different from their non-aggressive ones. This, in turn, implies that predatory pricing must be a temporary strategy that accompany or supplement a firm’s behaviour.

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The second part of the quote is more informative and usable, but has its drawbacks since it contains words, such as sufficient, low enough and in some way, that may suggest a lot to a lot of people.

Massimo Motta claims:” 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”\textsuperscript{3} and Brooks states that” predatory price cutting is indicated in such cases only when the firms being eliminated are selling products which – in the eyes of the market – are inferior to the product of the price cutter”.\textsuperscript{4}

Sullivan observes that:” The predator seeks not to win the field by greater efficiency, better services, or lower prices reflective of cost savings or modest profits. The predatory firm tries to inhibit others in ways independent of the predator’s own ability to perform effectively in the market. Its [conduct] is calculated to impose losses on other firms, not to garner gains for itself”\textsuperscript{5}. According to Gundlach there are game theory models that” go beyond suggesting that the rationality of predatory pricing is lowering prices to below-cost levels and then subsequently attempting to recoup losses through monopoly profits”\textsuperscript{6}. In other words, there are models that help a predator to block an entry through employing strategies other than those involving below-cost schemes.

These various definitions unfortunately differ greatly. While Morris focuses on extermination of those in the market and establishing a monopoly, Sheffet and Sullivan underline slow and painful cutting of competitors’ throats. Although all statements imply the lowering of prices, the definition put forth by Motta implies predators’ sacrifice of short-term profits and suggests strategic game, the

outcome of which is profits in the form of future benefits. Gundlach’s mention about the existence of the models makes his proposition stand out from all presented. This all makes it difficult to state clearly what predatory pricing is and when it occurs. Therefore, I adopt a definition that tries to reflect above observations borrowing the best of what they contain, and melting them into one, namely:

Predatory pricing is the corrupt practice that involves lowering prices to an irrational level (usually below cost) in a certain market in an effort to weaken, eliminate, or block the entry of a rival that would frustrate a predator’s plans of recouping losses sustained in the period when prices were manipulated.

3.2. Conditions necessary for the proof of price predation in the U.S. Courts

In its Brooke Group ruling put forward by the Court it was determined that” recoupment is the ultimate object of an unlawful predatory pricing scheme; it is the means by which a predator profits from predation.”

True, inherent in the predator’s strategy is the sustaining of short-term loss and an expectation of profits from its corrupt practice in the long-run. By making short run loss a predator assumes that prospective monopoly profits will be made. If no profits are to be made or they do not equal or exceed losses sustained, the predator’s pricing strategy is irrational and unlikely to be predatory.

Whether future profits will be made depends on the structure of the market concerned and proven ”where the structural characteristics of a market imply that the minimum efficient scale of entry is considerable, or entails considerable expenses, or involves assets that are not transferable from other markets”.

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The list could be enriched by analysing the quality of demand since “where demand is thriving, prospects for recoupment are good, whereas under conditions of declining demand and excess capacity, such prospects are poor”.

Proof of recoupment is not difficult as it requires the evidence that a predator’s competitors were removed from the market and that as a consequence of that the price was raised. To prove this an analysis of the market could be made and closer look taken at the firm’s price path.

### 3.3. Conditions necessary for the proof of price predation in the EU

**Market power** is first looked at in European predatory pricing cases. This inference is based on Article 82 that prohibits any abuse of a dominant position. As the article applies only if the investigated undertaking is dominant at the material time of abuse, predatory pricing cannot be proven without first establishing whether the firm is a key market player.

But being dominant is not enough and a proof of abuse has to be found. In its AKZO decision, the Commission found that AKZO’s actions, mainly its threats, the selective nature of its price cuts, and an exclusive purchasing obligation it imposed on its clients, unveiled a detailed plan on the part of that company to destroy ECS, its primary competitor. The Commission also indicated that, whenever low pricing may be explained in different ways, it is the *intent* of the defendant alone that will decide whether this pricing is predatory or not.”

Although, intuitively, intent is the main driving force of predatory pricing, which is incorporated in every illegal pricing plan, it is difficult to prove: ”Announcements that a firm will underbid its rivals and drive them out of the market may mean either that a firm will vigorously compete on the basis of superior efficiency, excluding its less

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efficient rivals, or that it will use its abundant financial resources, power and competitive advantages, to exclude its equally or more efficient competitors.\footnote{11}

As for the cost criteria used the Commission did not adhere to any lawful or unlawful cost base. It simply stated that prices above average total cost can be anticompetitive.\footnote{12} Later, the European Court stated that predation should be presumed where prices are below average variable costs. Prices above this level but below average total cost could still be predatory if set with the intention to eliminate a competitor. Finally, the Court did not accept the Commission’s ruling in which the latter stated that prices above average total cost could be predatory.

### 3.4. Current analysis of predatory pricing - static setting

J. Gundlach criticising the current thinking (including standards) on predatory pricing emphasises drawbacks of the current views underpinning predatory pricing concept saying that they are very economics-oriented:” Current policy assessments of predatory pricing rely on the narrow behavioural assumptions of neoclassical price theory.”\footnote{13} Similar accusations are made by Janusz Ordover who claims that static approach, that is the one in use, is faulty since” applying static models of competition and monopoly to the analysis of profitability of [predatory pricing] strategies.”\footnote{14}

The static model assumptions include:\footnote{15}

1. Competitors possessing complete information;\footnote{16}
2. Being motivated inclusively by profit maximization;\footnote{17}
3. Operating within market conditions that generally mitigate dominance;

\footnotesize{\begin{itemize}
\item[] \footnote{11} Emmanuel P. Mastromanolis, supra note 8, at p. 222.
\item[] \footnote{12} ECS/AKZO, O. J. (L 374) 1 (1985), at p. 20.
\item[] \footnote{15} Joseph P. Guiltinan & Gregory T. Gundlach, supra note 13, pp. 87-102, at p. 89.
\item[] \footnote{16} Janusz A. Ordover & Garth Saloner, supra note 14, at p. 541.
\item[] \footnote{17} Janusz A. Ordover & Garth Saloner, ibid., at p. 541.
\end{itemize}}
(4) Being completely rational in decision making, and
(5) Injury to consumers occurring only through monopoly pricing.

What comes of this assumptions is disbelief that "predatory pricing can ever be tried and successful since very costly". The scepticism is also to be observed in *Matsushita Electric Industrial Company v. Zenith Radio Corp.*: Predatory pricing is considered "rarely used and even more rarely successful".

The scepticism is mainly fuelled by perfect information assumption, which led to views that recoupment was never possible since above normal returns would attract new rivals, and that a would-be predator would incur such great expenses in waging a war that he would do better to differently spend his resources for example by innovating.

To put it differently complete information allowed both predator and firms in a sector to perfectly foresee each other’s moves and returns, and this led to erroneous inferences about the profitability of predatory pricing, according to which this phenomenon was too dear.

If the moves can be foreseen no counter strategies make sense because a predator has no chances of preventing others from entering the market or influencing financial institutions willing to lend money to finance counter attacks. Loans will be possible as long as the banks will see that any firm is likely to win the battle. In a perfect world this will be easy to gather since every market player is a know-all. Thus, banks can make a fortune as long as the predator will finance the war, firms will not perish since financed, and the only looser seems to be a predator. Therefore the striking views that a

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predator would never engage in predatory pricing since loosing too much and having no prospects of recovering losses.\textsuperscript{21}

Operating in an environment where profit maximization is the only goal\textsuperscript{22} makes it even more difficult to believe the profitability of the corrupt practice. Selling below cost, and not being sure about recoupment endangered by entering firms made assessments about profitability of this phenomenon look more unsatisfactory and gave rise to a view that because of its costs predation is rarely tried and hence not likely to occur.

The third assumption is also wrong. There is nothing worse for a predator than the ease of entry by rivals lured by excess profits very likely to be harvested. New firms entering the sector would significantly decrease market power held by a predator frustrating his plans about dominance and recoupment. If there could be no talk of dominance, then a would-be predator would be very unlikely to consider a move that would prove unprofitable and irrational. Thus, predators do not operate exclusively in environments that mitigate market power. If every predator did, he would fail.

Irrationality does not fit the model assumption about being completely rational in decision making as the model assumption rendered irrationality out of fashion. The consequence of this was the view about predatory pricing being fruitless.

Finally, the last assumption that too high prices are the only factors that compromise the consumer welfare lead to every analysis of predatory pricing being centred on whether the prices are not detrimental to competition forces.\textsuperscript{23} The assumption excluded from the analysis other factors that decide about the welfare. According to Gundlach one could include new factors such as:\textsuperscript{24}

\begin{flushleft}\footnotesize
\textsuperscript{22} I made this inference on the basis of the article of Areeda and Turner, where profit maximization is the only goal of a firm. \\
\textsuperscript{23} The threat to competition through too high prices is included in every current definition of predatory pricing phenomenon – authors’ note. \\
\textsuperscript{24} Joseph P. Guiltinan & Gregory T. Gundlach, supra note 13, at p. 94. 
\end{flushleft}
(1) High quality,
(2) Innovation and
(3) Variety.

With these factors in mind, an analysis of the possible threats to consumer welfare can be widened, that is other factors that may well compromise our well being can be taken into account.

It is indisputable that an analysis of the phenomenon with all five assumptions relaxed will be not only more interesting, but also will enable to detect more cases that are detrimental to competition and consumer welfare. Moreover, the proposed approach as opposed to the pure economic one,25 will allow to reflect the nature of strategic market interactions25 and accompany the standards with more tools needed for detection of the present day predatory pricing schemes.

As a way of defence of the current thinking it needs to be said that it harks back to a period where it was impossible to judge this phenomenon at so many different angles. Computers and other advanced research methods have been with us for the last thirty years or so, and price predation started as early as the end of the XIX century26. Moreover, such occurrences as international or global fusion were much the scope of science fiction rather than reality then.

In other words, it is the evolving environment that necessitates changes in the way we perceive and break down such a phenomenon as predatory pricing not the other way round. Thus, the assumptions used were good and still can be used in price cutting

25 Janusz A. Ordover & Garth Saloner, supra note 14, at p.591.
26 The first famous predatory pricing case came into being in January 1882. The standard Oil Trust as it was named used a number of techniques to eliminate competitors, including (1) buying them out, (2) temporarily undercutting their prices, (3) forcing customers to sign long-term contracts, (4) forcing customers to buy unwanted products in order to receive the products they wanted, and (5) dispatching thugs to use intimidation and violence when all other means of persuasion failed. See generally Janusz A. Ordover & Garth Saloner, supra note 14, at p.545, and F.M. Scherer,” Industrial Market Structure and Economic Performance, 2nd ed., Boston: Houghton Mifflin, 1980, pp. 336-337.
assessments. The only change is that they need to be relaxed to understand this practice in today’s environment.

3.5. Information asymmetry

It is indisputable that the world we live in is a turbulent place with much of the information unavailable, scattered across the market unevenly, sometimes irretrievable. As information is so spread, there are no firms that possess complete sets of data. However, there may be firms that possess more information than any other firms. A classical example could be any undertaking that exists long enough to gather this information or the one that acquired knowledge quickly because of core competencies that the firm possessed. These could be better managers, teams of workers or even better organized systems of work that allow quicker assimilation of concepts and knowledge27.

As knowledge involves all spheres of any organizational activity that encompasses for example marketing, distribution, cost analysis, and competitor research, the information collected by a firm that wisely do so, may differ greatly from that of the incumbent firms.

The gap between what this firm knows and the others’ intelligence levels is a source of asymmetry, rather informational asymmetry28.

It should surprise no one that different levels of knowledge may be the source of misconduct on the part of the firm that is for example to a lesser extent dependent for resources on external ones. And consequently if it may lead to abuse of dominance, then an analysis of information asymmetry should become another element of proof in a battle between likely predator, courts and plaintiffs29. Another reason why

27 Raphael Amit, Ian Domowitz and Chaim Fershtman define asymmetry as a firm’s competitive advantage. Included in the factors that lead to the competitive advantage are tangible (e.g. technology) or intangible assets as well as likely responses of the rivals to a firm’s strategic move. See R. Amit, I. Domowitz, C. Fershtman,” Thinking One Step Ahead: The Use of Conjectures in Competitor Analysis,” Strategic Management Journal, Vol. 9 (1988), pp. 431- 442, at p. 431.
28 See generally Janusz A. Ordover & Garth Saloner, supra note 14.
29 Ordover and Saloner [1989] make a similar point at the close of their Handbook chapter.
information asymmetry is vital to setting legal limits to predation is that it can help encumber those strategies - undetectable by present legal standards – that endanger the competition forces. A case in point is for example a reputation strategy that is to be come across in incomplete information settings where imperfect knowledge makes it possible to influence preferences other firms choose, and even induce their non-entry.

3.6. Proposed approach

The main advance offered by this approach over the static one will be a possibility to embed the concepts of purpose and planning into sound economic thinking. The new assumptions that will be taken into account are negation of the ones described. Moreover, I included one that helps understand predatory pricing strategic behaviour to be found today. They include:

(1) Competitors possessing incomplete information;
(2) Being motivated by profit maximization and other factors;
(3) Complex market conditions that may be conducive to market power;
(4) Being irrational in decision making;
(5) Injury to consumers occurring through too high pricing, lack of innovations, lower quality of the goods and services, and not enough products to choose from.
Moreover,
(6) Firm is a strategist.

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31 A complementary approach to a static one – strategic approach- was proposed in Patrick Bolton, Joseph F. Brodley, and Michael H. Riodan, supra note 21. However, I depart from their proposition as to asymmetric information being the only assumption of the complementary approach. The main reason being that this assumption does not allow for an analysis of all injuries caused by a likely predator. For example the authors are silent about complexity of the market structure, and fail to observe different attitudes towards views on consumer welfare-author’s note.
The implications of the first assumption are clear. Possessing incomplete information makes predation a highly likely strategy. Predator can now see through any firm it wages war against or willing to enter the market. This all makes predation sensible since now a predator can influence all market players, financial markets included.

The second assumption underlines other than profit maximization goals of a would-be price predator. As Simon shows managers are satisfied with sub optimal outcome levels, Stelzer, suggests that managers maximize their own goals:” Predation may not maximize profits. But it may nevertheless be a rational, far from unthinkable policy for business managers seeking to maximize their own career opportunities. Urbany and Dickson, in turn, provide evidence on the preference of managers for volume sales rather than profit maximization objective.

The implication of the above is that the US and EU courts should become aware of the fact that there may be cases where firms may be predating, but where the proof of that happening will be difficult to ascertain. Strategies adopted may result in below cost pricing, but recovering of losses will be impossible because managers value other strategies than profit maximization higher. This in turn calls for modifications to the current methods for detection of this phenomenon and emphasises their imperfection.

As for market conditions they may turn out to be conducive to market power. The entry of firms could be thwarted and recoupment allowed. A predator, possessing more information, may influence likely entrants causing their non-entry. However, as no one has perfect information no firm, predator included, can expect to recover all losses. “Projections and observing competitors’ moves is possible, but the difficulty of identifying the recovery period and nature of returns is big.” Moreover, I think that

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33 Janusz A. Ordover & Garth Saloner, supra note 14, at pp.548-560.
37 Joseph P. Guiltinan & Gregory T. Gundlach, supra note 13, at pp. 91-92.
complexity of actions and market players’ reactions may render it partly impossible to establish who did what, which enhances predatory pricing rather than make it unlikely.

The fourth assumption refers to the rationality of decision making. According to Gundlach rather than being perfectly rational,” decision making processes reflect only a desire to make the best possible decision under the circumstances to achieve particular goals”38. This implies that the set of decisions chosen by managers is the best alternative at a certain point of time. Given incomplete information and turbulence of environment no decision or no choice made can be optimal rendering the decision making process irrational although rational at chosen point in time, that is when decisions are being made.

Assumption about injury to consumers places them at a centre of analysis. Although the difference between this assumption and that of injury to consumers occurring to them through an injury to competitors is not big, it is crucial to understand why it is better to protect consumers themselves (as I suggest) rather than construct laws that only protect competitors. Less efficient competitors may collude and lobby for a surrender of a more efficient rival offering lower prices of the same product.39 Furthermore, a stronger monopolist with a solid brand name can drive higher cost entrants from the market by pricing below their cost, but above its own, which minimises the number of key players. One could possibly ask why the entry of higher cost rivals should be allowed. The only answer I can think of is for the sake of consumers. Recall a previous Gundlach’s proposition as to what constitutes consumer welfare. Now it becomes clear why competitors whose demise was brought about by a monopolist charging ‘legal’ prices are needed in the market place.

38 Joseph P. Guiltinan & Gregory T. Gundlach, ibid., at p. 92.
39 For example, Wal Mart was sued by rival pharmacists, not by consumers fearful of future monopoly prices. These pharmacists sought shelter from competitive forces. Rather than suffer lower profits or the necessity of matching the new higher standard of responsiveness to customer demands set by Wal-Mart, the plaintiffs instead accused Wal-Mart of ‘predatory pricing’. At trial one of the plaintiffs whined that he had to do “a lot of belt tightening” after Wal-Mart opened. The same plaintiff also admitted that the pharmaceuticals market became more competitive after Wal-Mart entered. See Wal-Mart Stores Inc. v. American Drugs, Inc. at http://courts.state.ar.us/opinions/old/94-235A.html.
Assumption about firms being a strategist requires a few words of explanation. The role of this assumption it to remind that it is people behind all decision making processes, and as such these people, be it managers or marketing staff have a number of options to choose from while devising strategies that either help gain dominance, or maximize their profits or employ any of the alternative strategies described in the next section.

Table 1 allows an overview of the current assumptions together with their implications.

<table>
<thead>
<tr>
<th>Assumption concerning</th>
<th>Economics oriented approach</th>
<th>Proposed approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information access</td>
<td>Parties possess “perfect information” and can foresee each other’s moves.</td>
<td>Parties possess incomplete information</td>
</tr>
<tr>
<td>Decision making process</td>
<td>Rational</td>
<td>Irrational</td>
</tr>
<tr>
<td>Market power</td>
<td>Recoupment unlikely</td>
<td>Recoupment hard to predict but likely</td>
</tr>
<tr>
<td>Decisions taken</td>
<td>Profit maximization</td>
<td>Profit maximization, goals connected with career opportunities, volume sales and other that only managers can explain</td>
</tr>
<tr>
<td>Injury to consumers</td>
<td>Through high prices</td>
<td>Through high prices, poor quality, lack of innovations, and sameness of the products</td>
</tr>
<tr>
<td>Strategy</td>
<td>“Below cost”</td>
<td>Numerous strategic moves</td>
</tr>
</tbody>
</table>

Source: Own research.
3.7. Possible predatory pricing strategies

For whatever reason, a number of strategies are available to the predatory firm. No matter whether a strategy is used alone or with combination with other strategies, its effect may be exclusion of rivals and reduction of consumer welfare. Table 2 presents these strategies along with observations concerning their nature.

3.7.1. Price warring and price-below cost strategies

The most famous predatory pricing strategies involve setting prices to below cost levels or price warring. The only difference being between the two is that price warring involves drastic but temporary lowering of the price to injure competitors. A good example of the latter is the setting of low prices by Aldi and Netto.

3.7.2. Price discrimination strategy

A seller charging competing buyers different prices for the same good may be caught by the guardians described in the first chapter as this strategy may hurt competition by giving favoured customers an edge in the market that has nothing to do with their superior efficiency. However, price discriminations generally are lawful, particularly if they reflect the different costs of dealing with different buyers or result from a seller’s attempts to meet a competitor’s prices or services.

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41 I do not include in the analysis other abuses of dominance or other non-price strategies for reasons of clarity. It is highly likely that these will be used in combination with price tactics described.

42 On 21st July 2004 Netto and Aldi set their prices of beer overnight to below rock bottom prices from DKK 2.50 to 1.50. A few days later the price of milk in one of these shops dropped to DKK 2.0 from 6.50.

Price discrimination also might be used as a predatory pricing tactic to harm competition at the supplier's level. Deliberately setting low prices, the predator may lead to the exclusion of his rivals, which in turn has the effect of hampering or extermination of competition.

Table 2. Predatory pricing strategies

<table>
<thead>
<tr>
<th>Predatory pricing strategy</th>
<th>Description</th>
<th>Underlying Approach</th>
<th>Asymmetric information</th>
<th>Need to devise new legal standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price below cost</td>
<td>Price below some measure of cost to kill off, weaken or deter entry</td>
<td>Static</td>
<td>Not used</td>
<td>No</td>
</tr>
<tr>
<td>Price warring</td>
<td>Drastic temporary lowering of the price</td>
<td>Static</td>
<td>Not used</td>
<td>No</td>
</tr>
<tr>
<td>Price discrimination</td>
<td>Setting different prices that do not reflect differences in the cost of supply</td>
<td>Static</td>
<td>Not used</td>
<td>No</td>
</tr>
<tr>
<td>Reputation</td>
<td>Building a reputation for aggressive competitive interaction in other markets</td>
<td>Strategic</td>
<td>Used</td>
<td>Yes</td>
</tr>
<tr>
<td>Signalling</td>
<td>Transmission of signals about unprofitability of entering</td>
<td>Strategic</td>
<td>Used</td>
<td>Yes</td>
</tr>
<tr>
<td>Price above cost</td>
<td>Prices cover variable costs</td>
<td>Strategic</td>
<td>Used</td>
<td>Yes</td>
</tr>
<tr>
<td>Signal-jamming</td>
<td>Stupefaction of the rival</td>
<td>Strategic</td>
<td>Used</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Source: Own thoughts.
3.7.3. Reputation strategy\textsuperscript{44}

Here a predator builds his reputation by showing to the outside world that he is a tough competitor and anyone who dares to face him will suffer losses. As reputation building requires time and effort, this strategy cannot be implemented instantly. However, its effects on competition are strikingly negative since once successfully used, it will enable a predator to dominate because all possible rivals will be afraid to enter the relevant market or any markets where the predator’s presence is felt.

As this strategy has to be conspicuous to be successful, a predator strives for exclusion to be observable in as many markets as possible. Therefore, reputation strategy is used by international firms that make use of “whatever means that are available (below cost strategy, signalling strategy)\textsuperscript{45} to give a successful threat and prevent any future entry on any market where predator is operating. In doing so asymmetric knowledge is a key helper. The prey views the predator’s seemingly low prices in one market and believes that these prices represent the firm’s short-run profit maximising response to entry in other markets.

Other types of reputation building are possible. Instead of establishing a reputation for toughness a firm could establish a reputation for weakness and underline its high costs\textsuperscript{46}. Thus, it will signal unprofitability of post entry move and as a result of its strategy it will certainly defend its market share.

3.7.4. Signalling strategy

When information about costs and market demand conditions is asymmetric, a predator can use a low price to signal to a rival strategist that cost or demand conditions

\textsuperscript{44} See Janusz A. Ordover & Garth Saloner, supra note 14, at pp. 550-556; Massimo Motta, supra note 3, at pp. 416-418.

\textsuperscript{45} Gregory T. Gundlach, supra note 6, at p. 283.

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make exit or non-entry a more attractive alternative than staying in the market or entering it\textsuperscript{47}.

The logic behind signalling strategy is simple. It is assumed\textsuperscript{48} that omniscient predator has an obvious incentive to convince any incumbent that its costs are low, which is mainly done by deliberately setting low prices. In that case any daredevil will leave the market as he, judging by the signals obtained, will gather that either a predator is a tough competitor or that the cost structure will unable to make enough profits and/or return on investment.

This belief may alter the firm’s strategies for entering the market, which is the main aim of the predator.

Another example is when a price cutter that may be even more efficient decides to increase his output. He suddenly produces more than he normally would, and due to the increased supply of the produce causes the prices to fall, which in turn causes his rival to exit. Both sub strategies can be used either when the goal is to eliminate any player or to thwart any attempts to enter the relevant market.

No matter which option is chosen the outcome is one - likely distortion to competition and compromising of consumer welfare.

Therefore, this strategy should be forbidden no matter whether a predator is more efficient or not\textsuperscript{49} as price manipulation allows firms to achieve predatory outcomes that laws are to protect market players against.


\textsuperscript{48} Deliberation on possible moves is in Janusz A. Ordover & Garth Saloner, supra note 14, at pp. 556-561.

\textsuperscript{49} Please note that any reduction in the number of competitors is to the detriment of consumers that will have to choose from a smaller number of products when they decide to shop around—author’s note.
3.7.5. Price above cost\textsuperscript{50}

The strategy’s key assumption is to price below one’s total cost, but above one’s own average cost level. The interesting thing is that this strategy is allowed according to both US and EU standards which require prices below cost levels to emerge to successfully penalise a price cutter. The thing is that even such strategies as this one could have an exclusionary effect.

The logic behind this strategy is simple. A monopolist that enjoys significant advantages over potential entrants, be it cost or other ones such as product quality or brand name, may easily outcompete any entrants. Customers may be used to its services, its image may be perceived as very good in the eyes of the customers, which the price cutter knows about and will use to its own advantage. Faced with an entrant sets one’s own prices to below total cost levels, but above average total costs. Any entrant that lacks a strong image is stuck for how to react. The only move is to withdraw since the standards offer protection from below-cost predation. A case in point is the behaviour of American Airlines\textsuperscript{51} that lowered its prices by 25% and increased the frequency of its flights leading to the demise of Vanguard Airlines.

Vanguard Airlines lost its case as it failed to provide the proof of recoupment—one of the elements of proof required by present day standards. The monopolist won increasing its prices.

This strategy is extremely dangerous to consumers because it is legal, and higher cost entrants will never attempt entry, at worst consumers may never enjoy low prices. Therefore, I propose a model that will help to eradicate this strategy, which will greatly increase consumer welfare that should be in the centre of analysis of any predatory pricing case.


\textsuperscript{51} See the complaint at \url{http://www.usdoj.gov/atr/cases/f2400/2438.htm} (13.8.2004).
3.7.6. **Signal-jamming strategy**

The strategy’s key feature is to obscure information about costs, demand and price setting. A prey has to be unable to foresee price trends – is the main mission. This plan is possible due to predator’s constant price breaks or promotions. These disrupt a prey’s test market results and influence its ability to forecast trends concerning prices. Similarly to signalling strategy all this move requires is asymmetrical knowledge. A predator observes the prey and accordingly adjusts its strategy so as to induce the latter’s exit.

3.8. **Predatory pricing border line**

In light of the informational asymmetry observable in business environment as well as assumptions of the approach I put forward, drawing the line between legal and illegal price setting seems to become more and more complicated since intricacy of the business life is enormous. One way of telling apart predators from non-predators would be to literally build a model with a border line separating those behaviours that are detrimental to competition and consumer welfare from those causing their growth. However, one needs to be certain as to one thing. By drawing the line one answers the question of when one deals with predation, but the lawyers would like to hear how to separate legal and illegal price setting. The difference between the two questions seems to be little, but is bigger than one can imagine. One requires proofs of crime, the other legislation that prevents crime.

The first question could be answered by enumeration of all behaviours that is strategies or tactics themselves that are harmful. The number of them will be infinite, and if one is able to point out the practises on the basis of the elements of proof, then the task of finding the culprit should not be difficult. The price predator will be found

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52 Gregory T. Gundlach, supra note 6, at p. 283.
53 According to the new model assumptions, the business environment generates an infinite number of illegal practices. One can be used alone, with two or five or with any combination of the rest according to what a predator wants to achieve.
54 Market power, intent, recoupment, informational asymmetry – author’s note.
as he will be employing one or two or any set of the underhand practises. Thus, one deals with price predation when one employs practices detectable by elements of proof.

The answer to the second question lies in the legislation itself that should provide solutions to any predatory price litigation that may arise. But it is unable to do so. As far as I can see, in respect of predatory pricing, the extant legislation is somewhat behind the developments in economics and strategic management theories. It is created, put into practice, but its emergence is brought about only after some drastic behaviour such as predatory pricing has happened. Examples are abound. Classical one-game theory that has brought into being practises that neither need to involve price below average level of costs nor recoupment, and still are regarded as price predatory55, unfortunately not by the legislation.

The ‘unadjusted legislation’56 is unacceptable since it gives rise to misconduct, and that is why it should be changed so as to allow an exclusion of those behaviours that endanger the competition and the well being of consumers. After the changes have been made, one will be able to satisfactorily answer the second question and draw the line between legal and illegal price setting.

As the new legislation supplemental to that described across the thesis is out of reach, and there are no chances that it will be implemented prior to the time of defence57, I have no choice but to propose one. However, in doing so I will resort to backward induction.

It is common knowledge that all discoveries of ‘legal loopholes’, lead to a new set of laws that protect against these. But in order to protect the new laws must employ a few testing mechanisms so that only the bad practises fail the test at hand. Now, if I assume that these tests are reflection of the laws in force, I will be able to at least establish what the legislation should look like through backward induction. That is exactly what I am going to do, but first I will put forward a new ‘interface test’ of predatory pricing.

56 Patrick Bolton, Joseph F. Brodley, Michael H. Riodan talk about” judicial neglect of modern strategic theories of predatory pricing” in their article on price predation. For reference see Patrick Bolton, Joseph F. Brodley, Michael H. Riodan, supra note 21, at pp. 2321-26.
3.9. Testing for predatory pricing – revival of the standards employed coupled with new propositions

The primary goal of the testing is to make it possible to distinguish price predation from competition. Criteria historically used to do so, namely market power, injury to competition, selling below average total cost were part of the ‘old legislation that allowed to conduct many suits and win the battle against defendants employing their price as a weapon. Times have changed and publication of the famous article by Areeda and Turner allowed more cases to be judged fairly. The authors developed a marginal cost standard.

The rule was based on simple short-run static economic price analysis and states that if the dominant’s firm’s price equals or exceeds its marginal costs it cannot eliminate a more efficient competitor. Areeda and Turner, therefore, consider as non-predatory any price changed by a dominant firm that at least equals its short-run marginal costs. As the incremental cost of making and selling the last unit cannot readily be inferred from conventional business accounts, they conclude, it may be necessary to use average variable cost as an indicator of marginal cost. Finally they state that:

1. A price at or above reasonably anticipated average variable cost should be conclusively presumed lawful.
2. A price below reasonably anticipated average variable cost should be conclusively presumed unlawful.

No matter how well defined, the test has its drawbacks. The Areeda and Turner rule is a very difficult standard to prove in order to show predatory

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57 Efforts are being made to change the wording of Article 82. I contacted Mrs Valerie Rebassa, Chief Economist Team, DG Competition, who replied that they are currently reviewing the article with regard to its underinclusiveness.
pricing. Counting the relevant costs may prove tiresome and having to calculate costs and interpret them by judges at each new trial anew may prove expensive. Another consideration is that the authors do not propose any standard set of costs to be taken into account, which gives rise to unfairness and speculations as to whether the judges were more or less favourable towards a different plaintiff at any new court trial.

A crucial step forward was made by Bolton, Brodley and Riodan. Novelties concerned a substitution of an average avoidable cost for average variable cost and a finding of below-cost pricing when price is below long-run average incremental cost. The test however is faulty. It is unable to successfully separate predatory from non-predatory behaviours because it involves a complex cost analysis. Moreover, a conclusion made by the authors that “a price above average avoidable costs, but below long average incremental costs may, under some circumstances be unlawful” renders the test a guiding device rather than a perfect formula. Moreover, as the test encompasses fixed costs and approximates a long average incremental cost, the firms with high sunk costs will be struggling through to prove their long-run low average costs no matter whether they are price predators or not. The thing is, that in any calculation of costs, high sunk cost firms’ results may well be much higher than those of low fixed cost firms. As their long run incremental averages may turn out to be much above average avoidable cost, but below long average incremental cost, they will pass the test unless “some circumstances” pointed out will lead to their exclusion. In other words, these high sunk costs firms may be price predating, and never proven to be doing so according to the test; of course unless "some circumstances” are brought

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60 According to Areeda and Turner themselves” determination of a reasonable price would require continuing supervision as cost, demand, and technological functions change. Antitrust courts have rightly resisted undertaking the heavy, continuous, and unguided burden of supervising the economic performance of business firms”, Areeda and Turner, ibid., at p. 707.


62 Avoidable costs are those that could have been avoided had the firm not produced the predatory increment of output. Avoidable average costs is avoidable costs divided by the predatory increment of output The long average incremental cost is the per unit cost of producing the predatory increment of output whenever such costs were incurred-Bolton, Brodley & Riodan, supra note 21, at p. 2272.

63 Bolton, Brodley & Riodan, supra note 60, at p. 2515.
before the court of justice. Even if they are brought, the test creates so formidable computation problems that I doubt whether any court will resort to this test and use it in a first line of defence against price predation.

The European Union does not lag behind. A new standard for predatory pricing⁶⁴ is to dispel any fears that one might have about separating the good from the bad price setters. However one looks at it, it is not a huge turning point in the legislation on predatory pricing. The Commission Decision”establishes incremental cost as the appropriate measure of cost that an incumbent monopolist has to cover in providing postal services open to competition”. The decision concerns postal services, but seeing the courts’ dependence on the past cases in formulating their judgements, it cannot be ruled out that the new standard may have implications for other businesses.

According to the decision an undertaking does not break the law by setting its prices if it” earns revenue on [the specific service open to competition] which at least covers the costs attributable⁶⁵ to or incremental⁶⁶ to producing that specific service.”⁶⁷ A yardstick for predatory prices based on attributable or incremental cost makes economic sense: If an undertaking is not able to cover the specific cost of supplying the service, then it would do better not to engage in that service. Continuing the service goes against the economic interest of the service provider and forecloses efficient competitors.

The test is indisputably better than the two proposed in a sense that the calculation of costs is easier, but still it does not mean it is an easy task as it involves an analysis of all steps in the value chain that comprise the service.⁶⁸ The method for

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⁶⁵ Attributable cost is the cost which ceases if a particular service is discontinued. See paragraph 9 of the Decision.
⁶⁶ The incremental cost is defined as” the difference in the firm’s total cost with and without service supplied. See W. Baumol and Gregory J. Sidak, ”Toward competition in Local Telephony,” MIT Press, 1994, at p. 57.
⁶⁷ Paragraph 10 of the Decision.
⁶⁸ A Value chain is a set of actions that lead from the product concept development to its sale and service-author’s note.
determination of the cost of providing one good, e.g. A out of three A, B and C requires deduction from the total costs of providing these three, the total costs of providing only two B and C. Although simple, the main sticking point is a determination of the total cost of providing the services out of which for instance one has been excluded from an analysis. ⁶⁹ Although the Decision, in paragraphs twelve through sixteen puts forward a cure, one has to become aware of possible errors since the method is based on approximation.

The standards proposed, no matter how well they may seem, owe little to strategic theory. Moreover, every standard inevitably leads to an oasis—the grey area—where behaviour is not predatory unless “some circumstances” may prove the opposite. This imperfection calls for a new standard that would thwart all present day firms’ attempts to distort the competition. Attempts should include all predatory pricing strategies I discussed since these are used for example to hold rivals at bay through influencing their beliefs ⁷⁰ or kill them off by slow or fast slushing of their throats.

I propose a complimentary test for price predation. This approach avoids price cost comparisons or at worst moves them to a second stage of analysis. The first one is reserved by an analysis of the present and likely future loss both to the competition and consumer welfare. Since, in the end, it is consumers that suffer the most, the test will first allow to check whether their welfare is not compromised or whether there are no indications as to a lowering of its quality.

An analysis starts by enumerating key market players that in the eyes of the consumers are important; that is those that are able to influence market outcomes such as price and their well being. The enumeration of the undertakings is followed by an in-depth analysis of the firms concerned. Their market power is to be taken into account, but also their strategic behaviour. The most important thing here to establish is whether the undertakings concerned are in a position to manipulate others’ beliefs, and whether the

⁶⁹ The incremental cost in this case for a good A would be IC (A) = [TC (A, B, C) – TC (A, B)].
⁷⁰ According to Raphael Amit, Ian Domowitz and Chaim Fershtman ”an assessment of an opponent’s reaction requires knowledge of what this opponent believes about the firm’s behaviour,” which leads to the latter being able to manipulate any firm. See R. Amit, I. Domowitz, and C. Fershtman, supra note 27, at pp. 431-432.
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others are able to diminish key market players’ dominance - enabling to act in a manipulative way. For example, the ease of entry and outside sources of information that enable both customers and other relevant market players to see through a dominant firm’s (or a group of firms) actions.

An analysis of the strategic behaviour -- an interface analysis - is crucial to the first stage as the interface is the medium by which the firm (or a group of firms) communicates in a given environment with consumers or with other businesses. Furthermore, it could be used to observe any firm’s strategies and lead to tests of their causes and likely effects. The interface includes such issues as marketing strategy, management views, firm’s strategic moves (extant and future ones), ability to influence others, and present-day exerting of a pressure whatever kind by whatever means on both rival and potential entrants.

It is here - in the first stage - that anything that might prove detrimental to other rivals and consumers has to be detected. The only difficult part of the test’s first stage (Figure 1) is answering whether the actions concerned including present day strategies will compromise the safety of consumers. As the components of consumer’s welfare comprise such difficult to quantify elements as the quality of the product, variety, and influence of innovations on quality and technology change, one might begin to doubt the test’s success. There is no need to worry. In the first stage it is vital to establish whether there is plausible loss to the welfare. An amount by which it may be compromised is not important. As a monopoly (or a group of firms compact), no matter how efficient it may be, tends to charge higher prices, provide inferior goods and suppress innovation\textsuperscript{71}, the task of establishing whether the loss to welfare is likely will not be difficult. The firm will have to pay a fine if found guilty of price predation, unless it proves that its products are superior in quality, that is more technologically advanced than those of the likely entrant, that the undertaking in question did not use any price fluctuations whose aim was to scare a likely entrant\textsuperscript{72}, or that its products are

\textsuperscript{71} This is my personal view-author’s note.

\textsuperscript{72} I assume that advancement in technology leads to more efficient methods of production that lead to lower prices.
so superior in quality that consumers will happily give up their welfare in a form of a right to choose from among more products (of different producers).

The first stage should act like a firewall, the second one should be complementary and helpful in proving the guilt in case an undertaking concerned opposes a monetary penalty\(^73\). This time it will be "mutual price-cost" comparisons stage. However, not in a traditional sense. A key assumption here is that firm’s costs and prices do not change over night, and that they reflect economic trends and result from technological change those undertakings may absorb or let pass by. Furthermore, even if the prices do change so quickly, there must be some reasons that the incumbent firm has to put forward.

If both stages are not likely to indicate a culprit, then the third stage that is current analysis is the best option.

In applying the test (Figure 2) one should be aware of its universality in a sense that it can be applied both to cases where both firms willing to acquire dominant positions as well as those dominant are involved. As The EU courts allow a firm which is

Figure 2. How to find a culprit?

Source: Own thoughts.

\(^73\) I will not be hiding that according to the "interface test" such behaviour as that of Netto and Aldi would be detected at worst in the second stage. The shops’ strategic "move" to impose lower prices may threat Lidl - a German rival that wants to enter the Danish market later this year –author’s note.

\(^{73}\) This is my personal view-author’s note.
initially not dominant to become dominant, and the US courts prohibit the wilful acquisition of monopoly power\textsuperscript{74}, I devised the test so that it could be used in both systems that are characterised by differing views of dominance.

The whole test’s successful implementation and success, however, is dependent upon our ability to interpret the issues discussed. Another problem is of technical nature. To be able to judge firms, there needs to be brought into being an independent institution whose existence is necessary to detect false evidence that may be provided by companies and to register all data. The independent body’s function is similar to that of a referee in a game of football, and is inevitably another element crucial to the test’s success.

3.10. Predatory pricing defences

Businesses throughout the course of their life may set prices to low levels without running the risk of being accused of price predation. However, the proof of non-predation is very difficult. As a defence, the firms may argue that their price differential is based on cost. However, in most predatory pricing schemes, the price is lower in the competitive market\textsuperscript{75}, so it would have to be shown in a market where it is cheaper to deal with a client, which is very difficult.

A second defence is to show that the price was ‘meeting competition as a defence,’\textsuperscript{76} which is a highly unsuccessful and risky solution. Following in the footsteps of the firms that employ price lowering strategies- caught by the ‘interface standard’- is bad in itself since both firms may end up paying penalties.


\textsuperscript{75} Michael L. Ursic, James G. Helgeson, supra note 58, at p. 127.

\textsuperscript{76} Michael L. Ursic, James G. Helgeson, ibid. at p. 127.
A third defence is promotional pricing. Unless continued over a long period of time, in which case it is no longer promotional, promotional pricing by new firms without monopoly power threatens little or no harm. Finally, promotional spending should be allowed when not timed to coincide with entry or promotion by a rival.

A fourth defence is that conditions had been changing. For example in *Willow Run Garden Shop* a company dealing in Christmas tree ornaments sold them at a lower price in the off-season. Governmental decisions that allow a reduction in duties on certain goods are another example of changing business conditions. Undertakings concerned may in that case lower their prices so as to stimulate consumer welfare through decreasing (likely to rise) unemployment rates were the changes not enforced.80

A fifth defence may be that the firm’s prices are above price above cost levels; and so that there is a compliance with both US and EU current standards. This argument is very strong and a likely analysis as the one I proposed should be applied to any case where the price is above cost since such a price could also be predatory and have exclusionary effects.

Lastly, a dominant undertaking may also argue that its conduct is not predatory because it is necessary to produce efficiency gains that outweigh the alleged anticompetitive effects.81 This explanation is not good as there is risk that short-term efficiency gains may be outweighed by long-term harm to the competitive process.

87 A promotional price is a temporary, low price designed to induce patronage with the expectation that the customer will continue purchasing the product in the future at a higher price. See Phillip Areeda and Donald F. Turner, supra note 59, at p. 713.
88 This is the reciprocal of Areeda and Turner’s conclusion, but true. At the close of their article they said that “promotional spending should be deemed predatory when timed to coincide with entry or promotion by a rival, and when average variable cost, including the promotional expenditure, exceeds price. See Phillip Areeda and Donald F. Turner, ibid. at p. 733.
80 Although the Treasury Minister Svend Erik Hovmand dismisses claims that Folketinget will lower duties on alcohol, there are many parties, The Danish Folk Party included, that want to have the duty lowered to stimulate employment, especially close to the German border. See an article titled “Politikerne vil igen sænke afgifterne på øl” at [http://www.dr.dk](http://www.dr.dk) (26.7.2004).
3.11. New legislation providing the line between predatory pricing and legal behaviour

Some changes to the legislation are needed which could be gathered through backward induction. Article 82 should have the following form so that the testing described and that proposed are possible.

It should state that any abuse by one or a group of undertakings of a dominant position whether it is direct abuse or through influencing others’ views by manipulating prices shall be prohibited as it may affect trade between Member states and consumer welfare on which variety of the products, quality of the products and quality of the competition between firms have an influence.

Such abuse may, in particular, consist in:

a) Directly or indirectly imposing unfair purchase or selling prices whose aim is to kill off the rivals or prevent their entry

b) Limiting production, markets, lowering quality of the produce or slowing technological development to the prejudice of consumers and

c) Influencing other firms by price warring, price-below cost and signalling strategies that are likely to prevent these firms from entering the markets or induce their exit.

Above rules should concern mergers.

As for the US legislation in respect of predatory pricing every contract, combination in the form of trust or otherwise, or conspiracy, or a strategy whose aim is to influence others, in restraint of trade or commerce among several States, or with foreign nations, is declared to be illegal. Every person who shall make any contract, give a threat by strategic behaviour or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding $10,000,000 if a corporation, or, if any other person, $350,000, or by imprisonment not exceeding three years, or by both said punishments.

The second section should stipulate: Every person who shall monopolize, or attempt to monopolize by giving threats and employing strategies based on influencing
Setting Legal Limits to Predatory Pricing

others’ views, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several states, or with foreign nations, shall be deemed guilty of a felony, and, on conviction thereof shall be punished by fine not exceeding $10,000,000 if a corporation, or, if any other person, $350,000, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.

The changes made are not big. They are specially designed to lead to the inclusion of the cases that ‘old’ guardians are stuck for how to defend consumers and competitors against. The change includes intertwining in the current thinking strategic planning that is absent from contemporary judges’ desks.

Finally the new line has been designated. The process would have failed if the changing of the current thinking from static to dynamic visualizations where the customers count most had not been made. Information asymmetry and relaxing of the strict assumptions were the key guides. They allowed to take a closer look at possible strategies that can be used by dominant firms, and lead to a new standard for predatory pricing scan to be proposed. The test includes strategic interface, price cost comparisons and builds on current thinking acting as a supplement to it rather than a contrary theory. This all allows for an eradication of underinclusiveness since it permits to furnish the guardians with new weapons that modern predators will fail to evade.
Conclusions

As the business environment has changed rapidly, both the US and European authorities need to change the way they look at predatory pricing phenomenon to more successfully separate legal from illegal price setting that influences consumer welfare and competition.

As modern day price setters have learnt how to operate either on the verge of the present day line between legal price setting and price predation or engage in new forms of price predation not prohibited by the current legislation, the current guardians of legal prices are at best equipped with old weapons and at worst harmful to competitors and consumers.

The guardians fail, for example, to capture those behaviours that influence other firms’ views and decision making processes. The courts reliance on unadjusted standards limits their horizons to despair of consumers whose welfare is diminished by key players who embed such aims as e.g. other than profit maximisation in their strategies.

This combined with other tactics gives an opportunity for firms to abuse their dominance since judges that are looking for proofs of abuse from a distant era are stuck these days for how to punish firms behaving badly.

For example, despite different proofs of the corrupt practice, the US courts’ blind reliance on ‘recoupment standard’ and the EU’s on ‘intent’ and ‘price below cost’, makes them unable to punish all that endanger competition and consumer welfare.

Employing for example a signalling strategy a firm may scare potential entrants.

A price warring strategy that can be used leads to the same outcome; is observable, but not punishable according to the present day guardians as neither price below cost, nor recoupment can be proven. Prices are not raised above after a possible rival has been scared off; moreover, they are above average price level. At this point the courts are likely to be perplexed the more so as recoupment is still possible owing to the existence of a wealth of other than profit maximisation aims. Increasing output is one possible opportunity I put forward.
As a cure of the current state of affairs I proposed an approach supplemental to a static one – currently referred to, to help eliminate such cases as the one described above.

The new testing procedure comprises three stages, each of which is designed to either detect strategic planning and/or address present court’s weak points; one of the greatest being the lack of understanding of the wealth of ways that losses can be recouped.

The point of departure was an assumption about consumers. It is them that laws are designed to protect since it is them who suffer the most. That is why the testing method is so constructed as to make it impossible to allow any behaviour where there is a likely risk of a possible injury to consumer welfare. This key assumption led to the test’s first stage.

The first detector out of three allows to detect present day firms’ strategic moves. Incorporated in it is an analysis of an interface by which firms communicate with each other and with consumers. Marketing plans, advertising, management’s decisions are all crucial elements that are subject to analysis here. If it is detected that they lead to distortion of competition or to benefit of consumers at first followed by the demise of their well being the firm is stopped in its attempts or pays a penalty. Even if it is not possible to prove that a firm’s actions may lead to the loss whatever kind to whoever there may suffer, a firm will have to pay a fine in the future, if it appears that future market will be more dominated by this firm, or this firm’s products will be chosen by consumers as a result of this firm’s actions, and not because they are of superior quality leading to better satisfaction of their needs and wants. The whole process of finding the culprit now or in the future will be possible as I included in the model an obligation to register data by both firms and an independent body so that very possible claim could be dealt with fairly.

The second stage of the test involves mutual price cost comparisons. The main aim of the second stage is to detect firms that may be price predating, but that managed to pass the first stage. The key assumption here is that prices do not change overnight, and even if they do, there must be some good reasons.
Fortunately, firms do not have many defences available. I mentioned price based on cost, meeting competition as a defence, promotional pricing, above cost prices, changing conditions and efficiency gains.

However, no matter which defence an undertaking may want to adopt, the chances of successfully defending its choice as to the price being lowered are small. Technology does not change instantly, let alone costs and prices.

If strategic planning detrimental to consumers and competitors is impossible to be detected, if price - cost comparisons that are based on trends do not lead to a detection of a likely price cutter (In the second stage it is assumed that the likely culprit will try to keep his prices above the long term average cost level), then the third stage follows. In the last stage is where the courts use their legislation used at present day trials.

The testing method developed allowed me to propose some changes to the present day legislation so that the concept of planning is embedded in current thinking.

Current laws combined with the innovations I proposed allow to eliminate underinclusiveness present in the legislation. This led to a new border line that lies between behaviours that are legal and those that lead to compromising of both consumer welfare and competitors’ health.

In other words, actions by firms that include such behaviours as influencing others’ beliefs and those that make it impossible to increase variety of the products, quality of the products and quality of the competition between firms are new undesired practises that need to be added to the current thinking.

Current considerations on predatory pricing need to enriched with views on consumers falling prey to price cutters; therefore it is urgent that courts both in the EU and the US become aware of the new tactics such as price warring, price-below cost, signalling strategies, price above cost, signal jamming and reputation strategy.

It is high time they set a new legal standard as the one I proposed to more successfully draw the line between legal and predatory pricing. It is also high time legislators changed their thinking and started protecting consumers as it is them who loose the most in every possible battle (Recall a Wall Mart case).
Conclusions

From the investigation I made it results that no system can be considered more developed or more modern; both have the same drawbacks in spite of differences in the standards adopted. The US system’s prohibition of gaining monopoly power and the EU’s proscription of abuse of it\(^1\) are both stuck for how to tackle present day predatory pricing phenomena since the judges’ thinking on both sides of the Atlantic is based on static reasoning. Moreover, as none of the systems have developed appropriate pan-continental measures of protecting consumers and competitors, I think the time has come to consolidate the systems and implement one standard such as the one I proposed. Currently firms in both systems may use the strategies described to the detriment of both consumers and competitors in the US and EU while operating in both or in one of the areas concerned. The exclusion of this happening would inevitably benefit us all because present day legislation does not guard consumers against likely incumbent firms’ actions.

It is to be noted that successful drawing of the line must be preceded by the development of psychology and marketing since these will be crucial elements underlying the testing proposed. Psychology will be needed to understand social processes, and motivations behind people’s choices as to their spending. Marketing’s role as a medium between consumers and firms is crucial and therefore cannot be omitted in any analysis where the line is searched for.

\(^1\) The new EU Merger Regulation is an exception to the EU system since it prohibits the acquisition of monopoly power. In this respect it is similar to the Section 2 of the Sherman Act-author’s note.
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