Predatory Pricing

Professor Patrick Bolton

Department of Economics and Graduate School of Business

Columbia University

Definition

- General Agreement on what Predatory pricing is:
- ***A price reduction that is profitable only because of the added market power the predator gains from eliminating, disciplining or inhibiting the competitive conduct of a rival***
- ***Predatory pricing involves two phases:***
  - ***Sacrifice***
  - ***Recoupment***
- ***An investment in market power***

Antitrust Policy

- Disagreements on:

- ***Basic Economic premise***
  - *Is Predatory pricing an economically rational strategy?*
  - *How prevalent are predatory pricing episodes?*

- ***Legal standard***
  - *Simple rules?*
  - *Rules that err on the side of under-deterrence to reduce risk of false positives?*

Brooke Decision (1993)

- *Cost Test*:
  - Price below some measure of cost or even *"some measure of incremental cost"* *(AVC, AAC, AIC, ATC, LAIC)*
  - Judicial Standard: presumptive illegality of Price below AVC
- *Recoupment Test*:
  - Predation caused subsequent price increases above competitive level sufficient to recoup predatory investment; or
  - Post-predation market structure (or other market conditions) makes recoupment likely

Brooke Decision (1993)

- Since *Brooke* plaintiffs have not prevailed in a single case
- Almost all cases decided by summary judgment
- Exacting proof and pleading requirements
- Recent exceptions: *Spirit v. Northwest*; *LePage v. 3M*?

Problems with present policy

- **Unreliable Cost test:**
  - Difficulties in measuring cost
  - Imperfect proxy for profit sacrifice
- **Biased enforcement**
  - Recoupment test only applied to predatory strategy and not to efficiency defense
- **Failure to focus on main issues:**
  - 1. What strategy drives alleged predation?
  - 2. Dynamic efficiencies and balancing of pro-competitive and predatory effects

Structured Rule of Reason

Bolton, Brodley and Riordan (2000, 2001)

Legal rule, including efficiencies defense, based on strategic analysis of predatory pricing:

- Financial Market Predation
- Reputation effect Predation
- Test Market Predation

Such a Policy is better able to:

- reduce risk of false positives
- exploit evidence of *intent* (deliberate effort to exclude; pursuit of a specified predatory strategy)

PROPOSED LEGAL ELEMENTS

1. Facilitating Market Structure
2. Scheme of Predation and Supporting Evidence
3. Probable Recoupment
4. Price Below Cost

Prima Facie Case: Elements 1+2+3 (+4)

5. Absence of Efficiencies Defense

PROOF OF ELEMENTS

1. Facilitating Market Structure: Sustainable Market Power

2. Scheme of Predation and Supporting Evidence

- Identify economically plausible predatory strategy
  - financial market predation
  - reputation effect
  - other equilibrium strategies

- Establish that conditions to implement strategy are present and provide direct or circumstantial evidence showing that such a strategy exists

PROOF OF ELEMENTS 2

3. Recoupment

- a. Exclusion or Disciplining of rivals

- b. Probable Recoupment
  - Supra-competitive prices in predatory (or related) markets over sustained period; OR
  - Market structure makes recoupment likely in future

PROOF OF ELEMENTS 3

4. Price below cost

- Cost benchmark good for business planning (?)
- Our elaboration of vague existing cost guidelines: substitute average avoidable cost (AAC) for AVC and long run average incremental (LAIC) cost for ATC
- Failure to meet cost test not necessarily a failure to demonstrate existence of issue of material fact
- Balance cost test against efficiencies defense

PROOF OF ELEMENTS 4

5. Efficiencies Defense

A safe harbor for price competition that benefits consumers

A. Defensive:

- Meet lower price of rival
- *Unilateral best response* (pricing not below short run cost – account for differences in quality of products)
- Minimize losses from unexpected market developments

B. Market Expanding:

- Promotional pricing
- Learning-by-doing
- Network externalities

EFFICIENCIES DEFENSE 2

Conditions for market expanding justification:

- Plausible efficiencies gain
- No less restrictive alternative
- Efficiency-enhancing recoupment
- Balancing test when both anticompetitive effects and efficiencies are present

ILLUSTRATIVE EXAMPLE: Proof of Financial Market Predation

- Economic Theory
  - A predatory strategy becomes viable because of capital market imperfections due to agency problems in lending
  - A predator may slash price to drain prey of sufficient funds to meet loan commitments, thereby forcing default

Proof of Financial Market Predation 4

Proof would require showing of five essential preconditions:

1. The prey is dependent on outside funding
2. The prey's outside funding depends on its cash flow
3. Predation will reduce the prey's cash flow sufficient to threaten its continued viability
4. The predator knows of the prey's dependence on outside funding or can be assumed to know, based on easily accessible facts or rational conjecture
5. The predator can finance predation internally or has substantially better access to external credit than the prey

Example: Entry into cable TV market in Sacramento, California

- Entrant began with outside financing amounting to $6 million, which enabled it to cover a compact area (the Arden district) serving 5000 homes in Sacramento

- First step in a larger plan to build out gradually to challenge the incumbent over a 400,000 home market
- Incumbent responded with drastic price cutting (and other predatory tactics)
- Entrant exited after only eight months

Proof of Scheme of Predation

1. *Dependence on outside funding:*
   - The prey obtained the funds through a loan, personally guaranteed by its owners
   - Entrant's owners unwilling to commit capital beyond their initial loan guarantee to a risky investment in a business they did not know

2. *Outside funding depends on cash flow:*
   - Incumbent targeted its price reductions on entrant's customers and potential customers - reducing cash flow
   - When entrant failed to produce a positive cash flow, banks lost interest in further financing

Proof of Scheme of Predation 2

3. Predation will reduce cash flow and threaten viability:

- Incumbent's actions limited entrant's initial customer base to 170 homes, far below the market size needed for survival

4. *Predator knows of the prey's dependence on outside funding:*

- Incumbent knew that entrant would need huge amounts of capital to reach viable scale
- Memorandum from incumbent's files speaks of sending a message to entrant's bankers

Proof of Scheme of Predation 3

5. *The predator has better access to credit than prey*

- Predatory expenditure of only $1 million by a profitable monopoly serving a market of 400,000 homes, would appear well within its internal funding capability

Conclusion: Potential Concerns

- *Posner (2001; second edition)*: Availability of evidence of intent
  - "a function of luck and of defendant's legal sophistication"?
- This concern is reduced if plaintiff is also required to prove that:
  - Defendant has market power
  - Market conditions and other objective evidence is such that predatory scheme is a plausible rational strategy
- Cost test can also be gamed