PREDATORY PRICING

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I. INTRODUCTION

A recent law review article by then-Professor and now Congressman Tom Campbell observed: "Many argue that predation is impossible, and hence, enforcement of the antimonopolization provisions of the Sherman Act should not be based on this empty concept."[1] The article mentions the *Matsushita* decision[2] and refers the reader to the articles cited in the opinion. As the article suggests, the idea behind the argument that predation is impossible is that the predator loses so much money in the process of attempting to drive out its rivals with low prices that it will never earn enough monopoly profits to recoup its losses. Hence, predatory pricing is an irrational strategy and should not occur in the real world.

Among economists, however, it is generally agreed that the argument that predation is impossible is incorrect, at least as a matter of economic theory. The economics literature is filled with articles containing models of predation in which predation is a rational strategy. By way of illustration, the recently published *Handbook of Industrial Organization*,[3] something like a "Restatement of Industrial Organization," contains a survey article on predatory pricing[4] that is some fifty-five pages long and contains more than 130 references. Moreover, each new issue of technically-oriented industrial organization economics journals such as *The Journal of Industrial Economics* or *International Journal of Industrial Organization*, and even an occasional law review, is likely to contain one or more new models of predation. (The nontechnical reader may not spot them so easily because the subject is no longer referred to as predatory pricing;

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[1] Campbell, *Predation and Competition in Antitrust: The Case of Nonfungible Goods*, 87 COLUM. L. REV. 1625 (1987).

[2] Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574 (1986).

[3] HANDBOOK OF INDUSTRIAL ORGANIZATION (R. Schmalensee & R. Willig eds. 1989).

[4] Ordover and Saloner, *Predation, Monopolization, and Antitrust*, in HANDBOOK OF INDUSTRIAL ORGANIZATION, *supra* note 3, at 537.

it's called "non-cooperative game theory with asymmetric information.") Even Tom Campbell, in the article cited above, noted:

> This article demonstrates that predation remains possible with respect to new entrants if one departs from the perfect market assumption that all goods are perfectly fungible. When each competitor's good or service is just a little different from that of every other competitor in a market, an established firm may successfully force an equally efficient entrant out of the market. Antitrust law should be able to identify and punish this particular form of monopolizing behavior.[5]

In sum, the literature does not rule out the possibility that predatory pricing can be a rational strategy, at least as a matter of economic theory. A policy of ignoring claims of predation cannot, therefore, be justified on the grounds that predation is *theoretically* impossible.

A related issue is whether there can be predation where the price is above (some measure of) the alleged predator's costs. This issue is complicated because it requires that we distinguish between the economic concept of predation and a legal definition. From an economics perspective, predatory pricing is simply a temporarily low price aimed at eliminating rivals and obtaining a monopoly.[6] The economics literature referred to earlier contains many theoretic models in which successful predation occurs without a monopolist having to reduce price below the level of its own costs.

The policy-oriented literature, however, deals with the legal definition of predation. This was the focus of the seminal article by Areeda and Turner, which set out cost-based rules for defining predation as a matter of law.[7] In their view, it is appropriate to have a legal definition that is not identical to the economic concept of predation and, in fact, is deliberately underinclusive in that it does not capture all theoretically possible instances of predatory pricing.[8]

The point is also well made in Judge Breyer's opinion in the *Barry Wright* case,[9] in which he acknowledged that above-cost pricing might be

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[5] Campbell, *supra* note 1, at 1625.

[6] Some would extend the economic concept of predatory pricing to include the possibility that the temporary low price is designed not to eliminate but to discipline rivals and get them to accede to a subsequent increase in price.

[7] Areeda & Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act,* 88 HARV. L. REV. 697 (1975).

[8] At the time, there may have been some ambiguity about whether the authors recognized that their cost-based approach was deliberately underinclusive, but that ambiguity is now unequivocally resolved. In the 1989 *Supplement* to *Antitrust Law,* Areeda and his *Supplement* co-author are very explicit about the fact that their proposed legal rule for defining predation will not capture all theoretically possible instances of predation. P. AREEDA & H. HOVENKAMP, ANTITRUST LAW 523–25 (1989 Supp.).

[9] Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227 (1st Cir. 1983).

harmful, but emphasized the policy reasons for defining predation so to exclude such cases from liability. Breyer makes it clear that this is a compromise. In his view, courts are simply not equipped to look for all instances of predation and if they try to do so they are going to make a lot of mistakes, with the consequence of deterring legitimate healthy price-cutting.

While few courts have adopted the Areeda-Turner test literally, virtually all courts, and almost all commentators, are generally supportive of the basic principle behind the Areeda-Turner tests, namely, that low prices are generally to be encouraged, and that prices which exceed the alleged predator's costs are unlikely to be anticompetitive in the sense that they are against the long-run interests of consumers.[10] (Moreover, defendants are winning most cases regardless of whether the court strictly adopts the Areeda-Turner test or endorses some modified version of it.[11]

In that spirit, there are three matters relating to how economists view predation that merit discussion: (1) technical issues connected with the use of cost-based tests; (2) the use of other filters, such as market share and barriers to entry; and (3) the relevance of intent.

II. TECHNICAL ISSUES

The technical issues connected with the use of cost-based tests are dealt with at some length in the 1989 *Supplement*[12] to the Areeda and Turner treatise and involve mostly the question of what is included in costs. In the recent *Windmere* shaver case, for example, one of the main technical issues was whether the defendant's advertising expenses should be treated as variable or fixed costs.[13]

One of the reasons there is some controversy about these technical issues is the fact that lawyers are borrowing concepts—such as marginal cost, average variable cost, and incremental cost—that were coined by

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[10] The classic statement is from the 11th Circuit's opinion in McGahee v. Northern Propane Gas Co., 858 F.2d 1487 (11th Cir. 1988), *cert. denied,* 109 S. Ct. 2110 (1989): "The Areeda and Turner test is like the Venus de Milo: it is much admired and often discussed, but rarely embraced." 858 F.2d 1487, 1495 (11th Cir. 1988). As Page Austin points out, the Supreme Court in *Cargill* and *Matsushita* seemed to be quite deliberately ambiguous about whether it would ultimately adopt the Areeda-Turner test. Austin, *Predatory Pricing Law Since* Matsushita, *infra* this issue, at 895.

[11] For an earlier survey, see Liebeler, *Whither Predatory Pricing? From Areeda and Turner to* Matsushita, 61 NOTRE DAME L. REV. 1052 (1986).

[12] P. AREEDA & H. HOVENKAMP, *supra* note 7, at 555–59, 589–603.

[13] U.S. Philips Corp. v. Windmere Corp., 861 F.2d 695, 704 (Fed. Cir. 1988). The broader issue in the case, discussed below, was the wisdom of relying on a cost-based test to the exclusion of other evidence, such as evidence of intent.

economists for reasons having nothing to do with predatory pricing cases. The result is that what lawyers, or judges, or business people mean by those concepts is sometimes not identical with the strict economic definition as found in the basic textbooks.

For example, Areeda indicates that while many commentators have asserted that marginal cost would not include any allowance for depreciation,[14] that assertion is not necessarily correct. If, for example, running the taxicab another ten miles today means that the taxi will need to be replaced sooner, that element of depreciation ("use depreciation") is properly accounted for even in short-run marginal cost.

A related issue is the difference between long-run and short-run marginal cost. It seems to be assumed in the predatory pricing literature and in the cases that long-run marginal costs are normally higher than short-run costs because the former includes an allowance for depreciation. As indicated above, even short-run marginal cost may include depreciation. Moreover, in economics textbooks, long-run marginal costs are the costs of increasing output when you have time to make whatever adjustments (including expanding the size of the plant) you want. Short-run marginal costs are the costs of increasing output when you are constrained to work with existing plant. Hence, it will often be the case that short-run costs are higher than long-run costs; i.e., it is more costly to expand output on a temporary basis than it would be if the increased output were intended to be permanent.[15]

Another technical problem in the use of cost-based tests has to do with the segment of the business for which the costs and revenues should be computed. In the *Janich* case,[16] the alleged predation involved half-gallon bottles of gin and vodka. The price was apparently not below cost on any of the other sizes of bottles that the defendant was selling. Applying the cost-based test merely to the one size distorts one of the main purposes of a cost-based test, which is to assist in predicting whether the predator is likely to wind up with a monopoly. If a firm is dropping the price below cost on one element of a product line, but the profit line as a whole is profitable, the low price will not eliminate efficient competitors from the market unless, for some reason, they sell only the single size for which the price has been reduced. For example, a supermarket is unlikely to

[14] P. AREEDA & H. HOVENKAMP, *supra* note 7, at 557.

[15] Short-run average costs are never lower than long-run average costs. Short-run marginal costs can be lower than long-run marginal costs when the existing plant is operating at less than the capacity for which it was designed. *See, e.g.*, R. LIPSEY, P. STEINER, & D. PURVIS, ECONOMICS 195–96 (8th ed. 1987).

[16] Janich Bros. v. American Distilling Co., 570 F.2d 848 (9th Cir. 1977), *cert. denied*, 439 U.S. 829 (1978).

succeed in obtaining a monopoly of retail groceries by selling milk below cost.

III. OTHER FILTERS

Cost-based tests, like the Areeda-Turner test, are filters in the sense that, if prices are above the appropriate measure of costs, the defendant is conclusively or rebuttably presumed not to be liable for predatory pricing. Other filters that have been suggested look to the basic structure of the market in which the predation is alleged to have occurred. The two most frequently mentioned structural filters are market share and barriers to entry. Unless a firm has a large initial market share, it is unlikely to succeed in monopolizing the market; unless there are high barriers to entry, monopoly cannot be exploited to the detriment of consumers.

The use of market share and barriers to entry as filters was a prominent aspect of the *Matsushita* case. However, *Matsushita* was a conspiracy case and, in that respect, offers nothing particularly novel for the treatment of the typical single-firm predatory pricing situation. In conspiracy cases, the burden on the plaintiff with respect to market structure issues has traditionally been less than it would be in a single-firm monopolization case. However, economists and most other commentators have long supported the notion that it is inappropriate to use the "attempt to monopolize" branch of Section 2 to attack low prices by firms with a small market share in markets with low barriers to entry.[17] Section 2 is not intended to be an incipiency statute. It is conceivable that for other kinds of behavior that are inherently undesirable—running around with a cannon blowing up your competitor's factories—one should be permitted to infer the dangerous probability of success from the nature of the conduct.[18] But, for conduct like low pricing, which in all but a very, very tiny percentage of the cases is exactly what we are trying to encourage, the idea that Section 2 should be invoked for somebody with a ten percent market share would achieve little support. Hence had *Matsushita* been a case of a single Japanese television manufacturer dumping its TVs in the United States, starting out with a zero market share and after twenty years eventually getting up to twenty-five percent, it's hard to believe that, even

[17] *See, e.g.*, Joskow and Klevorick, *A Framework for Analyzing Predatory Pricing Policy*, 89 YALE L.J. 213 (1979).

[18] This was the general position of the Shenefield Commission, which argued in its report that "Conduct that cannot serve any competitive purpose and is inherently destructive of competition in any affected market can be held to violate Section 2 without precise definition of the market affected or extensive consideration of the defendant's market position." REPORT TO THE PRESIDENT AND THE ATTORNEY GENERAL OF THE NATIONAL COMMISSION FOR THE REVIEW OF ANTITRUST LAWS AND PROCEDURES 148 (1979).

in the Third Circuit, it would have lasted the seventeen or eighteen years that it did.

Obviously, there will be debate over exactly how large the market share must be to succeed in a predatory pricing case—are we talking about thirty percent or eighty percent?—and, once that issue is settled there will be controversy about the precise definition of the market. But we are used to dealing with market definition in antitrust cases; there is no particular reason why we should expect it suddenly to go away in predatory pricing cases.

With respect to the use of entry barriers as a filter, it is worth remembering that there is a rather considerable debate in the economics literature about what constitutes a barrier to entry. At the ABA Antitrust Section 1987 Spring Meeting, Richard Schmalensee, now one of the three members of the Council of Economic Advisors, gave a paper in which he talked about the dispute regarding the various concepts of what constitutes a barrier to entry.[19]

Even putting aside some of the deeper philosophical issues regarding barriers to entry, there may be some mechanical problems with using barriers to entry as a filter in a number of cases. The difficulty stems from the fact that we do not have a simple measuring rod like the Herfindahl Index for measuring or describing barriers to entry. Hence, using entry barriers as a filter works pretty well in cases like egg farming,[20] or maybe in cases like the distribution of propane gas,[21] where most reasonable people would say the barriers are by any sense very low. That may be good enough to get rid of a large number of the cases. Once we get beyond industries with very low barriers, however, I am not sure how we will use the filter.

Another potential problem with entry barriers as a filter is that, according to some commentators, the very act of predatory pricing can create disincentives for subsequent entry.[22] By way of example, suppose we observed that the private garbage-hauling business in most parts of New York City was effectively monopolized, one company having all the busi-

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[19] Schmalensee, *Ease of Entry: Has the Concept Been Applied Too Readily?*, 56 ANTITRUST L.J. 41 (1987).

[20] A.A. Poultry Farms, Inc. v. Rose Acre Farms, Inc., 881 F.2d 1396 (7th Cir. 1989), *cert. denied*, 110 S. Ct. 1326 (1990).

[21] McGahee v. Northern Propane Gas Co., 858 F.2d 1487 (11th Cir. 1988), *cert. denied*, 109 S. Ct. 2110 (1989).

[22] For an early, nontechnical discussion of this point, see Posner, *The Chicago School of Antitrust Analysis*, 127 U. PA. L. REV. 925 (1979). For a more rigorous, mathematical discussion, see J. TIROLE, THE THEORY OF INDUSTRIAL ORGANIZATION 376–77 (1988).

ness on the Lower East Side, another company, the Upper East Side, and so forth. If we looked only for the traditional structural barriers to explain the absence of entry, e.g., capital market barriers, brand loyalty, or high sunk costs, we might be inclined to characterize the market as contestable. Cynics, on the other hand, might observe that the barrier to entry is that if you tried to enter that business you would end up in the East River with cement overshoes. I don't want to overdo the point, but simply to point out that, according to some economists, a major barrier to entry in certain markets will be the reputation of the monopolist as one who will stop at nothing to get rid of its rivals.

IV. CONCLUSIONS, PRESUMPTIONS, AND INTENT

The last point is whether the objective tests, especially the cost-based test, should be conclusive or should merely establish presumptions, potentially rebuttable by other evidence, such as evidence of the alleged predator's intent. Areeda and Turner intended that the test be conclusive, and some, such as Judge Breyer in the *Barry Wright* case, agree. As Page Austin indicates in her survey, however, the courts are all over the lot on this issue, with several courts willing to consider evidence of intent, at least under certain conditions.[23]

Judge Easterbrook, in his *Rose Acre Farms* opinion,[24] seems very concerned about the dangers in allowing courts to consider evidence of intent. Perhaps those who resist the use of intent evidence have overstated the risks *so long as* courts in all other important respects take an economically sensible approach. Thus, if one limits predation claims to situations where the defendant has a high market share and there are significant entry barriers, and uses the Areeda-Turner test to shift the burden to the plaintiff when prices exceed variable costs, the free world probably will not come to an end if judges (or juries) are permitted to consider evidence of the alleged predator's intent in marginal cases (such as, for example, where prices are below average total costs but above average variable costs). As indicated earlier, plaintiffs are not winning many predatory pricing cases even where intent evidence is permitted and it is doubtful that, regardless of how this issue is resolved, lawyers are going to be lining up to take predatory pricing cases on a contingent fee basis.

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[23] *See* Austin, *supra* note 10, at 904. In my view the best illustration of the issue is the recent case of U.S. Philips Corp. v. Windmere Corp., 861 F.2d 695 (Fed. Cir. 1988). Both the majority and the dissenting opinions are well written and the important differences between them did not turn on a dispute about the facts.

[24] A.A. Poultry Farms, Inc. v. Rose Acre Farms, Inc., 881 F.2d 1396 (7th Cir. 1989), *cert. denied,* 110 S. Ct. 1326 (1990).