

**From Rockefeller to Gates - The Evolution of Predatory Pricing
Or How to Distinguish Victims from Sore Losers.**

Patrick Massey¹

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**If a competitor claims a particular practice is bad, then it is probably
beneficial.**

A rule of thumb for competition analysis?

¹ The author was a member the Competition Authority from 1991-2001 and is a Director of Comecon Limited. Any views expressed are those of the author and do not purport to represent those of the Competition Authority.

Introduction and Summary.

I should point out at the outset that I am due to be released on parole with effect from midnight Sunday after serving ten years. I hope that nothing I say here today would cause the relevant authorities to revoke my parole. I would therefore point out that the disclaimer attaching to my paper today applies with even greater force than usual.

I am pleased that Andrew Whittaker has invited me here today to talk to you on such a relatively straightforward topic as predatory behaviour. Certainly my proposed first rule of thumb for competition analysis would lead to a fairly prompt finding that allegations of predation should be given little credence. Indeed up to the early 1980s there was widespread agreement among economists that predation was simply not possible. Unfortunately it is in the nature of economics that economists are apt to re-open questions just when they appear to have been safely put to bed. The result of this re-examination is that predation is now regarded as possible in certain circumstances.

Allegations of predation have featured in recent US cases brought by the Department of Justice against major companies such as Microsoft and American Airlines. Closer to home there are proceedings currently before the High Court alleging *inter alia* predatory pricing by Bus Eireann and these have been accompanied by newspaper reports of firms other than the plaintiff in this particular case making similar allegations.

Claims of alleged predation tend to greatly exceed the number of proven cases. This undoubtedly is due in part to the fact that predation is complex and rather difficult to prove. However, it is also due partly to the fact that firms may allege predation as a means of obtaining some form of protection against what is simply vigorous competition. Small firms have a clear incentive to allege predation by larger rivals:

‘so long as people in authority can be made to listen and perhaps persuaded to do something, it may pay competitors to complain that someone is preying on them. They have a natural interest in tying the hands of those who compete for consumers’ favours.’²

² J. McGee, (1980), Predatory Pricing Revisited, *Journal of Law and Economics*, Vol.23, 2380330 at 300.

For example, the Chief Executive of a small US airline was reported to have complained that for dominant airlines to match his firm's fares constituted 'unfair competition'.³ Here at home the ban on below cost selling in the Groceries Order is designed more to protect firms from aggressive competition than to prevent genuine predatory behaviour. Indeed some of the arguments made for the Order's retention implicitly recognise that it would not be possible to prove that simple below cost selling by one of the multiple supermarket chains constituted predatory pricing under competition law. Several years ago the National Newspapers of Ireland complained of predatory pricing by UK titles but the Authority, having been requested by the Minister under section 11 of the Competition Act, 1991 to investigate the matter, concluded that there was no evidence of predatory pricing.⁴ The EU Commission subsequently rejected similar claims by some Irish newspapers.

Economics of Predatory Pricing

Competition laws in most jurisdictions prohibit predatory pricing. Price competition involving price cutting or discounting is a normal part of competitive business behaviour. In order for price-cutting to be considered predatory some quite stringent conditions have to be satisfied. Predatory pricing refers to a policy of price-cutting by a dominant firm designed to eliminate competition so that the firm may reap higher profits at a later stage by charging higher prices once a competitor has been eliminated. There are therefore a number of features, which are necessary for pricing to be regarded as predatory.

1. It involves deliberately reducing profits (or even incurring a loss) for a period of time. Although it is normally considered that for predation to occur the predator must incur losses for a time, from an economics perspective this is not essential, all that is required is that the predator be prepared to endure a reduction in profits for a time.
2. The objective of price-cutting is to reduce the number of competitors by eliminating one or more of them, or to weaken them to a degree that they can no longer offer strong competition.

³ US Seeks to Curb Unfair Practices of Major Airlines, *New York Times*, 7 April 1998.

⁴ Competition Authority, (1995), *Interim Report of Study on the Newspaper Industry*.

3. For a firm to benefit from predatory pricing it is essential that it be able to earn supra-normal profits in the future. Where there are low barriers to entry, attempts to raise prices above their competitive level following predation will only serve to attract new firms into the market, thereby forcing prices back to their original level and eliminating any possible gain from predatory behaviour.

Blair and Harrison observe that for decades in the wake of the *Standard Oil* case 'it was an antitrust article of faith that predatory pricing was an effective monopolization device.'⁵ The widely accepted view was that Standard Oil responded to localised entry by pricing well below cost, imposing losses on the entrant and forcing new rivals to exit. Standard Oil could finance such losses by virtue of its 'deep pocket'.

Does a Deep Pocket Help?

However, in the late 1950s McGee⁶ challenged this view arguing that predatory pricing was not a rationale strategy. A merger or acquisition of the new entrant was an alternative less costly means for a dominant firm to eliminate a rival. Consequently predation only makes sense if the direct costs of a price war are small compared to the difference between the price that would have to be paid to acquire the entrant and its competitive market value. Of course active merger controls that prevent a dominant firm from acquiring smaller rivals might exclude this option. McGee also pointed out that the costs of predation are likely to be high for the dominant firm. It will suffer losses on a much larger volume of sales than its prey.

Another criticism of the 'deep pocket' theory is that it assumes that victims are subject to a financial constraint while the predator is not. The dominant firm can engage in a predatory price war until the financial resources of the target are exhausted. A rational would-be entrant that is subject to financial constraints will recognise that a dominant incumbent will respond to its entry by predatory pricing. Thus it would not enter the

⁵ R. Blair and J. Harrison, (1999), Airline Price Wars: Competition or Predation, *Antitrust Bulletin*, summer, p.489-518 at 495.

⁶ J.S. McGee, (1955), Predatory Price Cutting: The Standard Oil (N.J.) Case, *Journal of Law and Economics*, Vol.1, 137-69.

market to begin with or it would certainly exit before it suffered large losses. In other words, if predatory pricing were possible, it would never happen in practice, because it would never be necessary for a dominant firm to engage in actual predatory behaviour.

There is also the question posed by Tirole as to why a new entrant should be subject to financial constraints.⁷ The entrant's creditors could clearly indicate that predation would not succeed by agreeing to provide a new entrant with whatever credit is required to see off a predatory attack. This effectively eliminates the possibility that the dominant firm could bankrupt the new entrant. On this view, provided the entrant's business project is otherwise viable, predation cannot work. As Blair and Harrison observe, however,

‘This makes for interesting theory but fails the reality test if one imagines how the discussion might go between a potential new entrant and its creditors when it attempts to explain that it will not fail as long as there is unlimited funding.’⁸

Investing in a Reputation for Being Nasty.

An alternative view of predation is that a dominant firm, operating in a number of different markets, may have a strong incentive to establish a reputation for predation. Visible bouts of predatory pricing in response to entry in a particular market may well dissuade would-be entrants in other markets.

The reputation theory of predation was criticised by Selten in the late 1970s in what is known as the ‘chain-store’ paradox.⁹ The essential features of this model are relatively straightforward. Take a dominant incumbent firm that operates in many different markets and faces a potential entrant in each of them. Establishing a reputation for predatory behaviour requires that the dominant firm's response to entry in one market influences the behaviour of other potential entrants. Selten's model assumes that entry occurs sequentially and that in any single market the dominant firm's current profits exceed those that would arise from accommodating entry which in turn exceeds the (short-term) profits from predation.

⁷ J. Tirole, (1988), *The Theory of Industrial Organisation*, London, MIT Press.

⁸ Blair and Harrison, p.497.

Consider the position in the final market. Faced with entry the incumbent should not engage in predatory behaviour since it is more profitable to accommodate entry. As this is the final market, there is no one to impress. However, now consider the next to last market. A potential entrant knows that, because it never makes sense to predate in the final market, there is no point in predatory pricing in this market, since there is no benefit in trying to establish or maintain a reputation for predation. Thus in the ‘chain-store’ paradox, the reputation story simply breaks down.

Predatory Pricing – It’s Not for Wimps.

Until the early 1980s economic analysis indicated that predatory pricing was not a rational profit maximising strategy for firms to engage in, and consequently instances of actual predatory pricing were considered extremely unlikely and rare, if they could happen at all. However, the models on which this view was predicated depended on assumptions of perfect information and certainty. When these assumptions are relaxed we find that predatory pricing may be a rational strategy for a multi-product firm to adopt.

Predatory pricing in the face of entry is not a rationale strategy because the profit from accommodating entry exceeds that from predation. However, the dominant firm may be an *aggressor*. By that term we mean that the firm may value predatory behaviour more highly than the larger profits that accrue from accommodating entry, because it ‘suffers some nonpecuniary loss if it behaves like a wimp and permits entry to go unchallenged.’¹⁰

In the absence of perfect information, entrants are going to be unsure whether a dominant firm is rational or aggressive. Thus by accepting the losses necessary to eliminate a particular rival a firm may establish a reputation for toughness which discourages would-be entrants, even though there may be no actual barriers to entry. In this scenario a rational dominant firm has an incentive to pretend to be aggressive, since no one will

⁹ R. Selten, (1978), The Chain Store Paradox, *Theory and Decision*, Vol.9, 127-59.

¹⁰ Blair and Harrison, p.500.

enter if they perceive that it is. In these circumstances a rational dominant firm must always respond to entry by engaging in a predatory strategy, otherwise its reputation will be ruined and subsequent new entrants would never be fooled.

In the absence of perfect information rivals cannot necessarily distinguish between predatory behaviour and a genuine competitive response and are thus unsure whether they are dealing with a rational firm or an aggressive one. Dominant firms may engage in predatory pricing in response to entry in an attempt to convince rivals that fundamental market conditions are bad or that in fact the predator firm's costs are actually quite low thus contributing to uncertainty.

Identifying Predatory Prices.

Recent game theory therefore is able to show that predatory pricing can be rationalised when a number of conditions are met. The main requirements are that the predator be a multi-market firm and that its pricing behaviour is capable of being misinterpreted by an entrant as normal competition.

‘In the vast majority of cases, alleged predation is doubtful predation, which should not come as a surprise given that true predation requires the presence of such doubts. For the very same reason, predatory pricing may be more frequent, in the real world, than is generally thought.’¹¹

This highlights the difficulties facing Competition Authorities in dealing with predatory pricing. Knowing that it can occur is one thing, knowing when it is occurring is somewhat more complex.

The distinction between predation and other forms of exclusionary behaviour may be somewhat blurred. Blair and Harrison, for example, point out that massive advertising campaigns designed to improve brand recognition and customer loyalty can fit the definition of predatory behaviour if such action ‘would be unprofitable unless it hastened

¹¹ L. Philips, (1995), *Competition Policy: A Game-Theoretic Perspective*, Cambridge University Press. P.238.

the exit of a competing airline or deterred the entry of a potential new competitor.’¹² Thus what is effectively predatory behaviour may not be recognised as such since it need not involve cutting price.

Equally all price-cutting is not predatory. Pricing might be regarded as predatory when the predator sells at a loss. It is not essential for losses to be incurred in order for prices to be predatory. Clearly however it becomes much harder to establish predation where in fact a firm does not incur actual losses. Equally it can be perfectly rational for a discriminating monopolist to charge a price below average total cost in some markets since such a strategy is effectively profit maximising. The object of the firm in those circumstances is not to eliminate competitors; rather it is simply maximising its own profits. More commonly when firms launch new products they may frequently sell them at a loss initially as part of a promotional campaign. Changes in demand may also force firms to cut prices simply to dispose of unsold stocks. Thus predatory pricing cannot simply be defined as selling at a loss.

In general it is irrational for a firm to sell in a market at below the marginal cost of production since it would be better off not producing at all at that price. Based on this thinking Areeda and Turner argued in a highly influential article that predation only arises when prices are held below marginal cost.¹³ Recognising that, in practice, measuring marginal cost may be extremely difficult, they argued that courts could infer that pricing was predatory in nature where prices were set below average variable costs. Although easier to identify than marginal costs, average variable costs may also be difficult to measure.

The Areeda - Turner article prompted a considerable debate in the economics literature, some of it critical and some suggesting alternative approaches. The Areeda-Turner rule is designed to restrain firms’ pricing behaviour as little as possible reflecting the authors’

¹² Blair and Harrison, (1999), p.515.

¹³ P. Areeda and D. Turner, ‘Predatory Pricing and Related Practices under Section 2 of the Sherman Act’, *Harvard Law Review*, vol. 88 (February 1975), pp. 697-733.

view that predation is a rare phenomenon. It is therefore arguably overly restrictive. Nevertheless it has had significant influence in US cases.

‘The simplicity of their test may explain why it was adopted with remarkable speed by American judicial circles.’¹⁴

Phlips has been particularly critical of the Areeda-Turner arguing that it ‘obviously lacks serious analytical underpinning’ and that it ‘may constitute the instruction manual on how to prey with impunity’. He concludes that: ‘For all practical purposes, the Areeda-Turner price-cost relationship is impossible to measure and makes the proof of predation too difficult.’¹⁵ In public utility and other types of network industries marginal cost may be close to zero ‘so that a firm virtually cannot lose a predation case.’¹⁶ Gilbert and Katz note that the Areeda-Turner rule may afford too much latitude for predatory pricing where AVC is close to zero.¹⁷

The main EU case on predation is *Akzo*.¹⁸ The E.C.J., on appeal, held that prices below average variable cost were predatory. It went on to state that prices below average total costs ‘must be regarded as abusive *if they are determined as part of a plan* for eliminating a competitor.’ (Emphasis added)). Thus the ECJ was clearly prepared to accept that predation could occur in circumstances which did not satisfy the requirements of the Areeda-Turner rule where there was evidence of intent on the part of the alleged predator. Drawing inferences based on intent is itself fraught with risk.

‘It can also be argued that harming competitors is of the essence of the competitive process and that bringing an intention to inflict harm into the predatory pricing equation is economic nonsense.’¹⁹

Phlips argues that the evidence in the case was not consistent with predatory behaviour.²⁰

¹⁴ Phlips, (1995), p.231.

¹⁵ *Ibid.* p.233/4.

¹⁶ R. Noll, (1995), The Role of Antitrust in Telecommunications, *Antitrust Bulletin*, fall, p.501-28, at 506.

¹⁷ R.J. Gilbert and M.L. Katz, (2001), An Economist’s Guide to *US v. Microsoft*, *Journal of Economic Perspectives*, 15 2 (spring) 25-44.

¹⁸ *Akzo B.V. v. E.C. Commission*. [1993] C.M.L.R. 215

¹⁹ R. Whish, (1993), *Competition Law*, Third edition, Butterworths 1993 p.531

²⁰ Phlips, (1995).

A number of alternative rules have been suggested. Williamson proposed that an increase in output by an incumbent in response to entry should be deemed predatory.²¹ Baumol suggested that those fixed costs, which a firm could recoup if it exited the market, should be added to variable costs in order to estimate what he terms average avoidable cost.²² If price were less than average avoidable cost, the firm would be better off leaving the market. There is no rational explanation other than predation for selling at a price below average avoidable cost. Kahai et. al. have referred to the ‘infirmities’ involved in attempting to identify predation by comparing a firm’s prices and costs and complain that ‘judicial attempts to distinguish predatory from competitive behaviour are notoriously inexact.’²³ They employ a model that relies on evidence of actual exit while conceding that such a test is limited not least because ‘it cannot be used for preventive purposes.’²⁴

A more general definition of predation proposed by Ordoover and Willig ‘is any business strategy that is profitable only because of the long-run benefits of eliminating one or more competitors.’²⁵ This definition sensibly captures anti-competitive conduct – including nonprice conduct – which would harm competition yet, would not be deemed predatory under the cost-based Areeda-Turner test. Gilbert and Katz argue that this definition ‘should be modified to account for the fact that consumers and efficiency can be harmed when the prey is weakened, even if it is not eliminated.’²⁶

The MMC in its investigations of predation in the bus industry (see below) adopted a three-part approach to determining whether predation exists:

1. Is predation feasible, i.e. can the alleged predator sustain the losses or reductions in profit necessary to eliminate a rival?
2. Did the alleged predator incur losses or make lower profits as a result of the alleged predation?

²¹ O.E. Williamson, (1977), Predatory Pricing: a Strategic and Welfare Analysis, *Yale Law Journal*, Vol.87, 284-340.

²² W.J. Baumol, (1996), Predation and the Logic of the Average Variable Cost Test, *Journal of Industrial Economics*, 39 (April), 49-72.

²³ S. Kahai, D. Kaserman and J. Mayo, (1995), Deregulation and Predation in Long-Distance Telecommunications: An Empirical Test, *Antitrust Bulletin*, fall, p.645-66 at 653.

²⁴ *Ibid.*, p.655.

²⁵ J. Ordoover and R. Willig, (1991), An Economic Definition of Predation: Pricing and Product Innovation, *Yale Law Journal*, Vol.91, 8-53.

²⁶ Gilbert and Katz, p.33

3. Did the alleged predator intend to oust a specific competitor?

Phlips proposes that game theory can be applied to test for predation. Predation turns a profitable entry opportunity for an entrant into an unprofitable one. To discover whether such a profitable opportunity for entry exists, i.e., whether there is room for an additional firm in the market, it is necessary to find out whether the entrant would make a positive profit in a non-cooperative post-entry equilibrium. In other words, without the price cut, was there room in the market for an additional firm under normal competition, i.e. in a non-cooperative Nash equilibrium. He describes the information and the data that is required to answer this question. A practical difficulty is that the firms concerned are the source of the information that is required. Both the alleged predator and the alleged victim may seek to manipulate the data to assist their own case. Nevertheless this type of analysis has been applied.

Predatory Pricing Cases - A Quick Overview.

There is little EU case law on predatory pricing. In contrast the US has a much longer line of cases dealing with predatory pricing. There are also a number of UK cases investigated by the former MMC that may be of some interest.

Standard Oil is generally regarded as the original predatory pricing case. Subsequently the American Tobacco Company was found to have abused a dominant position by *inter alia* engaging in predatory pricing.²⁷ It frequently established 'fighting brands' that were sold in rivals' local markets at less than cost, in one case at an effective after-tax price of zero. Fighting brands effectively describes a strategy whereby the predatory behaviour is confined to selling particular brands at a loss so that the dominant firm avoids losing money on all of its sales. By engaging in such a strategy the dominant firm may seek to limit the cost of its predatory strategy. In *AT&T* the Justice Department alleged that AT&T had engaged in a form of exclusionary pricing which was 'pricing without regard to cost.'²⁸

²⁷ *US v. American Tobacco Co.*, 221 US 106 (1911).

During the 1970s and 1980s US government actions against alleged predatory behaviour declined reflecting official acceptance of the then widely held view that predation was unlikely to occur. Such a view also influenced a number of Supreme Court judgments on the question of predation. *Matsushita*²⁹ involved a case where Japanese TV manufacturers had engaged in a practice of selling televisions in the United States at much lower prices than in Japan. The Japanese firms gained a significant share of the US market and a number of US manufacturers closed after sustaining considerable losses. A number of US manufacturers brought a case alleging predatory pricing. The Supreme Court rejected the claim by a 5-4 majority. The Majority held that a predatory price cutting campaign must be capable of earning excess profits in the long run, once competition has been eliminated, to justify the cost of engaging in predatory behaviour. Yet after twenty years of alleged predatory pricing the Japanese firms had not managed to eliminate all of their US rivals, indeed the two firms with the largest market shares were US firms. In *Cargill v. Monfort of Colorado*³⁰ the Court warned that ‘mistaken inferences’ concerning alleged predatory prices ‘are especially costly, because they chill the very conduct the antitrust laws are designed to protect’. Subsequently in *Brooke Group*³¹ the Court referred to ‘the general implausibility of predatory pricing’ and concluded that ‘predatory pricing schemes are rarely tried, and even more rarely successful, and the costs of an erroneous finding of liability are high.’ The Supreme Court’s judgment in this case ‘cleared the way for summary rejection of most predatory pricing claims’.³² The Court’s views regarding the implausibility of predatory pricing appears to rely on somewhat outdated economic analysis.

In *Microsoft* the DOJ argued *inter alia* that Microsoft had engaged in predatory behaviour on the grounds that ‘Microsoft could recoup the costs of engaging in the behaviour only if Netscape were eliminated as a threat to Windows.’³³ In effect this is the

²⁸ *US v. AT&T*, 552 F. Supp. 131 (D.D.C. 1982).

²⁹ *Matsushita Electric Industrial Co. Ltd. et al. v. Zenith Radio Corp. et al.*, 475 US 574.

³⁰ *Cargill, Inc. v. Monfort of Colorado, Inc.*, 479 US 104, 122 (1986).

³¹ *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 US 209 (1993).

³² P. Areeda and H. Hovenkamp, (1996), *Antitrust Law*, rev ed.

³³ B. Klein, (2001), The Microsoft Case: What Can a Dominant Firm Do to Defend its Market Position, *Journal of Economic Perspectives*, Vol.15 (2) spring, p.45-62.

Ordovery-Willig approach. However, as Klein observes this would imply that a firm in natural monopoly industry could never make investments to defend its market position.

The airline industry is of particular interest as it has been the subject of a number of cases of alleged predation. For example, claims of predation were made following the collapse of low cost Laker Airways, which entered the transatlantic air travel market offering low fares. Following deregulation of the US airline industry over twenty years ago there were claims of predatory behaviour. It was believed at the time that airline markets were contestable and on that basis predatory behaviour was dismissed as irrational. Contestability theory argues that, provided it is relatively easy for firms to enter and exit a market, dominant firms will not be able to earn excessive profits. It is probably fair to say that airline markets would no longer be considered contestable.

More recently Blair and Harrison report how a number of start-up low fare airlines in the US have complained of predatory pricing by larger airlines at hub airports. In a number of instances a single carrier may control 70-80 percent of traffic at a particular airport hub. Prices on hub routes are apparently much higher than on non-hub routes prompting entry. These claims prompted the Department of Transport (DOT) to issue a proposed enforcement policy statement warning that it would regard major carriers as engaging in unfair exclusionary behaviour if:

‘in response to new entry into one or more of its local hub markets, it pursues a strategy of price cuts or capacity increases, or both, that either (1) causes it to forego more revenue than all of the new entrant’s capacity could have diverted from it or (2) results in substantially lower operating profits - or greater operating losses - in the short run than would a reasonable alternative strategy for competing with the new entrant. Any strategy this costly to the major carrier in the short term is economically rational only if it eventually forces the new entrant to exit the market, after which the major carrier can readily recoup the revenues it has sacrificed to achieve this end.’³⁴

³⁴ Department of Transportation, *Enforcement Policy Regarding Unfair Exclusionary Conduct in the Air Transportation Industry*, Fed. Reg. 17919, 10 April 1998.

The DOJ subsequently instituted proceedings against American Airlines, at the time the second largest airline in the US. The District Court, however, gave summary judgment against the Government.³⁵ The Court held that, following from *Brooke Group*, ‘the government must show pricing below an appropriate level of costs’. It noted that there was no evidence that American had set prices below average variable costs (AVC) and that it had simply matched but not undercut fares charged by low cost entrants. There was evidence that low cost operators continued to enter the relevant market.

The DoJ argued that American’s actions had caused its profits to be lower than they would otherwise have been and that its behaviour was therefore predatory. For example, the judgment quotes Professor Stiglitz a government expert witness as stating that:

‘The key is whether the alleged predator clearly passed up a *more* profitable alternative. ..If there is clear evidence that the predator had available one or more alternative actions that - but for the anti-competitive effect - would have yielded higher profits, then a suspicious sacrifice has occurred.’

This is very much in line with the DOT’s enforcement statement quoted earlier. However, such a standard appears seriously flawed. Klein, commenting on *Microsoft* argued that:

‘It is difficult to see the virtue in an antitrust rule that would require dominant firms always to charge as much as possible in the short-run or be accused of predatory behaviour.’³⁶

Of some concern is the Court’s dismissal of reputation arguments as being inconsistent with the Supreme Court’s judgment in *Brooke Group*. In so doing the Court rejected the notion that the costs incurred in predation in one market could be recouped in other markets and held that a firm must be likely to earn super-normal profits *in the specific market in which predation occurs*. This view is clearly inconsistent with current economic thinking which suggests that predation is only possible where a firm operates

³⁵ *US v. American Airlines, Inc., et. al.* Judgment of 27 April 2001, US District Court for the District of Kansas, case no. No. 99-1180-JTM

in different markets so that an investment in predation in one market yields benefits elsewhere.

Earlier this year the Canadian Competition Bureau forced Air Canada to abandon a discounted, one way, unrestricted, economy fare between Halifax, and Montreal, Ottawa and St. Johns, Newfoundland. This followed a complaint by CanJet a low fare airline that Air Canada was selling at a loss to force it out of business.³⁷ Hazledine et al. investigated behaviour in the Trans-Tasman airline market between Australia and New Zealand. They developed a game theoretic model to examine the response of the incumbent duopolists - Air New Zealand and Qantas - to entry by Kiwi International Airlines.³⁸ They conclude that their actions during 1995/96, when Kiwi was operating, were predatory.

Airline cases are of particular interest because of claims that Aer Lingus had engaged in predatory behaviour on the Dublin-London City route last year. Barrett argued that there was *prima facie* evidence in this case including 'timetable matching, significant fare increases after market exit by a competitor, and operation of services at a loss during the period of competition'.³⁹ I do not propose to comment on the specifics of the case, as it was the subject of a complaint to the Authority. This occurred at a time when, as has been widely reported, the Authority faced a particularly difficult staffing situation.

Bus transport is another industry that is perhaps of particular interest. As noted earlier this is a matter, which is currently before the courts, and I do not propose to comment on the specifics in that case. However, in the UK several OFT and MMC reports found that dominant operators had engaged in predatory behaviour in a number of local bus markets in various parts of Britain.⁴⁰ The MMC also found that predatory pricing was only one

³⁶ Klein, (2001), p.46.

³⁷ *Competition*, Vol.10(2), p.26.

³⁸ T. Hazledine, H. Green & D. Haugh, *The Smoking Gun? Competition and Predation in the Trans-Tasman Air Travel Market*, European Association for Research in Industrial Economics, 28th Annual Conference, 30th August - 2nd September 2001, mimeo.

³⁹ *Competition*, Vol.10(2), p.31.

⁴⁰ See for example, MMC (1990), *Highland Scottish Omnibuses Ltd.*; MMC (1993a), *Sussex Coastline Buses*, MMC 17.3.1993; MMC (1993b), *Mid and West Kent*, MMC 18.8.1993; MMC (1995), *The Supply of Bus Services in the North-East of England*, Cm2933, MMCLondon, HMSO. The OFT conducted inquiries into predatory behaviour in the bus market in Inverness, West Yorkshire, South Yorkshire, Kingston-upon-

aspect of anti-competitive behaviour engaged in by dominant firms and pointed out that in the bus industry predation frequently takes the form of over bussing.

Dodgson et al developed a specific game theoretic model to test for predation in the bus industry in a particular medium sized town.⁴¹ The results in this case indicated that at the non-cooperative Nash equilibrium entry was profitable. However, both firms in fact recorded losses so that the results were compatible with predation.

A situation where the entrant has a positive entry value but in fact makes losses is a necessary but not a sufficient condition for predation. The entrant may make mistakes. Equally either party may engage in aggressive behaviour in a fight to establish leadership in the market, a strategy referred to in the literature as Stackleberg warfare. Dodgson et al conclude that this is precisely what happened in the case in question with the entrant coming into the market with too many buses and the incumbent responding by putting in too many buses in turn. The entrant could have unilaterally reduced its losses by reducing its bus miles and so they argue that the incumbent was not denying the entrant a profitable entry opportunity and its behaviour was not predatory. Dodgson et al. reached a similar conclusion when applying the model to analysing the Inverness case where the MMC found that predation had occurred.⁴² Philips argues that *Akzo* was also a case of Stackleberg warfare rather than predation and notes that such episodes illustrate the difficulties involved in distinguishing predation from aggressive competition.⁴³

Must a Dominant Firm Roll-Over?

The *Microsoft* and *American Airlines* highlight a key issue in predation cases, namely the question of what action a dominant firm might legitimately take, in response to new entry.

Hull and Bognor Regis between 1989 and 1992.

⁴¹ J.S. Dodgson, Y. Katsoulacos and C.R. Newton, (1992), A Modelling Framework for the Empirical Analysis of Predatory Behaviour in the Bus Service Industry, *Regional Science and Urban Economics*, vol.22, 51-70.

⁴² J.S. Dodgson, Y. Katsoulacos and C.R. Newton, (1993), An Application of the Economic Modelling Approach to the Investigation of Predation, *Journal of Transport Economics and Policy*, 153-70.

⁴³ Philips, (1995).

‘The fundamental policy question posed by Microsoft’s competitive actions is determining what limits should be placed on a dominant firm’s ability to compete aggressively in defending its market position.’⁴⁴

Simply accommodating entry is likely to invite further entry so a dominant firm that passively accepts entry will ultimately find itself forced out of business. Not surprisingly therefore in *American Airlines* internal company documents stated that ‘ceding parts of the market...was not the proper way to respond’ to low cost entry. If a dominant firm accommodates entry by simply making room for a new entrant then it is effectively deciding not to compete, which is hardly the objective of competition law. The absence of any clear indication as to what types of behaviour are and are not acceptable may cause dominant firms not to compete overly aggressively for fear of falling foul of the law.

Remedies.

I want to make a few comments about possible remedies for predatory behaviour. At the outset it seems to me that criminal sanctions, by which I mean fines for firms engaging in predatory behaviour, are inappropriate. This is not just because of the serious difficulties that would be involved in proving predatory behaviour beyond a reasonable doubt, although that is obviously a very real concern. Rather it is because, in the case of predatory behaviour, it is far from clear that the threat of a fine would constitute a serious deterrent. A firm that engages in predatory pricing is essentially deciding to incur significant short-term losses in order to drive out a competitor and make supernormal profits in the long run. The threat of a fine really only increases the cost of eliminating the competitor and it is difficult to imagine that it would be sufficient to make predatory behaviour unprofitable. The fact that a firm is prepared to risk potential fines may simply enhance its reputation as an aggressor. Potential entrants are unlikely to be encouraged to enter the market by the fact that the incumbent has been fined for eliminating a previous new entrant.

⁴⁴ Klein, (2001), at 45.

I do not believe that prosecuting individual directors or managers or firms would be an effective solution to the problem I have just described. Assuming for one moment that such actions could be prosecuted successfully, then the effect may well be to discourage aggressive competition and not just predatory pricing.⁴⁵

Civil actions after the predatory action had achieved its objective would be a complete waste of time. The only effective response to predation are actions for injunctive relief before the predatory behaviour has succeeded, i.e. interim relief. That means that the Competition Authority is going to have to become more active and respond quickly in the face of predatory behaviour and actively seek interim injunctions in such cases. I recognise that such actions will expose the Authority to potential damages actions if it is unsuccessful at a full hearing. However, if Government is serious in its commitment to competition it must accept that there are significant costs involved. Protecting competition means ensuring that predatory behaviour does not succeed and I think the only way to do that is to stop it before it can achieve its objective.

The UK authorities have on occasion sought to counter predation by securing undertakings from firms to maintain prices and output at the lower level for a fixed period of time, usually a period of years, a response to predatory behaviour suggested by Baumol.⁴⁶ The idea here is that, even if the dominant firm eliminates its rival, the costs of doing so are increased considerably and it must wait much longer to secure any payoff from such behaviour. Such measures may deter firms from predatory actions, provided firms believed that prompt action by the Authority was likely. They benefit consumers by ensuring low prices are maintained and avoid a situation where action by the Authority to protect competition has the effect of increasing prices to consumers in the short-term. In seeking injunctive relief the Authority may indicate that it would accept undertakings of this type. If a firm were prepared to commit to maintaining its lower prices for a

⁴⁵ For a discussion on why criminal sanctions are inappropriate in abuse of dominance cases see P. Massey and P. O'Hare, Policing the Dominant Firm Under the Competition Act: Should Abusers go to Jail? IEA, Annual Conference, Dromoland Castle, April 1996 and P. Massey and P.O'Hare, (1996), *Competition Law and Policy in Ireland*, Dublin, Oaktree Press.

⁴⁶ W. Baumol, (1979), Quasi-Performance of Price Reductions: A Policy for Prevention of Predatory Pricing, *Yale Law Journal*, Vol.89, 1-26.

sufficient period of time, this of itself would suggest that it was not engaged in predation. However, one drawback is that such measures may facilitate collusion.

The other weapon in the Authority's arsenal is to seek a break up of the dominant firm. The Competition Bill 2001 proposes that such a power would be given to the courts. Obviously this is an extreme remedy. It may be appropriate in the case of a firm that displays a record of persistent successful predation. However, such an outcome only arises if previous predatory episodes have succeeded.

Conclusions

Although it is recognised that predatory pricing may occur, identifying it is fraught with difficulty. For example, *The Economist* reported just over three years ago that: 'the economics of predatory pricing is still fairly underdeveloped, and there are few theories to distinguish desirable price competition from undesirable predation.'⁴⁷ Recent US case law provides some rather undesirable precedents. The case law at both domestic and EU level is relatively underdeveloped. Nevertheless research is ongoing in developing models which distinguish predatory behaviour from mere aggressive competition. Such models requiring detailed economic analysis, rather than price cost rules should be required in such cases.

Philps argues that the following five conditions must be simultaneously met in order for predation to occur:

1. The aggressor is a multimarket firm (possibly a multiproduct firm).
2. The predator attacks after entry occurs in one of its markets.
3. The attack takes the form of a price cut in one of the predator's markets, which brings the price below a current non-cooperative Nash equilibrium price at which the entry value is positive for the entrant (possibly below a discriminatory current Nash equilibrium price with the same property).
4. The price cut makes the entry value negative (in present value terms) in the market in which predation occurs.

⁴⁷ *The Economist*, The Economics of Antitrust, 2 May 1998, p.62.

5. The victim is unsure that the price cut is predatory i.e. the price cut could be interpreted by the entrant as implying that its entry value is negative under normal competition. In other words, the victim entertains the possibility that there is no room for it in the market under competitive conditions.

Such a list at least offers some guidelines for identifying circumstances in which predation may occur and may be useful for screening out bogus claims.

The Competition Authority needs to become more active in tackling cases of alleged predation especially in light of indications that predatory behaviour occurs with greater frequency than previously thought. In order to deter such behaviour the Authority must be prepared to act speedily in response to genuine predatory behaviour. In the absence of a clear line of legal precedents, there is a need for it to issue clear guidelines setting out the circumstances in which it will act on such allegations. Such guidelines are not only for the benefit of potential victims but should also clarify for dominant firms the extent to which they may respond to competition from smaller rivals. I am afraid such guidelines will need to be more complex than that contained in the rule of thumb at the outset of this paper.