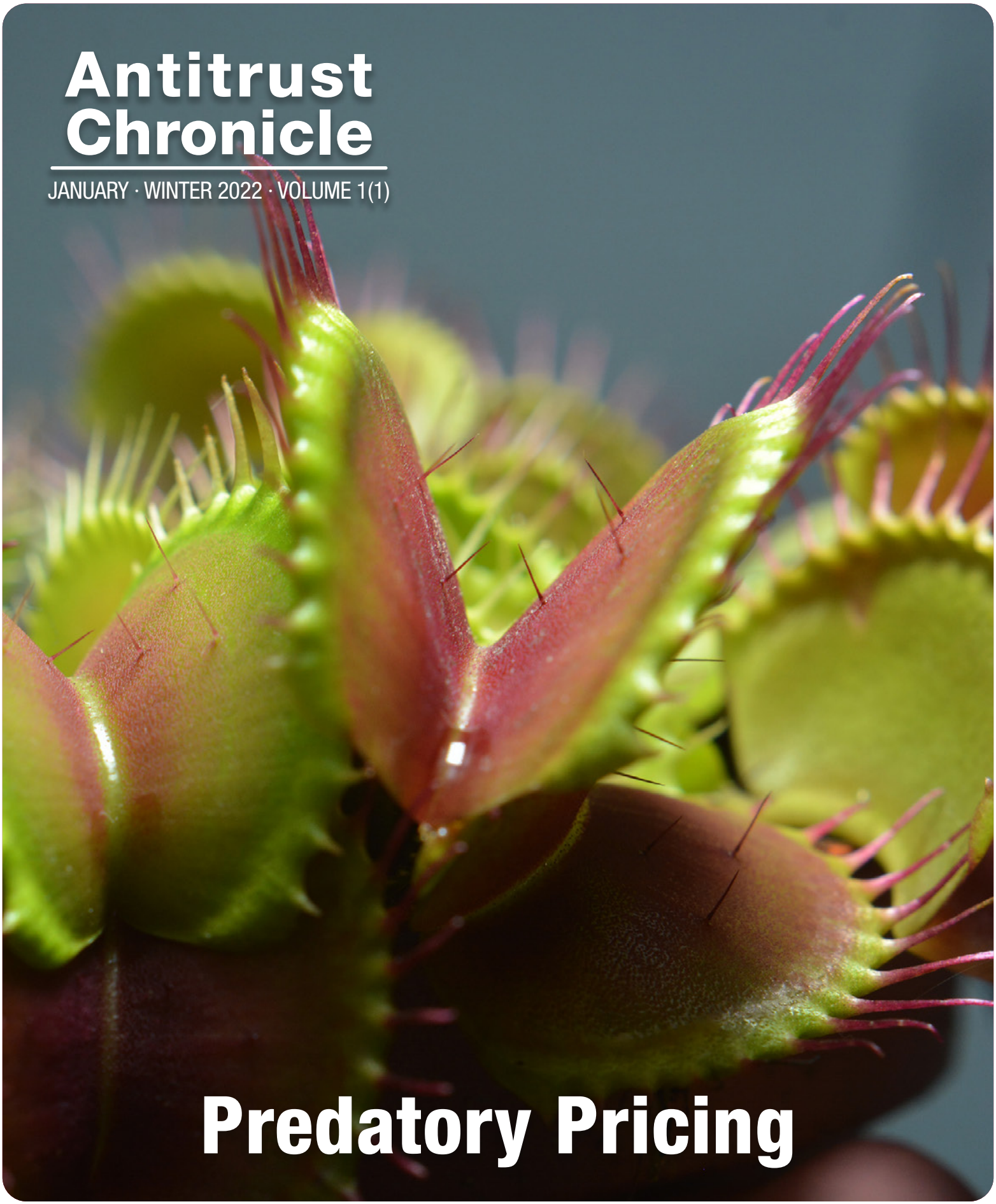

Antitrust Chronicle

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Predatory Pricing

CPI COMPETITION POLICY INTERNATIONAL

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LETTER FROM THE EDITOR

Dear Readers,

Price competition has famously been described as the "central nervous system of the economy." The underlying aim of antitrust and competition rules is to incentivize firms to maximize output and set prices as close as possible to their marginal cost of production. This goal applies with equal (if not greater) force to dominant firms.

Nonetheless, one of the canonical abuses of dominance or acts of illegal monopolization under antitrust rules has been so-called "predatory pricing." Briefly, the theory presupposes that a dominant firm might price below cost in the short term in order to eliminate competitors from the market, before then raising prices to monopoly level once they face no constraint.

This theory has been a constant source of debate, giving rise to countless doctrinal controversies among antitrust scholars, economists, and game theorists. Some scholars deny that predation is ever a rational strategy, even for a dominant firm (the archetypal Chicagoan "Antitrust Paradox" as Bork would have put it). Others (and indeed some competition enforcers) have developed more detailed game theoretic bases for potentially rational predation strategies.

The debate has raged on for decades and shows little sign of moderating itself any time soon. The contributions to this edition of the Chronicle represent the current state of affairs. Antitrust litigators, enforcers, and commentators continue to dispute the merits of given theories of predation, be they based on financial markets, signaling or reputational models of predation.

As always, thank you to our great panel of authors.

Sincerely,

CPI Team

SUMMARIES

Predation as a Leveraging Abuse – Filling the Gap Between Economic Theory and Antitrust Enforcement?

By Pietro Crocioni & Liliane Giardino-Karlinger

The conventional view of predation is that of a "one-market abuse," where profit sacrifice and recoupment necessarily take place on the same market. We argue that economic theory allows for a wider interpretation of predation as an exclusionary strategy, where the predatory attack may help a dominant undertaking to leverage its market power into other markets. Economic theory has long acknowledged this possibility, but case law on predation as a leveraging abuse is still scant, pointing to possible under-enforcement. We discuss the two examples we are aware of – *Napp* (UK) and *Qualcomm* (EU) – and identify conditions for predation to be a credible leveraging Theory of Harm.

The Chicago School and the Irrelevance of Predation

By Nicola Giocoli

Everybody knows that Chicago scholars dismissed predatory pricing as a practice of concern for antitrust law due to its alleged unprofitability, both relative and absolute. Many know that the dismissal dates back to the early years of the Chicago revolution in antitrust and has been reiterated ever since. What is less known is why those scholars focused so much on that specific unilateral practice. The paper shows that, from Aaron Director in the mid-1950s to, among others, John McGee (1958) and Robert Bork (1978), demolishing the traditional story about predatory behavior has always been a strictly necessary component of the Chicago School's broader assault against established Section 2 case law.

The Paradox of Predatory Pricing

By John B. Kirkwood

Predatory pricing is an antitrust paradox. In concept, the conduct is plainly anticompetitive, yet no predatory pricing case has resulted in an injunction or treble damages for over a generation. This article addresses two ways of restructuring U.S. law to improve the situation. The first approach would eliminate the first *Brooke Group* requirement and allow plaintiffs to challenge above-cost pricing. The second approach would drop the other *Brooke Group* requirement and allow plaintiffs to challenge below-cost pricing without establishing probable recoupment. Plaintiffs would, however, have to show that the defendant had no justification for pricing below cost. The article concludes that the second approach is likely to be superior. It would facilitate challenges to true predatory pricing by eliminating the element of existing law that is most difficult to establish. It is less likely to deter desirable price cutting because it creates less uncertainty. It is easier to tell whether a price is below cost than whether a price cut is likely to lead to long-run monopoly power. While the second approach would not reach above-cost predation, it would reduce predatory pricing overall and enhance consumer welfare.

Predation by the Dominant Buyer

By Brianna L. Alderman & Roger D. Blair

Just as a monopolist may eliminate its rivals through predatory pricing, a monopsonist may eliminate rivals through predatory buying. This, in fact, is what the Ross-Simmons Hardwood Lumber Company accused Weyerhaeuser of doing. This article uses the resulting antitrust case as a platform for defining the twin concepts of overbuying and overbidding, which satisfy the first prong of the modified *Brooke Group* test for predation. We then examine the feasibility of recoupment, which is the second prong of the modified *Brooke Group* test.

SUMMARIES

WHAT'S NEXT?

For February 2022, we will feature an Antitrust Chronicle focused on issues related to (1) **Economics of Potential Competition**.

ANNOUNCEMENTS

CPI wants to hear from our subscribers. In 2022, we will be reaching out to members of our community for your feedback and ideas. Let us know what you want (or don't want) to see, at: antitrustchronicle@competitionpolicyinternational.com.

CPI ANTITRUST CHRONICLES March 2022

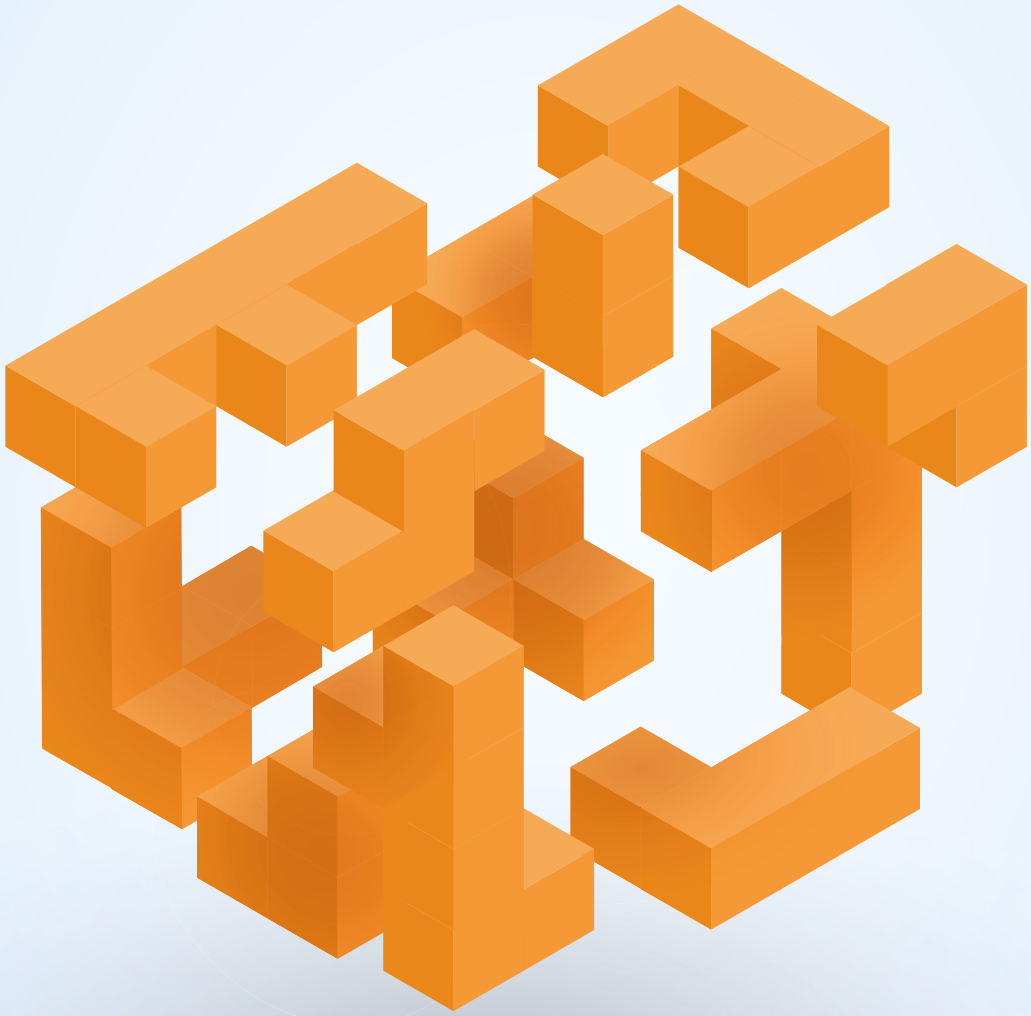
For March 2022, we will feature an Antitrust Chronicle focused on issues related to the **Developments in China**.

Contributions to the Antitrust Chronicle are about 2,500 – 4,000 words long. They should be lightly cited and not be written as long law-review articles with many in-depth footnotes. As with all CPI publications, articles for the CPI Antitrust Chronicle should be written clearly and with the reader always in mind.

Interested authors should send their contributions to Sam Sadden (ssadden@competitionpolicyinternational.com) with the subject line "Antitrust Chronicle," a short bio and picture(s) of the author(s).

The CPI Editorial Team will evaluate all submissions and will publish the best papers. Authors can submit papers on any topic related to competition and regulation, however, priority will be given to articles addressing the abovementioned topics. Co-authors are always welcome.

PREDATION AS A LEVERAGING ABUSE – FILLING THE GAP BETWEEN ECONOMIC THEORY AND ANTITRUST ENFORCEMENT?



BY PIETRO CROCIONI & LILIANE GIARDINO-KARLINGER[1]

1 Pietro Crocioni is an economist at the European Commission (DG Competition). Liliane Giardino-Karlinger is an economist at the EFTA Surveillance Authority (Competition and State Aid Directorate), and previously held a position at the European Commission (DG Competition) where she worked among others on the *Qualcomm* (predation) case. Disclaimer: The views expressed are those of the authors only and cannot be regarded as stating an official position of the European Commission or the EFTA Surveillance Authority.

I. INTRODUCTION

Predation as an exclusionary strategy is apparently simple and old, but still controversial. Simplicity comes from the temporal linearity of the exclusionary story. The predator engages in an initial phase of aggressive (below-cost) pricing to force its rivals to exit the market. In a later phase, after exit occurred, the predator can recoup its losses by charging high prices. There is a long-standing controversy among practitioners and economists on how likely and feasible predation is.

This article starts by briefly describing the recent historical divergence between Europe and the U.S. on the practical approach adopted towards predation cases. The main proposition we put forward is that there is another looming feature where the two main antitrust jurisdictions may have already started to diverge. The standard predation narrative developed in the case law, but also shared by many economists, is one of predation and recoupment in the same market.

In 2005, the European Economic Advisory Group ("EEAG") distinguished between "*three broad typologies of exclusion that differ in respect to the market position of the firms involved and in respect to the specific features that characterize the exclusionary effects: Exclusion within the same market, where an incumbent forces the exit or prevents the entry of a competitor, exclusion in an adjacent market where the dominant firm excludes producers active in markets different but related to its main market, and exclusion in a vertically related market, where exclusion takes places in different stages of the production process.*"[2] *Predation was squarely put into the box of "exclusion within the same market.*"

However, the economic literature already covers predation as a leveraging exclusionary strategy. Furthermore, already in 2001 with a UK case, *Napp*, and much more recently with the European Commission case *Qualcomm* (2019), authorities had explored predation cases with a wider theory of harm. Both cases can better be thought of as exclusionary strategies that have allowed a dominant company to leverage its market power from one market to another – or from one market segment into another market segment – where it faced an entry threat. In these cases, recoupment from a predatory strategy occurs in a market (or segment) other than the one where predation occurred. As there have not been any successful predatory complaints in the U.S. in the last three decades, this could be the next looming area of divergence between the two jurisdictions.

II. ECONOMICS OF PREDATION

Predation has long attracted the interest of economists. This is illustrated by the *Standard Oil* case, a historical and pioneering case that started after the enactment of the Sherman Act in the U.S. in 1890. Predation was one among the many anticompetitive practices the most famous monopolist of the turn of the 19th Century was accused of and condemned for in 1910. Surprisingly perhaps, the case is not yet settled. McGee's famous 1958 article argued that Standard Oil had not engaged in predation. He concluded that there was no evidence that it induced its competitors' exit or that its conduct reduced the value of its rivals thus facilitating their subsequent acquisition. This shift in conclusions is emblematic of economists embracing the Chicago school approach in the 50's.

While the Chicago School criticism that predation could not be a rational strategy was later confirmed, it was confined to situations when there is perfect information. When this is not the case, the predator can "fool" the prey into believing that it would be better off exiting the market. Several theories have been put forward to explain why predation may be a rational strategy. First, it can be successful if the predator is able to build a reputation for being tough which can then be used to extend the reputational effects of predation to other markets (Yamey, 1972; Posner, 1976; Scherer, 1980).[3]

Second, the predator can succeed in signaling that it has very low costs or that demand is too low to sustain an entrant (Milgrom & Roberts, 1982).[4] Third, the predator can exploit imperfect information in capital markets, so that the prey's decline in performance is misinterpreted by investors as inefficiency or underperformance. As a result, investors withdraw their financial support (Telser, 1966; Bolton & Scharfstein, 1990).[5] More recently, Fumagalli & Motta (2013) showed that a dominant firm that has already sunk some costs, by predating could deprive a

2 Report by the EEAG "An economic approach to Article 82," July 2005, page 17, available at https://ec.europa.eu/dgs/competition/economist/eagcp_july_21_05.pdf.

3 Yamey, B.S., (1972), "Predatory price cutting: Notes and Comments," Journal of Law and Economics, 15, 129-142; Posner, R.A., (1976), Antitrust Law: An Economic Perspective, Chicago University Press; Scherer, F.M., (1980), Industrial Market Structure and Economic Performance, Rand McNally & Co, U.S., Chicago

4 Milgrom, P. & Roberts, J., (1982), "Predation, reputation, and entry deterrence," Journal of Economic Theory, 27(2), 280-312.

5 Telser, L., (1966), "Cutthroat competition and the long-purse," Journal of Law and Economics, 9, 259-277; Bolton, P. & Scharfstein, D., (1990), "A theory of predation based on agency problems in financial contracting," American Economic Review, 80, 93-106.

more efficient entrant from enjoying the required economies of scale.[6] Critically, in none of these models, the predator needs to price below its short-run marginal cost to deter entry or induce exit.

III. CURRENTLY KNOWN DIFFERENCES IN VIEWS ACROSS THE ATLANTIC

In the U.S., more predation cases followed the historic Standard Oil case. However, as the Chicago School became the predominant guidance for judges, an increasing skepticism on the feasibility of predatory strategies took hold of U.S. antitrust. The strict interpretation of the recoupment test set by the Supreme Court in *Brooke* in 1993 – i.e. requiring evidence that there is a "*dangerous probability*" of (successful) recoupment and quantitative evidence that profits in the recoupment phase would more than offset all the losses incurred in the predatory phase - meant that no complainant has managed to bring a successful predation case in front of U.S. judges ever since.

The European Commission and national authorities came later to the predation enforcement saga, but quickly caught up. The *Akzo* case dates back only to 1985 compared to 1910 of *Standard Oil*. The European Commission found that Akzo, in reaction to entry by a competitor, had priced a few chemical products to selected customers below their respective Average Variable Costs ("AVC") over several years.

The European Courts in that case set the standard cost tests that are still applied today: "*first, […] prices below average variable costs must be considered prima facie abusive inasmuch as, in applying such prices, an undertaking in a dominant position is presumed to pursue no other economic objective save that of eliminating its competitors. Secondly, prices below average total costs but above average variable costs are to be considered abusive only where they are fixed in the context of a plan having the purpose of eliminating a competitor.*"[7] The first of these two tests, namely prices below AVC giving rise to a presumption of illegality, is akin to its U.S. counterpart, the Areeda-Turner test. However, the second test, where even prices above AVC, but below Average Total Cost ("ATC"), may be found abusive if embedded in evidence on intent, is a European peculiarity.

Several other cases followed in the last twenty years. The European Commission condemned the incumbent German postal operator (Deutsche Post, 2001) and the dominant French Internet provider (*Wanadoo*, 2003), both of which are cases of exclusion within the same market. Similarly, the UK Office of Fair Trading ("OFT") condemned similar behavior by a local bus incumbent (*Cardiff Bus*, 2008) and a local dominant Scottish newspaper (*Aberdeen Journal*, 2000). The latter was an *ante-litteram* two-sided market application. However, predation as a leveraging strategy first appeared in (*Napp*, 2001). More recently, the European Commission also joined in (*Qualcomm*, 2019).

The few cases of predation as a leveraging strategy differ markedly from the practitioners' conventional view of predation as a "one-market abuse," where both the profit sacrifice during the predation phase and the monopoly pricing during the recoupment phase occurred successively on one and the same market. The novelty lies in extending the concept of predatory conduct to settings where the predatory attack occurs on one market (or segment) in order to protect a different, yet related, market/segment, where entry may have occurred and where the predator can therefore recoup its losses, either subsequently or even simultaneously to the predatory pricing.

IV. PREDATION AS A LEVERAGING ABUSE IN ECONOMICS

Some of the economic models of predation clearly allow for profit sacrifice and recoupment to arise in different markets.[8] For instance, in the reputational predation models mentioned above, the reputation gained by the dominant undertaking as a "tough competitor" will unfold its entry-deterring effects on any market on which this incumbent is active (and can achieve sufficient market power to allow for recoupment) and not only on the market where the predatory episode occurred. The same can apply to the other predation mechanisms discussed.

In signaling models, one could imagine that the "signal" sent by an incumbent about being a very efficient (low-cost) seller would carry over to additional markets, provided that the production costs on that market are correlated with those of the market where the signaling through below-cost prices takes place. In financial predation models, the withdrawal of financial resources because of some predatory attack will make it impossible for the prey to remain in or enter any other market on which it would compete against the incumbent, not just the market on which the predatory attack occurred.

6 Fumagalli, C. & Motta, M., (2013), "A Simple Theory of Predation," The Journal of Law and Economics, 56(3), 595-631.

7 Case C-62/86, *AKZO v. Commission* (Court of Justice judgment of July 3, 1991), para. 72; Case C-333/94, *Tetra Pak v. Commission* (Court of Justice judgment of November 14, 1996), para. 41; Case C-202/07 P, *France Télécom v. Commission* (Court of Justice judgment of April 2, 2009), para. 109.

8 The term "market" in the economic sense as used here may also refer to "segments" of the same antitrust market when applied under competition policy, where the market definition applied in a particular case may give rise to a rather broad such entity with several discernable segments.

Analogously, the predation model by Fumagalli & Motta (2013) extends to a setting where the sunk cost that is incurred in entering one specific market is also needed for a different market in the future or simultaneously (rather than the same market). In a regulatory context where a price cap includes both contestable and non-contestable services in different markets, the predator can also simultaneously predate in the contestable and recoup in the non-contestable services (Crocioni & Ribas, forthcoming).[9]

Some economic models even pre-suppose the existence of two potentially separate markets for the predatory strategy to work. A case in point would be predation on a two-sided market, where the dominant undertaking sets predatory prices on one side of the market, while recouping instantaneously on the other side of the market, on those users who enjoy indirect network effects and are therefore locked into the platform serving all the users on the other side of the market (Vasconcelos, 2015; Amelio et al, 2020).[10]

V. RECENT EUROPEAN CASE LAW ON PREDATION AS A LEVERAGING ABUSE

The last 20 years have also witnessed the emergence of a couple of predation cases, both in the UK and the EU, where a leveraging strategy was at the heart of the theory of harm. Historically, the UK *Napp* case of 2001 was the first of this kind. It concerned sustained release morphine tablets and capsules (known as "MST"), which were sold both to hospitals (a price-sensitive segment consisting of 10–14 percent of all MST sales) and to the community segment, consisting of patients whose General Practitioner ("GP") prescribed MST to them, if needed.

According to the OFT, Napp had charged predatory prices to hospitals (with discounts exceeding 90 percent by 1996), while at the same time setting much higher prices in the less price-sensitive and larger community segment. Moreover, the OFT sustained that Napp would systematically match any discounts that Napp's competitor BIL initiated, thus selectively targeting its competitors' customers. The OFT considered both sets of prices as part of a single exclusionary strategy.

The rationale for Napp's conduct was that, once patients became acquainted with Napp's MST products while in hospital care, they would be more likely to request the prescription of the same drug (rather than the competitor's brand) after being released from the hospital and referred to their GP's care (this was referred to as the "follow-on" effect). In fact, Napp tried to build its defense based on this mechanism, by arguing that the discounts it granted on the hospital segment were "incrementally profitable" once the higher sales in the community segment were taken into account. In other words, by netting the profits from the segment on which recoupment occurred against the losses from the segment where the predatory attacks were carried out, the discount strategy became overall profitable.

On appeal, the CAT confirmed the OFT's decision. While accepting that a follow-on effect may exist, it did not accept Napp's justification for pricing below AVC because it was circular. Napp could earn high compensating margins in the community segment precisely because its discount policy in the hospital segment had hindered competition in the community segment. Likewise, the expectation of excessive margins on future sales or simultaneous sales on another (side of the) market cannot be a justification for current loss-making sales. The CAT agreed with the OFT on this point:

> *"…the net revenue test, as applied simplistically by Napp, provides no yardstick for distinguishing between what is legitimate, and what is abusive, behaviour on the part of a dominant undertaking. For instance, a monopolist driving away new entrants by predatory pricing is likely to maximize his net revenue by so doing, for example by avoiding loss of market share and erosion of prices in the profitable market where he holds a monopoly. Yet plainly such behaviour does not cease to be abusive merely because it is profitable for the monopolist to engage in it. In our judgment, therefore, a "net revenue approach" cannot, standing alone, constitute a defence to a charge of abuse by a dominant undertaking, unless it is accompanied by clear evidence that there was no intention or effect of foreclosing the market and impairing competition."* [11]
>
> *"To put the point another way, in most cases of predatory pricing, the predator is willing to forego short-term profits, in the hope of recouping its losses on subsequent, more profitable, sales. In some cases the recoupment may take the form of raising prices again once a competitor is eliminated; in other cases it may simply be that it is well worth the cost of short-term losses in order to protect the profits that flow from a large market share. As the Director submitted in the present*

9 Crocioni P. & Silos Ribas, M.;(2022),"Could ex ante Regulation Create Incentives for Anti-competitive Behaviour?" in Parcu, P.L., Monti, G. & Botta M. (eds.), Interaction of Competition and Regulation in Telecom, Energy and Pharma, Discussing Emerging Trends at the National and EU Level, Edward Elgar Publishing, (forthcoming).

10 Vasconcelos, H., (2015), "Is Exclusionary Pricing Anticompetitive in Two-Sided Markets?," International Journal of Industrial Organization, 40, 1-10; ; Amelio, A., Karlinger, L. & Valletti, T.,(2020), "Exclusionary Pricing in Two-Sided Markets," International Journal of Industrial Organization, Vol. 73: 102592.

11 CAT, Aberdeen Journals Limited II, Case No. 1009/1/1/02, 23 June 2003, available at http://www.catribunal.org.uk/files/JdgFinal2AJ230603.pdf, para. 259.

case, the fact that Napp's below-cost pricing in the hospital sector enables it to make money from 'follow-on' sales in the community sector merely signifies that the particular form of 'recoupment' available to Napp is more direct and more immediate than it is in other cases of predatory pricing." [12]

In essence, the *Napp* case is a good example of predation in the context of a leveraging theory of harm: Napp's plan was not to recoup the losses incurred on the hospital segment via future higher prices on that same segment (as the standard theory of harm of predation would suggest), but rather through higher prices on the community segment into which it leveraged its market power from the (abusively monopolized) hospital segment. In retrospect Napp's follow-on argument and evidence was indeed evidence that the exclusionary strategy was profitable and recoupment profits outweighed the predation costs!

A similar mechanism was also at play in the European Commission's Qualcomm (predation) decision of 2019.[13] The case concerned the market for "baseband" chipsets of the third generation – Universal Mobile Telecommunications System ("UMTS") chipsets – which were and are used in mobile devices (such as mobile phones, tablets, and "dongles") to enable calls and data exchange via the mobile network. During the relevant period (2009-2011), Qualcomm was the dominant developer and manufacturer of such UMTS baseband chipsets. A small British start-up called Icera had meanwhile developed a radically new chipset technology (so-called soft modems) that promised to achieve data rates on par with Qualcomm's top-tier chipsets, but at much lower upgrade costs.

Both chipset suppliers marketed their products to device makers that purchase baseband chipsets and integrate them into their mobile devices before selling them to mobile network operators ("MNOs") or wholesalers of electronic devices. Qualcomm was particularly concerned by Icera's threat because of the expected growth potential of chipsets with high data-rate capabilities due to the global take-up of smart mobile devices. While such capabilities were less relevant for feature phones, which represented the vast majority of mobile phones sold in 2009, they became increasingly important in smart phones which had started to replace the technologically inferior feature phones during the relevant period of this case.

Qualcomm's conduct during the investigated period was selective both in terms of the market segment and also the customers that were affected by predatory prices. First, Qualcomm's strategy focused on a small segment of the UMTS chipset market, called the "leading-edge segment," which comprised chipsets that offered advanced data rate performance. It was precisely in this segment that Icera had started to gain traction in 2008/2009 due to the software upgradability of its chipsets to leading-edge data rates; its smaller die size; and its competitive pricing.

Second, Qualcomm's strategy focused on the two strategically most important customers for leading-edge UMTS chipsets during the relevant period, namely Huawei and ZTE. These two customers were the main OEMs of "mobile broadband" ("MBB") devices (such as data cards or dongles) at the time. While the market for MBB devices was (and still is) relatively insignificant compared to the mobile phone market, the former was particularly important for the leading-edge chipsets that were supplied by Icera and Qualcomm. Indeed, Icera's entry strategy consisted of first gaining a foothold in MBB devices, before acquiring the full technological capabilities to also enter the much larger market segment for UMTS chipsets for smartphones.

The internal evidence revealed that Qualcomm's pricing strategy aimed at containing Icera's growth at the two key customers in the leading-edge segment, with the aim of protecting Qualcomm's dominance in the entire UMTS chipset market – and in particular its strong position in the high-volume segment of baseband chipsets for use in mobile phones. Thus, while only a small part of the wider UMTS chipset market was affected by below-cost pricing, and the resulting losses incurred by Qualcomm were relatively low, this selective and targeted predatory strategy had an adverse impact on a market segment that was multiple times as large and yielded monopoly profits that exceeded the incurred losses by a wide margin.

Moreover, during the investigated period, the first chipsets reading on the successor standard to UMTS, called "Long Term Evolution" ("LTE"), were being developed and sold. Qualcomm's conduct on the UMTS chipset market is likely to have slowed down Icera's capability to invest in R&D on LTE chipsets, thus considerably delaying Icera's entry on this new market (which had been scheduled for the end of 2011, but only occurred in February 2013) and relegating it to a niche presence there. Icera was acquired by semiconductor company Nvidia in May 2011, which decided to wind down Icera's modem operations in May 2015.

12 *Supra*, para 261.

13 See Case COMP/39.711 *Qualcomm* (predation) (Commission Decision of 18 July 2019), public version available at: https://ec.europa.eu/competition/antitrust/cases/dec_docs/39711/39711_4493_4.pdf. The decision is currently under appeal before the General Court. For a detailed account of the economic analysis in this case, see Karlinger et al (2020). Karlinger, L., Magos, D., Régibeau, P., and & Zenger, H., (2020), "Recent Developments at DG Competition: 2019/2020," Review of Industrial Organization, Vol. 57: 783–814, December 2020.

VI. POSSIBLE LEVERAGING PREDATION SCENARIOS

Building on the brief discussion on economic theory and the *Napp* and *Qualcomm* cases, there are several possible scenarios where predation as a credible leveraging theory of harm can arise. We have identified the following:

1. Predation on one segment of two co-existing market segments, or on one side of a two-sided market, with recoupment occurring on the other segment/side of the market (as in *Napp*). Recoupment will occur simultaneously with the predatory attacks, but in a different segment of the same or even in a different antitrust market. For this to be a credible theory of harm, it should be shown that these two segments/markets are linked with each other, either via demand or via shared fixed cost investments, so that it is sufficient for the incumbent to marginalize the entrant on one of these segments to achieve monopolization/consolidation of market power also of the other;

2. Predation in a small initial market (or segment), which is key for success in a subsequent, larger (or more profitable) market(s) or segment(s), where recoupment occurs, as in *Qualcomm* predation. Profit sacrifice and recoupment are then sequential (as in the standard predation theory of harm), but they arise in different antitrust markets (or segments). Again, the key condition for this to be a credible theory of harm is to show that successful entry in the "initial" market (or segment) is a prerequisite for entry in the subsequent market. Or conversely, that failure to succeed in the initial market will prejudice the rival's ability to succeed in the subsequent market(s) or segments. Such conditionality may be grounded in financial constraints under which the entrant operates (where cash-flows derived from sales in the initial market are critical to finance investment into the technologies needed to be present in future markets or segments), in reputational effects of being present in the initial market, and the like; and

3. Predation in an upstream market by a vertically integrated provider, creating barriers to entry in a downstream market. In this case, profit sacrifice and recoupment occur in separate but vertically related markets. Absent the creation of downstream entry barriers by the predatory behavior, lower upstream prices may feed into lower downstream prices benefitting rather than harming consumers. However, this may not be the case if, and when, predation forces exit upstream, and this also hampers the rivals' ability to compete effectively downstream. In this instance, this would allow the predator to recoup upstream losses simultaneously downstream.

VII. CONCLUSIONS

While in the U.S., the high threshold for bringing forward a successful predation cases meant that the behavior was rarely sanctioned, the European Commission and European national agencies have taken a more pro-active approach. Yet, even in the more "interventionist" Europe, very few cases of predation as a leveraging exclusionary strategy have been explored: *Napp* and *Qualcomm* are the only exceptions we know of.

Such cases are of course challenging, not least because of the applicable legal test. Under European case law there is no need to prove recoupment if the predator is found to be dominant. This is well tailored to the concept of predation as "*exclusion within the same market*." Dominance is sufficient to ensure that the predator can recoup when it succeeds in forcing exit of its rivals. After all, the predator, if successful, would strengthen its dominance.

Does the same approach work in a leveraging predation strategy case? We consider that there is no need to prove that the predator has become dominant in the market where recoupment occurs. We are also not arguing for a modification of the current legal standard for predation. However, given the specific circumstances of any given case, particular attention should be paid to any elements that may explain why predation in one market would allow the predator to gain a position of sufficient market power in another market to make recoupment possible.

In other words, not only pricing below cost in one market must be proven, but we suggest that, without prejudice to the legal standard as established in AKZO, the plausibility of a leveraging predatory behavior would be enhanced by convincing arguments and evidence that its behavior allows the predator to leverage market power in the market were recoupment is likely to unfold. In *Napp* this was the "follow-on" effect, while in *Qualcomm* it was the inability of its rival to compete in the entire UMTS chipset market due to Qualcomm's predatory behavior.

THE CHICAGO SCHOOL AND THE IRRELEVANCE OF PREDATION

BY NICOLA GIOCOLI[1]

1 Department of Law, University of Pisa, nicola.giocoli@unipi.it . The paper is a shorter and largely revised version of Chapter 6 of Giocoli, N. 2014. Predatory Pricing in Antitrust Law and Economics. A Historical Perspective. London and New York: Routledge.

I. INTRODUCTION

In a famous 1963 article in Fortune magazine, later expanded in the 1965 *Columbia Law Review*, Robert H. Bork & Ward S. Bowman, two Yale professors with close connections to the Chicago School, argued that long-standing contradictions had brought antitrust doctrine to a state of crisis. While enforcement had long oscillated between protecting competition and protecting competitors, the latter had ultimately prevailed: "*Anti-free-market forces now have the upper hand and are steadily broadening and consolidating their victory. The continued acceptance and expansion of their doctrine […] threaten within the foreseeable future to destroy the antitrust laws as guarantors of a competitive economy*" (Bork & Bowman 1965, 364).[2] While shared by courts, enforcement agencies and Congress, in their view that misconception was above all the Supreme Court's responsibility, on account of its deliberate pursuit of a "*predominantly anticompetitive*" social policy and ever more frequent "extreme anticompetitive positions" (375).

Among the fallacious theories that provided the logical underpinnings of the recent "dismal record" on antitrust, Bork & Bowman singled out the theory of exclusionary practices (366). Playing a tune that in the following decades would become a cliché of the Chicago approach to antitrust, they argued that practices labeled by courts as "exclusionary," like price predation or vertical agreements, were competitive profit-maximizing actions. Calling those practices anti-competitive meant assuming that they were deliberately loss-making operations, that by adopting them "*a competitor can impose greater costs upon his rivals than upon himself*" and that some unspecified "*imperfections in or difficulties of access to the capital market*" denied rivals the funding necessary to resist them (367). Yet, the fallacies were not just theoretical. The current notion of exclusionary practices was "*remarkably lacking of factual support*," the product of "*an elaborate mythology, that […] has operated for years on hearsay and legends rather than on reality*" (ibid.). For Bork & Bowman, the mythology dated back to the famous *Standard Oil* decision of 1911, the landmark for all subsequent exclusionary cases.

Published in a popular outlet such as *Fortune*, Bork & Bowman's tirade against contemporary antitrust law was one of the earliest public episodes of the Chicago war against, and eventual conquer of, the American antitrust citadel. Remarkably, their opening salvo relied on just two authorities, both from the Chicago School, Aaron Director & John S. McGee. While that selection was, in general terms, unsurprising, what is less known is why a few years earlier those very authorities had picked, among several exclusionary practices, predatory pricing as the ideal battlefield to run their first assault to that citadel. Indeed, the same reason would later lead Bork to spotlight price predation in central chapter of his *The Antitrust Paradox*. Challenging the received theory of predatory behavior thus looks like a methodological red thread connecting some foundational works of the Chicago approach to antitrust.

II. THE DIRECTOR'S CUT

Aaron Director's role as the intellectual leader and operative engine of the modern Chicago School of law and economics is widely recognized.[3] His specific interest in antitrust began soon after he replaced Henry Simons after the latter's tragic death in 1946, taking on his price theory course at the Law School, which he then held for almost two decades. Law professor Edward Levi invited Director to also collaborate in the teaching of his antitrust course. As the story goes (Kitch 1983, 183), Levi would teach traditional antitrust four days each week; Director would then come in on the fifth day and apply price theory to show that the traditional legal approach could not stand up to rigorous economics.[4] The method worked particularly well for exclusionary practices. Director would ask whether a specific practice was consistent with monopolistic profit maximization and, in the negative case, would conclude that the practice ought to have some legitimate rationale. It is no exaggeration to say that the Chicago approach to antitrust came out of that course. As Bork recalled, many of those who took Director's course "underwent what can only be called a religious conversion. It changed our view of the entire world" (*ibid.*).

The scientific manifesto of the new approach was Director & Levi (1956).[5] In that essay Director & Levi undertook a meticulous critique of standard antitrust doctrines. Writing at the dawn of the Warren Court era, they envisaged what the Court had in the pipeline, namely, using

2 Bork, R. H. & Bowman W. S. Jr. 1965. "The Crisis in Antitrust." *Columbia Law Review* 65 (3): 363-376.

3 On Director's key role within the Chicago School, see e.g. Kitch, E. W. 1983. "The Fire of Truth: A Remembrance of Law and Economics at Chicago, 1932-1970." Journal of Law and Economics 26 (1): 163-234.; Van Horn, R. 2010. "Aaron Director." In The Elgar Companion to the Chicago School of Economics, edited by R. Emmett, 265-269. Cheltenham and Northampton: Edward Elgar; and Medema, S. 2011. "Chicago Price Theory and Chicago Law and Economics. A Tale of Two Transitions." In Building Chicago Economics. New Perspectives on the History of America's Most Powerful Economics Program, edited by R. Van Horn, P. Mirowski & T. A. Stapleford, 151-179. Cambridge: Cambridge University Press.

4 Kitch, E. W. 1983. "The Fire of Truth: A Remembrance of Law and Economics at Chicago, 1932-1970." Journal of Law and Economics 26 (1): 163-234.

5 Director, A. & E. H. Levi. 1956. "Law and the Future: Trade Regulation." Northwestern University Law Review 51: 281-296.

antitrust law to promote a specific social agenda. Fostering economic welfare by protecting the free working of competition no longer seemed the Court's main goal, as the emphasis was shifting from economic to socio-political themes. Issues of power, fairness, equality of opportunities, and democracy – "*which may have nothing whatever to do with economics*" (Director & Levi 1956, 282) – topped the Court's agenda.

These were the same themes classical liberals à la Henry Simons cared the most about. Their prominence among the possible goals of antitrust was hardly a novelty, as several courts, and Congress itself, had openly recognized since 1890. However, a consensus had existed until then that those goals had to be pursued only *indirectly*, applying to concrete cases the most up-to-date version of economic analysis, and then drawing from that the necessary policy implications. While many agreed that monopoly had to be fought first and foremost because of its socio-political consequences than because of its economic effects, still monopoly had to be defined, recognized, measured, and possibly eliminated using economic tools. Such an analytical orientation was the reason commentators of different political orientations had for instance welcomed the landmark *Alcoa* decision.[6] There the Second Circuit had explicitly employed microeconomic tools to defend competition and, because of that defense, achieve broader socio-political aims.

Now, the authors complained (*ibid.*), the Warren Court aimed at something different – that is, at pursuing its socio-political agenda via an opportunistic exploitation of economic ideas, regardless of their intrinsic correctness or mutual consistency. An ad hoc application of dubious economics for extra-economic goals was more dangerous for the future of antitrust than any argument – correct or not – made within a purely economic framework. The latter could always be amended by applying good economics,[7] but the former would be invulnerable to analytical critique because its validity could only be assessed in a different sphere.

The same *Alcoa* decision was exemplar of the threat this new approach to antitrust law could bring to the American economy – not because of the decision itself,[8] but for fear of what other courts might do with it. Right or wrong, *Alcoa* had been grounded on basic market share analysis, the new doctrine being that size sufficed for §2 liability. But what to do in the case of a big firm with less than monopoly power – that is, of a firm whose sheer size "mandated" condemnation, but that did not partake of Alcoa's almost absolute market power? An additional criterion was required for liability.

This, Director & Levi argued (289), amounted to identifying some business practices (like vertical restraints, tying, or predation) as abusive, i.e. as exclusionary devices aimed at reaching monopoly. Far from being supplanted by the *Alcoa* doctrine, the traditional "abuse approach" to §2 case law – the approach epitomized by the *Standard Oil* decision[9] – had to be summoned back in all those cases where condemnation was motivated by size, but where, absent complete monopoly, the *Alcoa* catchphrase "size destroys competition" would not resist scrutiny.

Unfortunately, according to Director & Levi the abuse approach as applied until then by American courts was seriously flawed. A hodgepodge of ad hoc notions aimed at corroborating decisions taken on different grounds, it rested on faulty economic basis. Although the Clayton, FTC and Robinson-Patman Acts had introduced "a certain automaticity into the law" against specific business practices, by making "unnecessary [a] separate inquiry in each of the cases as to [their] effects, advantages, or disadvantages," the fact remained that "no one of the special statutes is completely insulated from a pervasive concern with the doctrines of economics in the field of competition and monopoly" (289-90). Correct economic reasoning did, and should, matter in antitrust in general, and in §2 case law in particular. Director, Levi and their Chicago colleagues and disciples were determined to affirm it, as the only way to prevent the disruption of antitrust enforcement that, in their view the *Alcoa* doctrine and the Warren Court would bring.

Their criticism targeted one decision in particular. The pivotal role of *Standard Oil* in granting "substance and historical veracity" (Bork and Bowman 1965, 367) to the abuse theory of monopolization made the case a stumbling block on the way to a Chicago-style rebuilding of antitrust law. Director and Levi attacked it directly. With its loose blend of a size-based presumption plus a superficial account of alleged abuses *Standard Oil* was deemed exemplary of a shallow treatment of allegedly abusive practices, unconstrained by rigorous economics and blind to possible efficiency justifications. Worse, the 1911 precedent had legitimized the above-mentioned procedure, where a court would *first* make up its mind looking just at a business's size and *then*, having decided that the business deserved condemnation because of its size, would search within the list of allegedly abusive behaviors a rationale for its decision – that is, the seemingly abuse-based, but in practice size-based approach to monopolization that loomed over post-*Alcoa* antitrust.

6 *United States v. Aluminum Corporation of America*, 148 F.2d 416 (2d Cir., 1945).

7 Which to Chicago scholars was, and has always been until very recently, synonymous with price theory. On the peculiarities of Chicago's price theory see Hammond et al. 2013.

8 The *Alcoa* court had embraced one of the two approaches to monopoly the authors themselves recognized as equally legitimate: monopoly as abuse or combination and monopoly as sheer size. See Director & Levi 1956, 287.

9 *Standard Oil Co. v. United States*, 221 US 1 (1911).

Attacking *Standard Oil* was therefore a core element of Chicago's game plan. This might *prima facie* seem odd because, by establishing the rule of reason, that very decision was still a bulwark against the proliferation of *per se* prohibitions. Still, if Chicago aimed at bringing antitrust law back on track – the track of rigorous economic analysis – *Standard Oil* had to go. And given that the main monopolizing practice ascribed by the White Court to Rockefeller's behemoth had been predatory pricing, the attack would inevitably require questioning the existence and plausibility of anticompetitive below-cost pricing. Chicago economist and Director's protégé John McGee delivered with a vengeance.

III. A PRICE-THEORETIC REBUTTAL: MCGEE 1958

The importance of McGee's "Predatory price cutting: the Standard Oil (N.J.) case" cannot be exaggerated.[10] Published in the first volume of the *Journal of Law and Economics*, it is simply one of the most influential antitrust articles ever[11] and, under several respects, the real academic breakthrough of Chicago antitrust.

Writing under Director's impulse, McGee attacked the Holy Grail of antitrust case law, *Standard Oil*, and established two key results. First, that the traditional legal standard for predatory pricing was untenable in terms of standard price theory. Second, that a price-theoretic assessment of factual evidence refuted the Supreme Court's decision convicting Rockefeller's trust for predatory behavior.[12] The latter result disposed of the Holy Grail, but it was the former that satisfied the theoretical urge behind the paper. As McGee acknowledged in a footnote, the essay had been written to validate Director's own intuition – namely, that price theory could be harnessed to show that Standard Oil had neither achieved nor maintained its monopoly position via predatory pricing (McGee 1958, 138, n.2). In the spirit of Director & Levi's manifesto, it was a theoretical argument – an analytical point in price theory – that sparked the fire. The incineration of bad case law was just the (much appreciated) result.

McGee performed a meticulous case study, drawing directly from the 1911 trial record. Yet what his paper became famous for was the Director-inspired second section where he applied price theory to demolish the basic predatory pricing story (138-43). Curiously, what can actually be found in this section is far less than one might expect given the legendary aura of the paper. Several of the standard story's weaknesses were not even mentioned by McGee, who basically made two points, one more forcefully than the other, although that which received less attention in the paper would eventually become the most important.[13]

McGee's main theoretical point was that acquiring the rival firm was always a more profitable strategy for the would-be monopolist than predation (139-40). Predatory pricing would cause both firms – predator and prey – some unnecessary losses that could be avoided in case of immediate takeover. To purchase its competitor, the predator could offer a sum up to the discounted value of the full monopoly profits. This would be the maximum bid price, but any price above the prey's market value (i.e. above the present discounted value of its future profits) would suffice for the takeover to be *mutually* beneficial. By replacing predation with direct acquisition, the buyer would immediately earn full monopoly profits, without delaying them to the post-predation recoupment period and, above all, without incurring the (potentially large) losses of a price war. Part of the latter amount could then be offered to the rival "as a bonus" (140) beyond its market value.[14]

What remained to be proven was that the costs incurred by the predator during the price war could never be less than those necessary to directly purchase the rival. This possibility was refuted by McGee's second, and most famous, thesis – namely, that predatory pricing was generally unprofitable even in an absolute sense (140-2).

The argument is well known to students of introductory IO courses. First, a predator wishing to "lure customers away" from the prey ought to have spare capacity to serve them, but this extra capacity did not come for free. Provided the predator could sell

10 McGee, J. S. 1958. "Predatory Price Cutting: The Standard Oil (N.J.) Case." Journal of Law and Economics 1: 137-169.

11 Even modern critics of its factual and theoretical analysis recognize the article's impact on modern antitrust law and economics: see Dalton, J. A. & Esposito, L. 2007. "Predatory Price Cutting and the Standard Oil: a Re-examination of the Trial Record." In Research in Law and Economics, edited by R. O. Zerbe & J. B. Kirkwood, 22: 155-205. Significantly, Leeman (1956), a paper in the Journal of Political Economy that foreran some of McGee's most famous points, went almost undetected in the literature. See Leeman, W.E. 1956. "The Limitations of Local Price-cutting as a Barrier to Entry." Journal of Political Economy, 64 (4): 329-334.

12 McGee carefully avoided claiming that Standard Oil deserved acquittal. His point was just that its monopoly position had not been gained, or defended, using predatory pricing. See McGee 1958, 168-9.

13 Also curious is the circumstance that, despite the hundreds of authors who quoted, either favorably or unfavorably, McGee's paper, for decades none questioned the robustness of his case study. Only recently has the latter been re-examined, with the conclusion that, regardless of the validity of his analytical argument, McGee's factual analysis was blurred by a series of mistakes and omissions: see Dalton & Esposito 2007.

14 The point will be fully developed by another Chicago scholar: see Telser 1966.

more, it would, but then, given its already larger market share, it would inevitably lose more – potentially much more – than the prey (140).

Further, predation might well be unprofitable whenever the recoupment phase was delayed, shortened or, possibly, non-existent. This in turn might happen whenever the predator's efforts to get rid of competitors ran into trouble. Several things might go wrong. The rival, foreseeing the price would soon rise again, might simply shut down production, rather than exit the market, and resume operations as soon as the price increased. Alternatively, the rival's plant might be purchased by "some opportunist" or "wise men," who aimed at re-selling it to the monopolist at the maximum affordable price.

Finally, McGee evoked a perennial friend of antitrust skeptics, potential competition: "Obstacles to entry are necessary conditions for [predatory pricing] success. Entry is the nemesis of monopoly" (142). Absent significant barriers to entry, the monopoly profits gained during the recoupment period would always induce rivals to enter (or re-enter) the market. The latter claim would be the most significant one for later antitrust courts: the existence of entry barriers making recoupment possible would become a necessary requirement for proving predatory pricing violations, and a distinctive trait of the Chicago approach to exclusionary behavior.

McGee's case study in the rest of the paper was consistent with his theoretical analysis. He found evidence in the trial record that Standard Oil achieved and maintained its monopoly in oil refining via mergers and acquisitions, not predation. From Rockefeller's point of view, this was just rational, because using local price cutting to reduce competition "would have been foolish" (168). Provocatively, McGee noted that consumers would have actually benefited had Standard Oil's monopoly really been achieved via predation, rather than mergers: at least during the predatory phase oil prices would in fact have been lower.

The paper ended with another key claim, again in line with Director & Levi's skepticism about exclusionary abuses: "If the popular interpretation of the *Standard Oil* case is at all responsible for the emphasis that antitrust policy places on 'unfair' and 'monopolizing' business practices, that emphasis is misplaced. This limited study suggests that what businessmen do to one another is much less significant to monopoly than what they find it useful to do together to serve their common interest" (169, original emphasis). Not only did the Holy Grail of antitrust not even deserve being a key precedent for §2 case law – it actually showed that enforcers should focus on collusion and mergers to monopoly, rather than unilateral behavior.

Such a drastic conclusion was, as we said, the main goal of McGee's contribution to the newly-launched Chicago assault against contemporary antitrust. Still, even on the more specific issue of predatory behavior, his readers were led to a sweeping result. Given that predatory pricing was *rarely* profitable, and given that even when profitable it was *always* less so than the alternative takeover strategy, it followed that predatory pricing was *never* rational behavior.

Predatory attempts (let alone successful ones) should therefore be considered *very* uncommon in real markets.[15] The implication for antitrust enforcement was straightforward: if predatory pricing was *de facto* impossible, observed price cuts should be always considered evidence of normal competitive behavior, beneficial to consumers and, thus, not a matter of antitrust concern. In short, *The Antitrust Paradox*, Chapter 7 (Bork 1978, 144 ff.) – only twenty years before Bork himself.[16]

IV. REFINING MCGEE, WAITING FOR THE COURT

Given that the demolition of the basic predatory pricing story was not his primary goal, it is unsurprising that McGee left the task incomplete. Yet, his display of the power of price theory made it easy for other Chicago scholars to step in and finesse the argument. For example, a major weakness in the standard, deep-pocket story of predation was the requirement that the predator enjoyed greater financial strength than its rival(s). Absent such financial edge, predatory pricing could never be a profitable strategy.

15 As McGee himself would proclaim in a later paper, predatory attempts "have been rare, and […] successful attempts will be found to be still rarer" (McGee 1980, 292). This phrase would become a mantra of Chicago antitrust, especially after its quasi verbatim reproduction by the Supreme Court: "there is a consensus among commentators that predatory pricing schemes are rarely tried, and even more rarely successful" (*Matsushita Elec. Indus. Co v. Zenith Radio Corp.*, 475 US 574, 1986, at 589, quoting *inter alia* McGee 1958).

16 Bork, R. H. 1978. *The Antitrust Paradox. A Policy at War with Itself*. New York: Free Press.

Curiously, McGee himself has been credited with the observation that the requirement would never be satisfied if the prey could find in capital markets the means to withstand the losses. Though this observation was not in the 1958 paper,[17] it fit so nicely with its logic that it quickly became one of the major themes of debate.

The idea was simply that the availability of financial help for the prey would prolong the predation phase beyond its maximum possible length, with the latter being defined by the condition that the monopoly profits of the recoupment phase outweigh (in present value) the losses suffered during the price war. But why should capital markets help the prey? The answer was that if the prey's market value was positive, there would always be a creditor ready to lend against such a positive value all the money required to survive predation. In short, unlimited borrowing possibilities guaranteed by *well-functioning* capital markets made predatory pricing unprofitable.[18]

On the empirical side, a couple of works in the early 1970s brought support to McGee's thesis. In 1970 Kenneth Elzinga showed that the decision in another famous §2 case, *Gunpowder Trust*,[19] was also unfounded. Of the 14 companies allegedly preyed upon by the trust, evidence of predation could be found in only two cases, and even there it was hardly conclusive (Elzinga 1970, 236). One year later Roland Koller published the first attempt at an empirical analysis of the "123 federal antitrust cases since the passage of the Sherman Act in 1890 in which it was alleged that behavior generally resembling predation had played a significant role in the matter complained of" (Koller 1971, 110).[20] Out of the 95 cases that had resulted in convictions, Koller concluded that predation had actually been attempted just in seven cases and had succeeded only in four (111-12). The result stroke a decisive blow against existing case law. Four cases in eight decades seemed to validate McGee's thesis that predatory pricing was very rare and undeserving of enforcers' attention.[21]

Though fact-based at its core, McGee's paper exercised the utmost influence on theoretical matters. Armed with price theory, the Chicago School showed that both the standard legal narrative and the basic economic story of predation were logically untenable. Predatory pricing could hardly be rational behavior because it would often be an unprofitable – and, in any case, never the most profitable – strategy. Economic analysis provided no grounds for predatory pricing charges unless, at the minimum, the predator's "deep pockets" *and* the impossibility of the victim finding support in capital markets *and* the existence of entry barriers protecting the predator's recoupment were *all* explicitly proved. Predatory intent should also be demonstrated (see next section), to avoid confusing lawful price rebates with anti-competitive behavior. Even more certainly, price theory legitimized no naïve deductions like those Director & Levi imputed to the Warren Court – namely, that *if* a firm had large market power, *then* the predatory character of its price cuts could be presumed.

Having discarded the basic story, Chicago authors proposed their own, alternative account, allegedly supported by a combination of hard facts and robust theory. In the Chicago story, absent strong reasons to believe otherwise, all price rebates were lawful business practices that fostered competition and consumer welfare. Indeed, one could even conclude that the Supreme Court should replace its price predation stories with a much simpler rule of *per se* legality of all price cuts.[22]

However, despite their theoretical success, the seeds cast by Director were slow to bring real-world fruit: the success of the Chicago approach in antitrust case law was neither immediate (it had to wait until the late 1970s) nor complete (*per se* legality of most unilateral practices was never affirmed by courts). In the case of predatory pricing the delay was even longer because McGee's argument did not conquer the Supreme Court until the mid-1980s.

17 See Telser 1966 and Stigler, G. J. 1967. "Imperfections in the Capital Market." Journal of Political Economy 75 (3): 287-292. A complete analysis of the so-called unlimited borrowing case was already in Shubik, M., 1959, Strategy and Market Structure. Competition, Oligopoly and the Theory of Games. New York: Wiley, , Ch.10, esp. 256-7.

18 As typical of Chicago, the argument's logic is simple and unassailable, but holds only as far as the (often hidden) assumptions underlying it. Here a key role is played by the hypothesis of well-functioning capital markets. In the presence of market imperfections, the prey could well be unable to borrow enough money to resist predation, making the latter once again a potentially profitable strategy. The unlimited borrowing case is, in methodological jargon, an idealization (i.e. it rests on an assumption about some parameter assuming an extreme value – typically zero or infinite – which is known to be unrealistic or at least very unlikely: For a recent overview, see Peruzzi, E., & Cevolani, G. 2021. "Defending De-idealization in Economic Modeling: A Case Study." Philosophy of the Social Sciences. December: 1-28 (doi:10.1177/00483931211049759).) This is instrumental to showing that predatory pricing cannot be rational behavior. Hence, the burden of proof should fall on those who make such an extreme hypothesis, in the sense of either proving that (a reasonable approximation to) unlimited borrowing actually exists in the real world or that their thesis (the irrationality of predation) is robust to de-idealization, i.e. to a weakening of the hypothesis itself. While George Stigler famously ridiculed the objection of imperfect capital markets, remarking that no convincing explanation existed of what the alleged imperfections amounted to (Stigler 1967, 287), it may be worth noting that Stigler's defense of the perfection postulate was, for once, not based on the usual, only-prediction-matters argument à la Friedman (1953). See Friedman, M. 1953. "The Methodology of Positive Economics." In Essays in Positive Economics, 3-43. Chicago: University of Chicago Press.

19 *United States v. E.I. Du Pont*, 188 F. 127 (C.C.D. Del. 1911). See Elzinga, K. G. 1970. "Predatory Pricing: the Case of the Gunpowder Trust." Journal of Law and Economics 13 (1): 223-240.

20 Koller, R. H. II 1971. "The Myth of Predatory Pricing: An Empirical Study." Antitrust Law & Economics Review 4: 105-124.

21 Re-examining Koller's sample, Zerbe & Cooper (1982) concluded that predatory pricing had occurred more often, at least in 27 cases. See Zerbe, R. O. & Cooper, D. S. 1982. "An Empirical and Theoretical Comparison of Alternative Predation Rules." Texas Law Review 61 (4): 655-715.

22 See e.g. Easterbrook, F. H. 1981. "Predatory Strategies and Counterstrategies." University of Chicago Law Review 48 (2), 336-7.

The topic in which Chicago had first hit hard was among the last in which its views won courtroom acceptance. Explaining such late reception would exceed the limits of this paper,[23] but there is little doubt that when reception eventually happened, it was complete and unconditional. When in 1993 the Supreme Court landed *Brooke*,[24] with its almost-impossible-to-satisfy recoupment test, it put nail in the coffin for the next three decades of allegations of predatory pricing in American antitrust law.

V. STICK TO THE PLAN: BORK 1978

The strategy devised by Director in the mid 1950s was still operational in the late 1970s. The above-mentioned Chapter 7 of *The Antitrust Paradox* offers a sophisticated example of its application. In those crucial pages, Bork did not merely demolish the traditional view of predatory pricing, but followed a line of reasoning that, like in McGee (1958), stemmed directly from Director's teaching and that, again as in McGee, promised to deliver a much bigger win to Team Chicago – this time, no less than the demise of the whole case law of exclusionary practices. Without downplaying Bork's fundamental role in persuading the Supreme Court to eventually endorse the Chicago view of predatory pricing,[25] it is important to recall that his true goal in that chapter was more ambitious than polishing McGee's thesis.

The would-be federal judge distinguished between two branches of the law of exclusionary practices (Bork 1978, 137). The theory of predation was in his view the less significant one; of much greater import was the other branch, which struck at practices (such as vertical mergers, exclusive dealing contracts and requirement contracts) said to *automatically* exclude rivals, without asking whether they excluded by efficiency or improperly, and without requiring a showing of wrongful intent.

Bork considered the notion of automatically exclusionary practices as the most important one in contemporary antitrust law, and thus as the main target of his critical endeavor. Automatic exclusion, he argued, was no real-world phenomenon: the notion could only be taken seriously as a "legal fiction" (142), based upon the judicial intuition that predatory practices were extremely common but very difficult to prove because of the intent requirement.[26]

As a kind of "prophylactic rule" (143), the courts had therefore dropped the element of wrongful intent and replaced it with a presumption of automatic exclusion. This reading of §2 case law offered Bork an easy target and a clear strategy: by showing that predatory practices were hardly common – indeed, extremely rare – he would destroy the rationale underlying the "legal fiction" of automatic exclusion. This was the very same strategy devised by Director & Levi (1956) against another legal fiction, namely, those abusive practices invoked by courts to justify condemnation of antitrust defendants whose only "fault" was bigness. Now as then Chicago price theory had to be put to work to dissolve the fiction.

Of course, by 1978 most of the work had already been done. Among the literature critical of the received view of predatory behavior, Bork highlighted the contributions by fellow Chicago scholars John McGee & Lester Telser.[27] Significantly, however, he added that even those key studies had limitations. In particular, they focused only on price predation, neglecting other, more effective predatory practices (145-6).

The latter remark was instrumental to Bork's biggest goal, namely, getting rid altogether of the theory of automatic exclusion. To do so, he devised a smart blueprint. First, he would show that exclusionary practices such as exclusive dealing contracts or other distributional arrangements were more than a legal proxy for predation. Indeed, these practices could not be deemed unlawful *unless they themselves were also predatory*. As he wrote in a key passage: "Antitrust should attack no practice or arrangement on the grounds that it is exclusionary or foreclosing unless deliberate predation can be proved" (160). Then, if he managed to show that predatory behavior, even when broadened to encompass these further practices, was still quite rare, it would be mission accomplished. Not only the theory of automatic exclusion would have been demolished, but a list of practices that the Warren Court had declared *per se* illegal would have been rehabilitated.

23 See Giocoli, N. 2011. "When Low is no Good: Predatory Pricing and U.S. Antitrust Law (1950–1980)." European Journal of the History of Economic Thought 18 (5): 777-806 and Giocoli, N. 2014. Predatory Pricing in Antitrust Law and Economics. A Historical Perspective. London and New York: Routledge (Chs. 7-8).

24 *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993)

25 Bork himself argued the Brooke case in front of the Supreme Court. On his fundamental contribution to the rise of the Chicago approach to antitrust, see Elzinga, K. G., & Mills, D. E. 2014. "Antitrust Predation and The Antitrust Paradox." Journal of Law and Economics 57 (S3), The Contributions of Robert Bork to Antitrust Economics: S181-S200..

26 Together with the structural element of monopoly power, proof of intent was required at the time by U.S. courts to establish a §2 offense of monopolization. The explicit formulation of both requirements had been given by the Warren Court in *United States v. Grinnell Co.*, 384 US 563 (1966), at 570-1.

27 See Telser, L. G. 1966. "Cutthroat Competition and the Long Purse." Journal of Law and Economics 9: 259-277.

According to Bork, price theory showed beyond doubt that "predatory pricing is the most unlikely to exist" and that "attempts to outlaw it are likely to harm consumers more than would abandoning the effort." Still, other methods of predation existed, "which do not require the predator to expand output and incur disproportionately large costs" (155). He collected those "other methods" under the general heading of "disruptions of distribution patterns" (156-7). The general idea was that a firm might impose costs upon a rival by disturbing its optimal distribution policies.

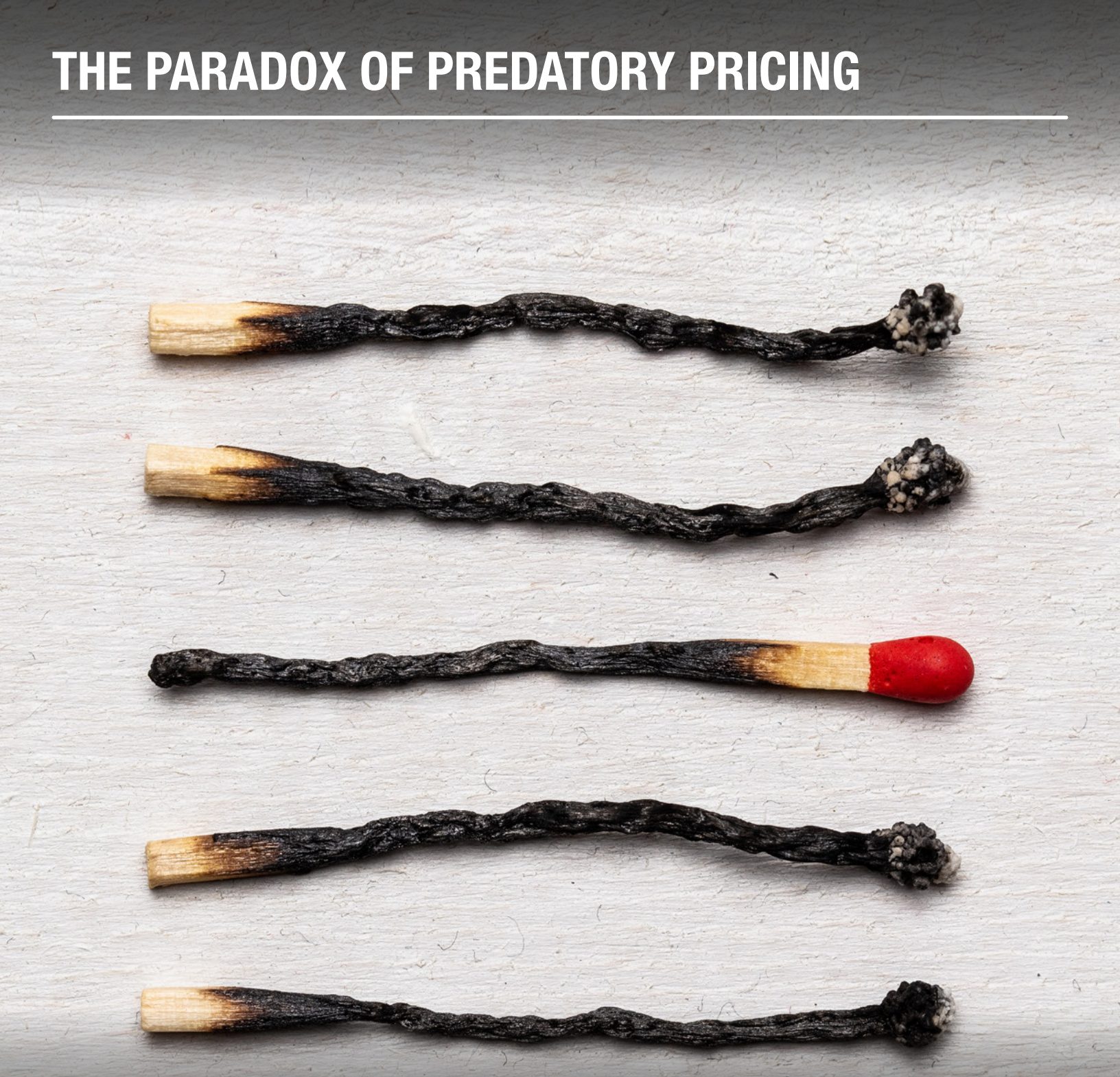
Under specific conditions, these extra costs might occasionally be so high as to transform the disturbance into a full-blown predatory practice: forced out of its best distribution pattern, the rival could find itself unable to compete. So, Bork willingly admitted that even in the case of (to his view) usually pro-efficiency exclusive dealing contracts, it could not be "entirely excluded on theoretical grounds" that they might turn into a predatory practice (157). And while the *Grinnell* Court required evidence of predatory intent as well as of a large market share to find against such distributional predation, price theory should always have the final word as to what specific practices deserved scrutiny under the Grinnell criteria. If economic analysis showed that a given practice had a chance, "however slim it may be" (*ibid.*), to become predatory, so be it.

These words might seem surprising given Bork's fame as the keenest critic of pro-active antitrust. Indeed, Bork himself emphasized that admitting the possibility of distributional predation or other non-price predatory practices could harm genuine competition: "The real danger for the law is less that predation will be missed than that normal competitive behavior will be wrongly classified as predatory and suppressed" (*ibid.*). So why was he willing to bring courts to pursue such unlikely violations? Why give them another opportunity to turn antitrust law against pro-efficiency practices?

The answer is: for the very same reason Director (and McGee) had targeted *Standard Oil*. Armed with price theory, Bork had demonstrated that at least some of the practices courts had declared "automatically exclusionary" as a shortcut for condemning defendants when ordinary predatory intent was too difficult to prove could themselves be predatory under rigorous economic analysis. This invalidated the shortcut itself and, as a consequence, should force courts to apply to those very practices the same demanding standards of price-theoretic analysis and *Grinnell*-style predatory intent.

Bork was confident that, facing the task of demonstrating that, say, an exclusive dealing contract had been signed with a specific predatory intent, a court would recognize the task's impossibility and accept what "proper economics" showed, namely, the likely pro-efficiency nature of the contract. That price theory could be used not only to formally elucidate the efficiency of some allegedly exclusionary business practices, but also to induce potentially hostile courts *to acknowledge such efficiency* in real-world cases, was perhaps the most effective intuition in the 1978 book. For sure, it was another display of the internal consistency of the Chicago game plan against §2 case law, as originally devised by Aaron Director.

THE PARADOX OF PREDATORY PRICING



BY JOHN B. KIRKWOOD[1]

1 Professor of Law, Seattle University School of Law; American Law Institute; Chair-Elect, Executive Committee, AALS Antitrust and Economic Regulation Section; Advisory Board, American Antitrust Institute; Advisory Board, Institute for Consumer Antitrust Studies.

I. INTRODUCTION

Predatory pricing is an antitrust paradox. In concept, the conduct is plainly anticompetitive. A dominant firm cuts its price below its incremental costs, losing money on every additional sale, solely to injure a significant rival.[2] The rival, unable to withstand the assault,[3] exits the market or abandons its expansion plans, enabling the predator to raise its price to supracompetitive levels. This two-step maneuver – a price reduction followed by a larger or longer lasting price increase – enhances the dominant firm's profits and reduces the welfare of consumers.

U.S. courts, however, have made this harmful practice exceedingly difficult to challenge. The Supreme Court has insisted that a plaintiff establish both below-cost pricing and a reasonable likelihood of recoupment,[4] and few plaintiffs have been able to overcome these twin obstacles. Plaintiffs have lost every predatory pricing case (and every similar case) in the Supreme Court,[5] and study after study has found that plaintiffs' success rate in the lower courts is abysmal.[6] To be sure, recent evidence suggests that plaintiffs' prospects may have improved somewhat. A study of decisions since 2013 found that plaintiffs were victorious almost 30 percent of the time.[7] But the number of cases was small, and the victories occurred on motions to dismiss. To my knowledge, there is still no instance since Brooke Group in which a plaintiff successfully litigated a predatory pricing case to final judgment. In consequence, the paradox remains: predatory pricing is clearly anticompetitive, but it has not resulted in an injunction or treble damages for over a generation.[8]

The courts' hostility to predatory pricing claims rests on two principal grounds. First, predatory pricing cases tend to chill price competition. Because a predatory pricing case is an attack on price cutting, a mistaken finding of liability will punish the very behavior that antitrust seeks to encourage.[9] Second, some early studies indicated that true predation almost never occurs. In the Supreme Court's famous language, these studies suggested that "predatory pricing schemes are rarely tried, and even more rarely successful."[10] Both factors, if true, imply that courts ought to be hostile to predatory pricing cases. In essence, they discourage procompetitive behavior and seldom uncover real predation. Moreover, under the Court's current rules litigating a predatory pricing case is costly and complicated. Why incur these costs when the chance of a beneficial outcome is low?

This pessimistic conclusion, however, hinges on the accuracy of its underlying premises. If predatory pricing cases were simpler to litigate and less likely to chill desirable conduct, and if true predation were more common, courts should be more receptive to predatory pricing claims.

One premise – that true predation is almost nonexistent – has already been undercut. Numerous studies since *Brooke Group* have

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2 In the pure case of predatory pricing, the price cut makes no economic sense except for its adverse effect on competition. See Gregory J. Werden, *Identifying Exclusionary Conduct Under Section 2: The "No Economic Sense" Test*, 73 Antitrust L.J. 413 (2006).

3 In the traditional "deep pocket" model of predation, the rival cannot survive the price war because it lacks the financial resources of the dominant firm. Modern economic theories of predation emphasize other factors that impede a rival's ability to withstand a predatory assault, such as higher costs, inadequate information, or lack of a track record.

4 See *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

5 See *Brooke Group*, 509 U.S. at 209; *Cargill, Inc. v. Monfort of Colo., Inc.*, 479 U.S. 104 (1986); *Matsushita Elec. Indus Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986). See also *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., Inc.*, 127 S. Ct. 1069 (2007) (rejecting liability in a predatory bidding case); *Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328 (1990) (rejecting liability in a maximum resale price maintenance case).

6 See Christopher R. Leslie, *Predatory Pricing and Recoupment*, 113 Colum. L. Rev. 1695 (2013); Patrick Bolton, Joseph F Brodley & Michael H. Riordan, *Predatory Pricing: Strategic Theory and Legal Policy*, 88 Geo. L.J. 2239 (2000); James D. Hurwitz & William E. Kovacic, *Judicial Analysis of Predation: The Emerging Trends*, 35 Vand. L. Rev. 63 (1982).

7 See John B. Kirkwood, *Predation and Discrimination*, in Handbook on Abuse of Dominance and Monopolization , (Pinar Akman ed., forthcoming). This chapter also discusses European Union law on predatory pricing, which is more favorable to plaintiffs.

8 Perhaps the answer is that no firm engaged in predatory pricing during this period. But that seems doubtful, given the theory and evidence cited in this article. Moreover, one case – Spirit's action against Northwest Airlines – appeared to involve a compelling case of predation. Spirit had begun to offer service on two of Northwest's routes and Northwest responded with deep price cuts, causing Spirit to withdraw. After Spirit left, Northwest raised its prices *sevenfold*. While the district court, like so many courts before it, granted summary judgment for Northwest, Spirit persuaded the Sixth Circuit to allow the case to proceed. See *Spirit Airlines, Inc. v. Northwest Airlines, Inc.*, 431 F.3d 917 (6th Cir. 2005). Spirit's victory was pyrrhic, however, because Northwest declared bankruptcy and Spirit decided to withdraw its suit, without obtaining an injunction or damages. For an excellent discussion of Spirit's strong claim but its failure to achieve more, see Kenneth G. Elzinga & David E. Mills, *Predatory Pricing in the Airline Industry: Spirit Airlines v. Northwest Airlines (2005)*, in The Antitrust Revolution 354 (John E. Kwoka, Jr. & Lawrence J. White, eds., 2019). To be sure, a plaintiff could achieve a victory without a litigated judgment by extracting a substantial settlement from the defendant. But Elzinga & Mills provide no evidence that Spirit secured a substantial settlement. See id. Moreover, to my knowledge, no other predatory pricing plaintiff has done so since *Brooke Group.*

9 See *Brooke Group*, 509 U.S. at 223, 226.

10 *Id.* at 226 (quoting *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 589 (1986)).

shown that predatory pricing is not only a viable strategy in many circumstances but it has occurred repeatedly.[11] The Tenth Circuit acknowledged this new literature, noting that it proves that "price predation is not only plausible, but profitable, especially in a multi-market context where predation can occur in one market and recoupment can occur rapidly in other markets."[12] Consequently, the court stated: "Although this court approaches the matter with caution, we do not do so with the incredulity that once prevailed."[13]

The Court's other premise – that predatory pricing cases unduly chill procompetitive price cuts – could be reduced by restructuring predatory pricing litigation so that it is less likely to deter desirable behavior and more likely to result in liability when true predation has occurred. Such restructuring could also reduce the cost and complexity of predatory pricing cases, making them less expensive and time consuming.

Some scholars have proposed to achieve these ends through a dramatic alteration of predatory pricing law. Economist Aaron Edlin, for example, would do away with the *Brooke Group* requirements altogether and substitute a limited ban on reactive price cuts. Specifically, a monopolist could not reduce its price in response to entry if the entrant is charging a price 20 percent or more below the monopolist's price.[14] This clever proposal creates an incentive for a monopolist to lower its pre-entry price, since a lower pre-entry price would give the monopolist greater latitude to respond to entry. But the proposal also eliminates both existing *Brooke Group* requirements. Such a radical reworking of existing law may be too much for Congress or the courts.

This essay explores a more moderate approach. It addresses the desirability of eliminating one of the *Brooke Group* requirements, either the below-cost test or the recoupment requirement. Either change would make it easier to combat true predatory pricing. The crucial question is whether the change would create an unacceptable risk of chilling procompetitive price cutting. Part I examines the wisdom of eliminating the below-cost requirement. This approach would allow a plaintiff to challenge above-cost as well as below-cost price cutting so long as the plaintiff establishes that the defendant was likely to recoup its profit sacrifice and impose long-term harm on consumers. Part II addresses the other alternative: eliminating the recoupment requirement. This option would allow a plaintiff to challenge a price cut if it proves that the defendant priced below its average variable cost and rebuts the defendant's asserted justifications for that pricing.

This essay concludes that the second approach – dropping the recoupment requirement – is superior. It would facilitate challenges to predatory pricing by eliminating the requirement that is most difficult to establish. And it is less likely to deter desirable price cutting because it provides firms with a reasonably bright line they can follow. They can reduce prices whenever they want so long as they do not price below average variable cost.

Eliminating the below-cost requirement would deprive them of this guardrail and leave them with only the recoupment requirement, which is less definite because it demands that they predict whether a price cut would result in *long run* harm to competition and consumers. Because predicting the long run is difficult, firms interested in playing it safe will be more inclined to avoid aggressive price cutting.

II. ELIMINATING THE BELOW-COST REQUIREMENT

The below-cost requirement is not necessary to distinguish predatory from procompetitive price cutting. A dominant firm need not price below its average variable costs – the usual cost standard – to drive out, discipline, or deter a rival. So long as the dominant firm has significant advantages over the rival, an above-cost price reduction can achieve a predatory effect. For example, a dominant firm may possess economies of scale that are unavailable to the rival, and as result, the dominant firm's average variable costs are substantially below those of the rival. In this situation, the dominant firm can drive the rival's price below its average variable cost without pricing below average variable cost itself. In other words, the dominant firm can impose losses on the rival without incurring comparable losses itself. Other advantages such as learning-by-doing economies, network effects, brand loyalty, and access to cheaper capital could have the same effect. In consequence, a price above average variable cost or even average total cost can be predatory. Numerous scholars agree.[15]

11 For reviews of the new scholarship, see Leslie, supra note 6; Bolton, Brodley, & Riordan, *supra* note 6; Richard O. Zerbe Jr. & Michael T. Mumford, *Does Predatory Pricing Exist? Economic Theory and the Courts After* Brooke Group, 41 Antitrust Bull. 949 (1996); Jonathan B. Baker, *Predatory Pricing After* Brooke Group: *An Economic Perspective*, 62 Antitrust L.J. 585 (1994).

12 *United States v AMR Corp.*, 335 F.3d 1109, 1115 (10th Cir. 2003).

13 *Id.*

14 See Aaron S. Edlin, *Stopping Above-Cost Predatory Pricing*, 111 Yale. L.J. 941 (2002). The ban would apply for 12 to 18 months or until the incumbent no longer has monopoly power.

15 See, e.g. Herbert Hovenkamp, *The Harvard and Chicago Schools and the Dominant Firm*, in Where the Chicago School Overshot the Mark 132, 148-49 (Robert Pitofsky ed. 2008); Aaron S. Edin, *Stopping Above-Cost Predatory Pricing*, 111 Yale L.J. 941, 944 (2002); Bolton, Brodley & Riordan, *supra* note 6, at 2271; Jonathan Baker, *Predatory Pricing after* Brooke Group: *An Economic Analysis*, 62 Antitrust L.J. 585, 591 (1994); John B. Kirkwood, *Controlling Above-Cost Predation: An Alternative to* Weyerhaeuser *and* Brooke Group, 53 Antitrust Bull. 369, 382-86 (2008).

Abolishing the price-cost test would make sense in many ways. It would allow plaintiffs to challenge above-cost predation, and it would let them avoid the cost measurement issues that frequently plague predatory pricing litigation.[16] At the same time, plaintiffs would still have to establish a reasonable likelihood of recoupment, which is often difficult to do.[17] In consequence, this approach would still block most challenges to procompetitive price reductions.

Dropping the below-cost requirement, however, would deprive firms of a reasonably bright line for determining whether their pricing is legal or illegal, While that line is not sharp, given the cost measurement issues, it is still something that business executives can readily understand. It tells them that they can reduce price, even if it harms the competition, so long as they do not cut price below average variable cost. They must maintain a positive contribution margin.[18] If that line were removed, firms would be less uncertain about what they could do and would be more inclined to moderate or forego aggressive price reductions. It is not clear, of course, how much chilling would occur, since the recoupment requirement would remain in place. But there is reason to fear significant chilling.

III. ELIMINATING THE RECOUPMENT REQUIREMENT

The second approach would remove the recoupment requirement, as Christopher Leslie has recommended, and replace it with a less onerous approach. This requirement has frequently defeated predatory pricing claims. Indeed, Leslie found that the recoupment requirement was the single largest reason these claims failed.[19] In addition, the requirement is arguably unnecessary. As Scott Hemphill & Phillip Weiser point out, a "price below cost is, in effect, prima facie evidence that the firm thought it could recoup its predatory price cut."[20] Thus, a court could infer recoupment from both the existence of below-cost pricing and the absence of a non-predatory explanation for the behavior. Accordingly, the second approach would require the plaintiff to prove not only that the defendant priced below cost but also that its asserted justifications for that pricing were invalid.

As Hemphill & Weiser note, the principal procompetitive justifications for a price below cost are "when a firm introduces a product with temporary low prices, or sets a low price in anticipation of later scale economies."[21] If a defendant advances one or both reasons, the plaintiff's burden would be to show that the asserted justification is incorrect. The plaintiff might demonstrate, for example, that an introductory pricing explanation was inapt because there had been no significant improvement in the defendant's product, or the defendant had priced below cost far longer than necessary to introduce a new product. Likewise, the plaintiff might rebut a scale economy explanation by demonstrating that there was no reason to expect that a sharp increase in the defendant's market share would result in a substantial reduction in its costs. Whatever the purported justification, the plaintiff would have to establish that it was invalid.

This approach is likely to produce better results than the first option. By retaining the below-cost test, this approach would send clearer signals to business and encourage aggressive above-cost price cuts. It would protect procompetitive below-cost pricing by insulting it from challenge unless the plaintiff can rebut the defendant's asserted justifications. Most important, by abolishing the recoupment requirement, it would reduce the costs of challenging true predatory pricing.

IV. CONCLUSION

This article suggests that the law governing predatory pricing should be restructured to eliminate the recoupment requirement and replace it with a requirement that the plaintiff rebut the defendant's explanations for pricing below cost. This reform is likely to increase challenges to genuine predatory pricing while limiting a plaintiff's ability to attack procompetitive price cuts. Although it is not perfect – it would not reach above-cost predation – this reform is likely to enhance consumer welfare and mitigate the paradox of predatory pricing.

16 See, e.g. Hovenkamp, *supra* note 15, at 132 ("In some cases measuring [price-cost relations] is extraordinarily difficult, particularly if the defendant produces multiple products with common costs").

17 See Leslie, *supra* note 6, at 1740 (noting that as of 2013, summary judgment in the U.S. was most often granted for defendants because the plaintiff could not supply adequate evidence of recoupment).

18 In fact, as discussed below, a firm may sometimes be able to justify a negative contribution margin (a price below average variable cost). A contribution margin is the profit margin on an incremental sale, normally measured as price minus average variable cost.

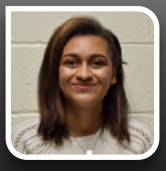
19 See *supra* note 17.

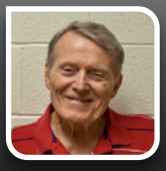
20 C. Scott Hemphill & Philip J. Weiser, *Beyond* Brooke Group: *Bringing Reality to the Law of Predatory Pricing*, 127 Yale L.J. 2048, 2055 (2018).

21 *Id.* at 2055 n. 28.

PREDATION BY THE DOMINANT BUYER

BY BRIANNA L. ALDERMAN & ROGER D. BLAIR[1]





1 Respectively, Ronald E. McNair Research Scholar, Department of Economics, University of Florida; and Professor, Department of Economics, University of Florida, and affiliate faculty, Levin College of Law, University of Florida.

I. INTRODUCTION

Section 2 of the Sherman Act condemns anyone who monopolizes or attempts to monopolize a relevant antitrust market.[2] Over time, the standards for unlawful monopolization evolved as judicial decisions put flesh on the bare bones of the statute.

In its *Grinnell* decision, the U.S. Supreme Court spelled out a two-part test for unlawful monopolization:

> The offense of monopoly under section 2 of the Sherman Act has 2 elements: (1) the possession of monopoly power in the relevant market and (2) the willful acquisition and maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.[3]

The notion of "willful acquisition and maintenance" refers to competitively unreasonable, i.e., unlawful conduct. Conduct that is anti-competitive is forbidden, but competition on the merits is not.

Since 1911, the quintessential exclusionary conduct has been predatory pricing, that is, pricing below cost to drive rivals from the market.[4]

From 1911 to 2007, the focus had been on dominant sellers and their predatory efforts to become monopolists. In the *Weyerhaeuser*[5] litigation, the focus shifted to allegations of predation on the part of a dominant buyer that was aiming to become a monopsonist.[6] In this article, we address the law and economics of buyer side predation.

In order to put our analysis in context, we begin with a brief overview of the Weyerhaeuser case. We then examine the incentive to engage in predatory bidding (or buying). Next, we present several attempts to identify predatory buying. We follow up with a brief examination of recoupment and close with some final remarks.

II. THE *WEYERHAEUSER* LITIGATION

In 1980, Weyerhaeuser entered the Pacific Northwest by buying an existing hardwood lumber company. It invested some $75 million in modernizing the facilities between 1990 and 2000, which improved its hardwood lumber yield from the sawlogs.[7] By the time of the suit, it operated six sawmills in the region. While Weyerhaeuser was apparently flourishing, Ross-Simmons was floundering financially. For several years, it had lost substantial sums until 2001, when Ross-Simmons succumbed and closed down its business. It then sued Weyerhaeuser for violating §2 of the Sherman Act.

The dispute involved an allegation that Weyerhaeuser had engaged in predatory conduct in the alder sawlog market. Unlike most predatory price claims, Ross-Simmons did not allege pricing below cost in an effort to drive rivals out of the market. Instead, it involved claims that Weyerhaeuser overpaid for alder sawlogs and, thereby, denied an essential input to Ross-Simmons. In essence, Ross-Simmons alleged that Weyerhaeuser's purchasing practices were aimed at denying Ross-Simmons and other hardwood lumber companies access to the inputs that were essential for their continued vitality as competitors in the hardwood lumber market.

At the District Court, the jury found Weyerhaeuser guilty and awarded damages to Ross-Simmons which were trebled to $78.8 million. In its appeal to the Ninth Circuit, Weyerhaeuser argued that Ross-Simmons had failed to satisfy the *Brooke Group* test for predatory pricing.[8] The Ninth Circuit rejected Weyerhaeuser's appeal and affirmed the District Court's ruling, but the tide turned at the U.S. Supreme Court.

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2 15 U.S.C. § 2.

3 *United States v. Grinnell Corp.*, 384 U.S. 563, 570-571 (1966).

4 *Standard Oil Co. of New Jersey v. United States*, 221 U.S. 1 (1911), and *United States v. American Tobacco Company*, 221 U.S. 106 (1911).

5 *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co.* - 549 U.S. 312 (2007).

6 For an extensive economic analysis, see Roger D. Blair & John E. Lopatka, *Predatory Buying and the Antitrust Laws*, 2008 Utah Law Review 415 (2008).

7 It appears that Ross-Simmons did not make similar investments in its facilities.

8 *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

The U.S. Supreme Court found that monopsony and monopoly should be treated symmetrically.[9] Consequently, allegations of predatory bidding (or overbuying) would have to meet the standards set out in *Brooke Group*.[10] More specifically, a successful plaintiff would have to prove two things. First, the plaintiff would have to prove the existence of predatory bidding. This requires proof that the defendant overpaid for the input in question such that the average cost of its finished product exceeded the market determined price.[11] In essence, the overbidding resulted in unprofitable sales.

Second, the plaintiff had to prove that the defendant had a reasonable probability of recouping its losses after the plaintiff's demise as a rival.[12] In the case of Ross-Simmons, they had to prove that Weyerhaeuser paid so much for the sawlogs that the prices that it could realize in the output market were below its costs, and that Weyerhaeuser has a reasonable probability of recouping the losses that it experienced during the period of predation. Since Ross-Simmons failed to satisfy this modified *Brooke Group* test, the U.S. Supreme Court reversed the judgement of the lower court.[13]

III. MOTIVATION TO EXCLUDE ROSS-SIMMONS

A dominant buyer's efforts to maximize its profits are offset to some extent by the competitive responses of its smaller rivals. Consequently, it has an incentive to exclude these smaller rivals from the market. This can be illustrated with the aid of the dominant buyer model.[14]

The dominant buyer is a close cousin of the pure monopsonist. In this model, a single large buyer is surrounded by a collection of small buyers, which are referred to collectively as the competitive fringe. For the purposes of our analysis, we will consider Weyerhaeuser to be the dominant firm and Ross-Simmons represents the competitive fringe. Due to its size, Weyerhaeuser recognizes that its purchases of alder sawlogs will influence the market price.

As a result, it will act as a price setter rather than a price taker. Ross-Simmons is small enough that it acts as a price taker because it believes that its purchases are too small to influence price in the market. In essence, the fringe of competitive buyers accepts the price that Weyerhaeuser pays as the market determined price. Behaving competitively, Ross-Simmons and the other fringe buyers will buy the sawlogs up to the point where their collective demand equals the price set by Weyerhaeuser.

In the Pacific Northwest, red alder sawlogs are a byproduct of soft wood harvesting. When a tract of timberland is clear cut, the pine forest contains relatively few hardwood trees, but there are some. Consequently, the supply of red alder sawlogs from a harvest is fixed, i.e. it does not respond to changes in the purchase price of these sawlogs. After separating the hardwood from the softwood, a certain fraction of the resulting sawlogs are red alder.

The supply is perfectly inelastic above the minimum price necessary to bring the hardwood to market. Below that minimum, the supply available to the market will be zero. Thus, the supply is horizontal at the minimum price until the total quantity in the harvest is reached as that reflects the costs of making the already harvested sawlogs available for sale, which we will refer to as P_R or the reservation price. From there, the supply curve is vertical.

The price is determined by the demands of the hardwood lumber companies. This can cause some firms to experience problems in acquiring sawlogs, which are an essential input in producing hardwood lumber.

Now, Weyerhaeuser's problem is to adjust its purchases to maximize profit subject to the competitive behavior of the fringe buyers such as Ross-Simmons. This is shown in Figure 1 where D_{rs} represents the demand for alder sawlogs by Ross-Simmons, D_w represents the demand

9 "[M]onopoly and monopsony are symmetrical distortions of competition from an economic standpoint….The kinship suggests that similar legal standards should apply to claims of monopolization and claims of monopsonization." *Weyerhaeuser* at 322.

10 There is no distinction between overbidding and overbuying. The only way to buy too much is to stand ready to bid too much; if one bids too much, one must stand ready to buy too much. Identifying what constitutes "too much" is no mean feat.

11 *Weyerhaeuser* at 325.

12 *Weyerhaeuser* at 325-326.

13 *Weyerhaeuser* at 326.

14 What follows is an adaptation of the dominant firm price leadership model. See Roger D. Blair & Jeffery L. Harrison, *Monopsony in Law and Economics* (2010) at 55-61.

of Weyerhaeuser, and S is the supply of red alder sawlogs. Weyerhaeuser recognizes that at any price that it sets, Ross-Simmons will purchase the quantity of sawlogs where D_{rs} equals that price.

Weyerhaeuser incorporates this behavior into its decision calculus by subtracting D_{rs} from S to obtain the residual supply of alder sawlogs, which is denoted by S_r in Figure 3. The curve marginal to S_r, which is labeled ME_r, represents the marginal expenditure for Weyerhaeuser. Given the presence of the competitive fringe, Weyerhaeuser acts like a monopsonist. Weyerhaeuser purchases the quantity (Q_w) that corresponds to the equality of ME_r and D_w. The price (P) is found at the residual supply at that quantity. At a price of P, Ross-Simmons will purchase Q_{rs} where P equals D_f. At price of P, sellers will provide Q, which is equal to the sum of Q_{rs} and Q_w. The marginal expenditure (ME_r) exceeds the price of the sawlogs (P).

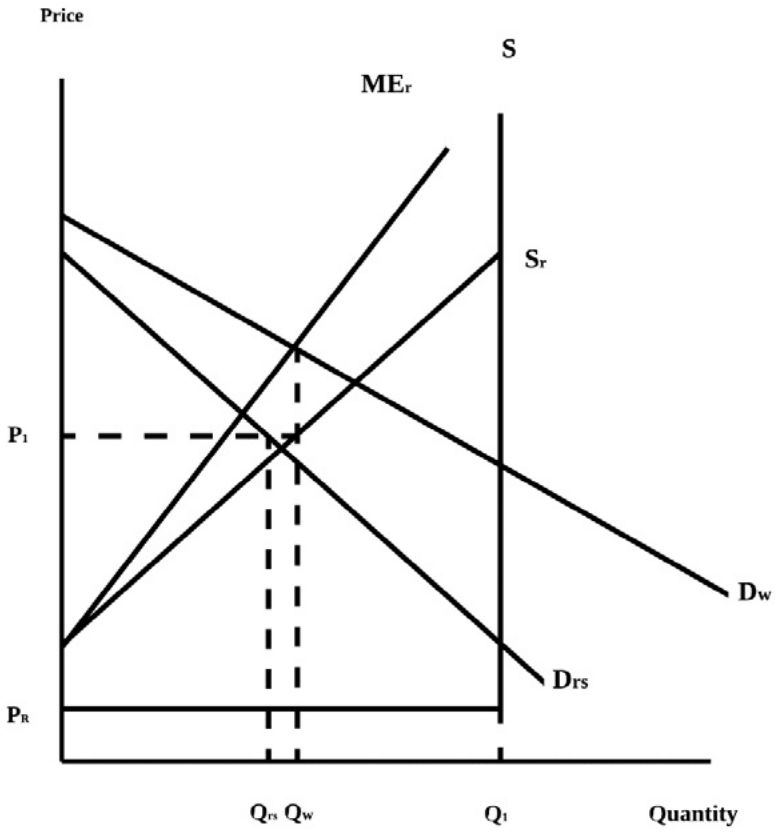


Figure 1

At the equilibrium price and quantity, Weyerhaeuser enjoys buyer surplus equal to the trapezoidal area below its demand (D_w) and above the price (P) between the origin and Q_w. This is nice but it could be better. If Weyerhaeuser can exclude Ross-Simmons, it can operate as a pure monopsonist. Weyerhaeuser would be able to purchase all the hardwood supplied in the market, and so Q_w would equal Q_1. In the limit, Weyerhaeuser could depress the price paid to P_R because it is the only buyer in the market.

This would expand their buyer surplus to the entire trapezoidal area below Weyerhaeuser's derived demand but above the reservation price. The potentially extreme increase in buyer surplus produces the economic incentive to exclude rivals, as shown in Figure 2.

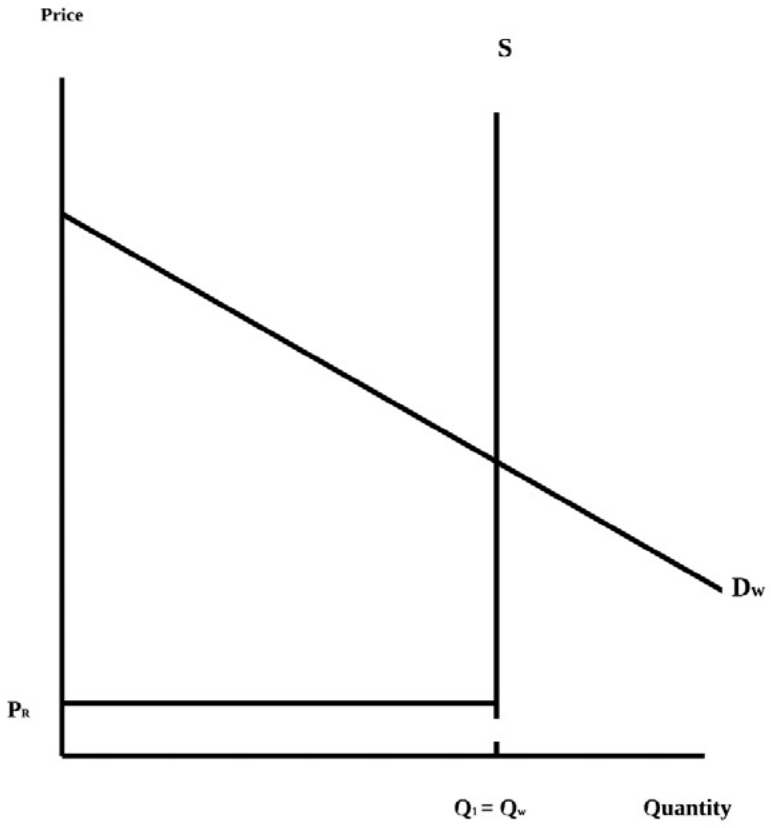


Figure 2

IV. PROBLEMS IN IDENTIFYING PREDATION

Identifying the fact of overbuying may not be easy. Consider the economic situation depicted in Figure 3, where VMP is the derived demand, S is the supply, and ME is the corresponding marginal expenditure. In order to maximize its profit, the buyer will expand its purchases until ME equals VMP, which is Q_1. The price that corresponds to this quantity is P_1. This decision does not involve predation. The firm is not incurring losses; it is maximizing its profits.

If rival buyers are priced out of the market, they must be decidedly less efficient. If the buyer were to buy Q_2 at a price of P_2, one might object that the firm is behaving in an odd way since its profits will be lower than it would be at Q_1 and P_1. But a price-quantity combination of P_2 and Q_2 is the competitive solution – supply and demand are equal. It would be difficult to characterize the competitive solution as predatory. In this case, the firm has monopsony power, but is not exercising it.

If the buyer purchases Q_3 at a price of P_3, it is overbuying in the sense that the price paid exceeds the value of the inputs being purchased – at least at the margin. The problem of proof in litigation is the fact that we cannot see the lines in Figure 3. All we know is the actual price-quantity combination.

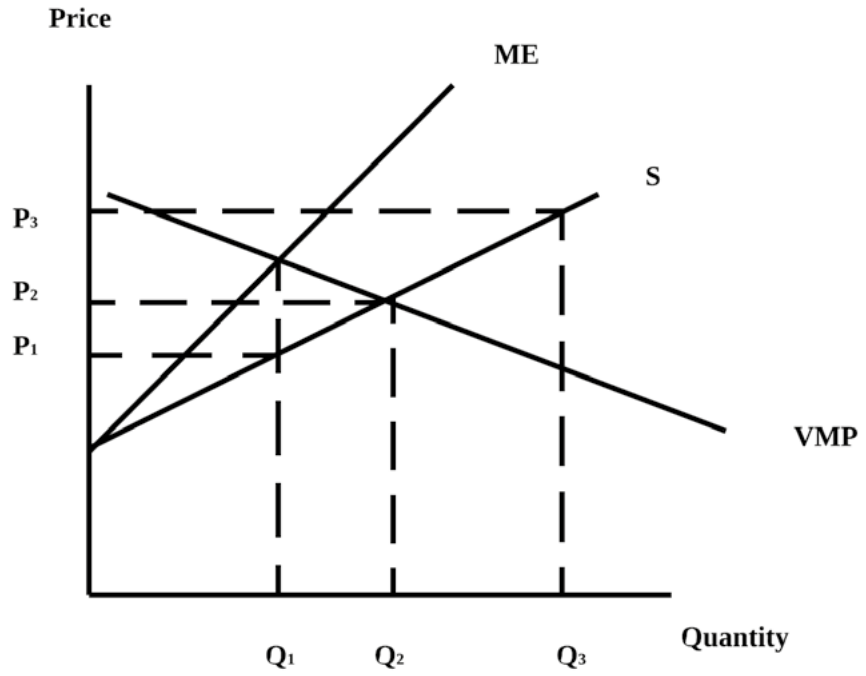


Figure 3

In Figure 4, D_{rs} and D_w are the derived demands for red alder sawlogs by Ross-Simmons and Weyerhaeuser, respectively. The aggregate demand D_w+D_{rs} is their resulting sum. As shown in the figure, the market clearing price will be P_1. At that price, Ross-Simmons will buy Q_{rs} while Weyerhaeuser will buy Q_w. Of course, Q_{rs} plus Q_w equals Q_1.

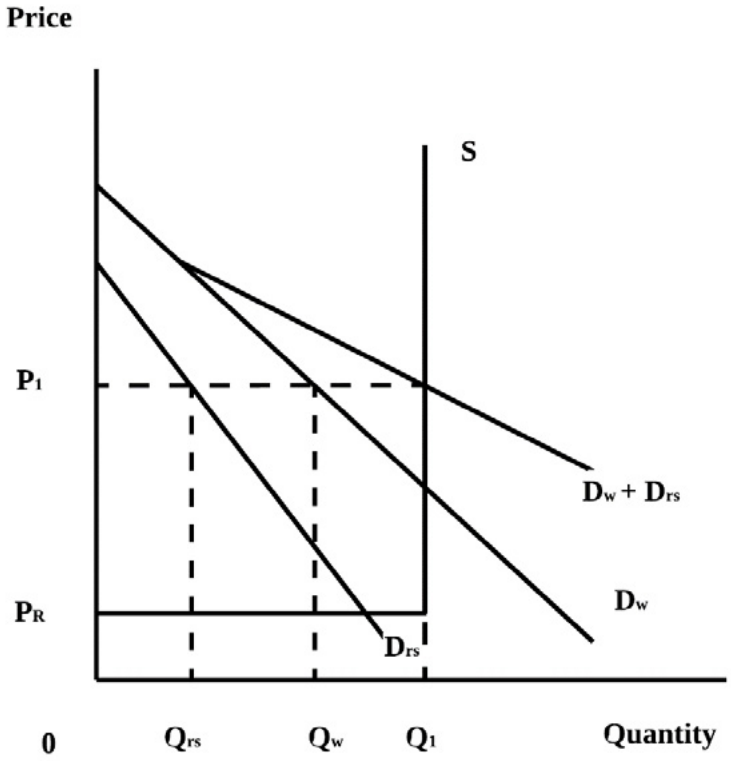


Figure 4

Weyerhaeuser's sawmills generally produced more hardwood lumber from a given quantity of sawlogs than Ross-Simmons facilities. Consequently, the derived demand for Weyerhaeuser (D_w) will be higher than that for Ross-Simmons (D_{rs}). In that case, Ross-Simmons may not be able to buy any sawlogs. It is apparent from Figure 4 that a smaller harvest could result in Ross-Simmons being priced out of the market. In that event, its hardwood lumber production will be zero. It is true that Weyerhaeuser is buying more than Ross-Simmons, but it is not overbuying. The greater quantity of purchases is due to Weyerhaeuser's greater size of its purchases and efficiency.

There are even extreme cases where Ross-Simmons is essentially shut out of the market simply because of its own inefficiency. In Figure 5, the derived demand for Ross-Simmons is so small in comparison to that of Weyerhaeuser's that when the market clears, Weyerhaeuser is the only firm purchasing hardwood in the market. This is not predation by a large buyer. Instead, it reflects Weyerhaeuser's greater efficiency in converting sawlogs into lumber.

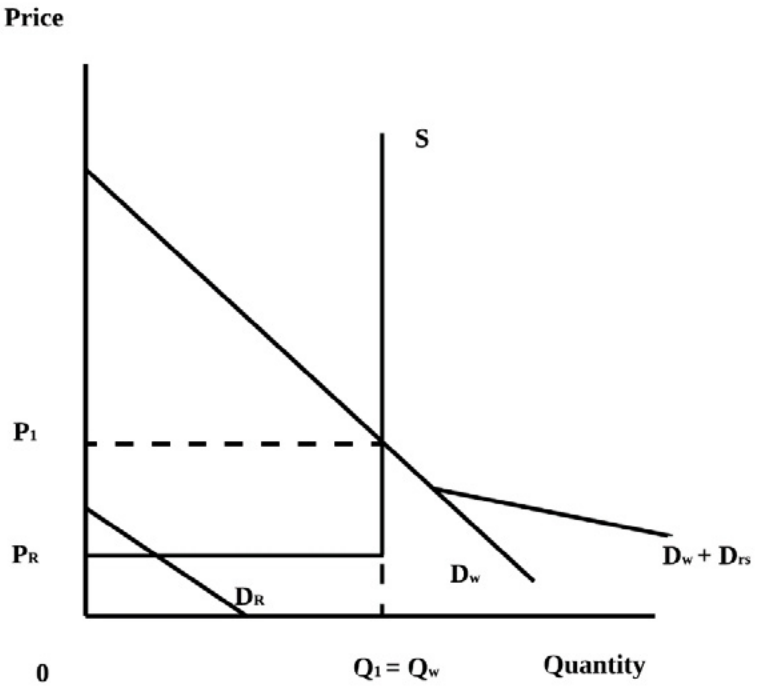


Figure 5

V. THE REQUIREMENT OF RECOUPMENT

When a dominant firm engages in predation, it incurs losses during the time it takes to eliminate its smaller rivals. One can think about these losses as an investment. Economically rational firms only make investments if they expect them to be profitable. For this to be the case, the firm must recover its investment and earn some positive return. The U.S. Supreme Court recognized this in its *Brooke Group* opinion.

In *Brooke Group*, the U.S. Supreme Court made it clear that an alleged predator must have a reasonable expectation of recouping its losses after the demise of the prey. This, of course, makes economic sense because the purpose of predatory pricing is to eliminate competition to charge monopoly prices – and earn monopoly profits. If the period of predation is so prolonged and the losses so large that recoupment seems unlikely, the predatory pricing would be economically irrational. As a result, allegations of predatory pricing would be undermined. Much the same is true for allegations of monopsonistic predation.

If Weyerhaeuser had embarked on a predatory buying campaign aimed at eliminating Ross-Simmons as a rival buyer of alder sawlogs, it would expect to experience reduced profit, or even losses, during the campaign. These losses should be viewed as an initial investment in acquiring monopsony status. The return on this investment comes in the post-predation period in the form of monopsonistic profits. For this investment to be rational, the net present value ("NPV") must be positive:

$$NPV = \sum_{t=0}^{T} \frac{L_t}{(1+R)^t} + \sum_{t=T+1}^{\infty} \frac{\Pi_t}{(1+R)^t} > 0$$

Put differently, the present value of the future profits must be greater than the present value of the losses during the period of predation.

In this expression, Σ is the summation operator, t denotes time, T is the length of the period of predation, L_t is the loss incurred in period t, Π_t is the profit earned in period t, and R is the discount rate. For this to be positive, the discounted present value of future profits must exceed the discounted present value of the losses experienced during the period of predation.

A. Monopsonistic Profits

The return on investments by eliminating a rival depends on market structure. Suppose that Ross-Simmons had been the only rival in purchasing alder sawlogs. The market structure would have been duopsony, which simply means that there were two buyers.

What is relevant in the NPV calculations is the incremental profit. This sum will depend on how the duopsonists behaved before one of them was eliminated. If they were acting as Cournot doupsonists before the elimination of Ross-Simmons, Weyerhaeuser was earning its share of the Cournot duopoly profit. Following the elimination of Ross-Simmons, Weyerhaeuser would earn all the monopsony profit. If they had been competing as Bertrand duopsonists, i.e. competing on price, they would have been paying the competitive price. Consequently, the price that Weyerhaeuser paid would have dropped from the competitive level to the monopsony level. The incremental profit would have been much larger in that event.

B. Uncertainty of Future Profits

All investments involve costs now and profits later. This makes investments risky since unforeseen events may reduce or even eliminate future profits. This is no less true when the investment is aimed at eliminating a rival. For one thing, the predatory campaign may be unsuccessful. In effect, the prey refuses to die. In that event, the losses will not be recouped.

Second, if the prey exits the market, another firm may purchase its assets at distress prices and begin competing. To head off this risk, the predator may have to buy these assets and then neutralize them.[15]

Third, government regulations could reduce timber harvests and thereby reduce the predator's ability to earn monopsonistic profits.

Fourth, there could be a surge in imports of hardwood lumber, which would reduce the demand for domestic production.

C. A Numerical Example:

A numerical example may be useful in understanding the risks associated with an investment in predation. Suppose that Weyerhaeuser had to experience losses of $2.0 million per year for five years in order to eliminate Ross-Simmons as a rival buyer of alder sawlogs. At a 10 percent discount rate, the present value of that investment would be about $7.5816 million.

Given the fact that Weyerhaeuser did not have any power in the hardwood output market, all the future profits would have to come from its monopsony power in the local alder sawlog market. This investment would be marginally profitable if Weyerhaeuser could earn profits of $2.0 million per year over 10 years. The flow of profit begins in year 6 and extends to year 15. The present value of $2.0 million per year for 10 years beginning six years out is $7.6306 million. Thus, at the end of the 15 years, Weyerhaeuser would be ahead by $49,000. Given the risks of engaging in a predatory buying campaign, this sum seems pretty meager.

15 Arguably, this was the strategy adopted by American Tobacco. For an account, see Malcolm R. Burns, *Predatory Pricing and the Acquisition Cost of Competitors*, 94 Journal of Political Economy 266 (1986).

VI. SUMMARY AND CONCLUSION

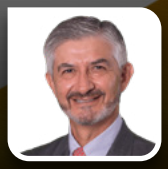
Predatory buying requires paying more than an input is worth in an attempt to deny rival buyers access to an input that is essential for competition. This is a risky business strategy. First and foremost, it is a violation of §2 of the Sherman Act. Consequently, a predator would be vulnerable to public sanctions and private damages. Second, during the predatory period, the predator incurs losses due to forgone profits and excessive payments. If recoupment turns out to be infeasible, the strategy will have backfired.

As with predatory pricing, this business strategy may be "seldom tried and rarely successful."[16]

16 Paraphrase from *Brooke Group* at 226.

PREDATORY PRICING IN THE LIGHT OF COLOMBIAN ANTITRUST LAW

BY ALFONSO MIRANDA LONDOÑO[1]



1 Lawyer and Socioeconomist graduated from the Pontificia Universidad Javeriana. Specialist in Financial Law from Universidad of los Andes. Master in Comparative Economic Law from Cornell University. Professor of Competition Law at the Pontificia Universidad Javeriana and Los Andes Universities. Private Consultant.

I. INTRODUCTION

In order for the market economy to function efficiently, it is necessary for the State to guarantee, within reasonable limits, certain fundamental economic rights, such as private property (Art. 58 P.C.), freedom of enterprise and private initiative (Art. 333 P.C.), freedom to choose a profession or occupation (Art. 26 P.C.), freedom of association (Art. 38 P.C.) and, most importantly, free economic competition (Art. 333 P.C.).

Free economic competition is understood as the effective possibility for market players to compete in a market in order to offer and sell goods or services to consumers, and to build, maintain and/or strengthen a clientele.

As is well known, free competition may be legitimately restricted, eliminated or altered by: (i) the establishment of legal monopolies (in the manner provided by Article 336 of the P.C), (ii) the recognition of trademarks, patents and other industrial property rights, (iii) price regulation in the pharmaceutical sector, among others established by Colombian law. The foregoing, given that they embody principles and protect legal values such as the State's profitable monopoly or the protection of industrial property rights, which within the scale of values of our legal system are preferred in certain instances to the right to free economic competition.

On the contrary, free competition will be illegally affected by restrictive practices, which include the following: (i) in general, any kind of practice, procedure or system tending to limit free competition and to maintain or determine unfair prices,[2] (ii) agreements between two or more companies that prevent, restrict, or distort competition,[3] (iii) unilateral acts performed by companies,[4] (iv) abuses behavior of a dominant position,[5] or (v) engaging in acts of unfair national or international competition (e.g. dumping).[6] These behaviors constitute "pathological behaviors," which arise spontaneously without the natural laws of the market being able to correct or suppress them, and which, on the contrary, introduce important elements of distortion and imbalance.

The behaviors that we have referred to as pathological must be repressed by the State, in order to guarantee freedom of competition and the very subsistence of the market economy. To this end, our legal system, based on the principles of the former Article 32 of the 1886 Political Constitution and Article 333 of the 1991 Political Constitution, which is currently in force, contemplates rules such as the following: (i) rules on prohibition of anti-competitive practices and abuse of dominant market position,[7] (ii) rules on consumer protection,[8] (iii) antidumping and countervailing duty rules [9] and (iv) Rules on the prohibition of unfair competitive conduct.[10]

Now, having exposed a map of competition law in Colombia, it is worth mentioning that the purpose of this paper is to analyze the conduct of predatory pricing under the current legal system that prohibits it when it occurs in the context of an abuse of dominant position.

II. PREDATORY PRICING

In Colombia, predatory pricing is considered an abuse of a dominant position. In this regard, Article 50 of Decree 2153 of 1992, makes a non-exhaustive list of the forms of conduct that are considered abusive, when committed by a company with a dominant position in the market. The complete text of article 50 of Decree 2153 of 1992 is as follows:

> "**ARTICLE 50. ABUSE OF DOMINANT POSITION**. In order to comply with the functions referred to in Article 44 of this Decree, it shall be taken into account that, when there is a dominant position, the following conducts constitute abuse of such position:

2 Article 1 of the Law 155 of 1959.

3 Article 47 of Decree 2153 of 1992.

4 Article 48 del Decree 2153 of 1992.

5 Article 50 del Decree 2153 of 1992.

6 Law 256 of 1996.

7 Contained mainly in the Law 155 of 1959, the Decree 2153 of 1992 and the Law 1340 of 2009.

8 Contained mainly in the Law 1480 of 2011.

9 Contained mainly in the Decree 299 of 1995.

10 *Supra* note 6.

1. The lowering of prices below costs when their purpose is to eliminate one or more competitors or to prevent the entry or expansion of these competitors.

2. The application of discriminatory conditions for equivalent operations, which places a consumer or supplier in a disadvantageous situation compared to another consumer or supplier with analogous conditions.

3. Those whose purpose or effect is to subordinate the supply of a product to the acceptance of additional obligations, which by their nature did not constitute the object of the business, without prejudice to the provisions of other provisions.

4. Selling to a buyer on terms different from those offered to another buyer when it is with the intention of diminishing or eliminating competition in the market.

5. Selling or rendering services in any part of the Colombian territory at a price different from that offered in another part of the Colombian territory, when the intention or effect of the practice is to diminish or eliminate competition in that part of the country and the price does not correspond to the cost structure of the transaction.

6. Obstructing or preventing third parties from accessing markets or commercialization channels." (Emphasis added and Author's free translation).

Of the six forms of conduct listed in the provision, the one referred to as *"predatory pricing"* corresponds to the abuse of a dominant position by *"lowering prices below costs when the purpose is to eliminate one or more competitors or to prevent the entry or expansion of competitors."*

As stated above, and following the interpretation previously made by the Superintendence of Industry and Commerce ("SIC"),[11] in order to establish whether a company is involved in this conduct of abuse of a dominant position, it must be proven: (i) that the company under analysis has a dominant position in the relevant market, and (ii) that this same company abuses its capacity to determine market conditions by *"subordinating the supply of a product to the acceptance of additional obligations" or "obstructing or preventing third parties from accessing the markets."*

A. Concept of Abuse of Dominance

In Colombia, the concept of market dominance is defined in article 45 of Decree 2153 of 1992, which states as follows:

> **ARTICLE 45. DEFINITIONS**. For the performance of the functions referred to in the preceding article, the following definitions shall be observed:
>
> (…)
>
> 5. Dominant Position: the possibility of determining, directly or indirectly, the conditions of a market.
>
> (…)" (Author's free translation)

Now, in order to determine whether an economic agent has a dominant position in a market, the SIC, like other competition authorities worldwide, must carry out an analysis of the market and the position of the economic agent in it. This analysis typically involves one of the most complex tasks within the free competition regime, which is to understand the true dynamics of each market. Thus, the relevant market is defined through three (3) elements which are:

- Product Market: this refers to the products/services that compete directly with the product/service offered by the economic agent under analysis. Within the product market, three (3) factors are taken into account, which are: (i) characteristics, (ii) end uses and (iii) price.

- Geographic Market: refers to the geographic location of the consumers' options to purchase a given service or product.

11 Administrative Act No. 33361 of 2011, issued by the Superintendence of Industry and Commerce on June 26, 2011.

- Temporal Analysis: since markets are dynamic, it is important to mention that the position of an economic agent in the market varies depending on the time period being measured.

Secondly, in order to affirm that there is an abuse of the dominant position of an economic agent in the market, it is necessary to make a normative interpretation of what is legally understood as an abuse of such position. Regarding the latter, it is worth noting that the mere fact of having a dominant position does not mean that a company is infringing the free competition regime, much less that having a dominant position cannot be a legitimate objective of the economic agents. Due to the foregoing, what is prohibited by the Colombian free competition regime corresponds to the abuse of this position, in such a way that it distorts the market and generates barriers that prevent free competition.

B. Concept of Predatory Pricing in Colombia

As mentioned above, the conduct known as predatory pricing is defined in paragraph 1 of Article 50 of Decree 2153 of 1992, according to which *"[t]he reduction of prices below costs when the purpose is to eliminate one or several competitors or to prevent the entry or expansion of these … constitutes abuse of a dominant position."* (Author's free translation)

While discriminatory conduct and tied sales, defined in paragraphs 2 and 3 of the same Article 50, may be committed either in a concerted manner through anticompetitive agreements prohibited by Article 1 of Law 155 of 1959 and Article 47 of Decree 2153 of 1992, or unilaterally through acts or abuse of dominant position, predatory pricing conduct, can only be committed by a competitor with a dominant position in the market, since by its nature no other market player could do this in regular market conditions.

Thus, predatory pricing conduct will take place when the dominant company lowers prices, for a limited period of time, below its cost level, in order to maintain or increase its dominance and/or market share, which may result in the exclusion of one or more of its competitors, may prevent the expansion of existing competitors, and/or prevent new competitors from entering the market.

Moreover, paragraph 1 of Article 50 of Decree 2153 of 1992 does not establish which cost should be used to identify a predatory price: the average cost, the average variable cost or the marginal cost. Said norm is limited to consider abusive *"prices below costs."* For this reason, different theories have emerged that describe the cost parameter that identifies a predatory price. The following paragraphs will provide a brief theoretical framework explaining the theories, and the following section will briefly discuss their applications.

According to classical economic theory, a company makes a profit when it sells above marginal cost. Hence, predatory pricing should be determined considering marginal cost. However, since it is very difficult to determine the marginal cost in real cases, the competition authorities and the doctrine have considered that the cost that most closely resembles the marginal cost is the average variable cost, which corresponds to the variable cost of production, divided by the number of units produced.

Thus, if prices do not cover the company's average variable costs, there is no rational economic justification for it to continue producing, since it is not even covering the variable costs of production. Therefore, if the company holds a dominant position in the market and sells at prices below its average variable costs, this theory states that abuse of its dominant position through predatory pricing should be presumed, unless the company proves that it is minimizing losses.

On the other hand, another theory states that any price that covers average costs (total cost divided by the number of units produced or marketed) should be considered legal, even if it implies the expulsion of one or more competitors from the market, since this price is generating profits and production efficiency should not be punished.

Although the SIC has accepted that the cost to be taken into account for the purpose of determining whether or not predatory pricing exists is the average variable cost, when trying to apply this parameter it has encountered industries that have the same production line for different references, which is why it has used the average cost as a reference.

Likewise, by means of the Resolution 36191 issued on November 15, 2002, the SIC, in order to establish the existence of predatory pricing, continued with the analysis of average cost using the following terms:

> *Thus, in the case under study, it was established that the net price at which Clarks chewing gum was sold was below its average full cost during the period of investigation from August 2002 to December 2003. (Author's free translation)*

Now, once the existence of (i) a dominant position and (ii) pricing below the average cost to produce a certain product or provide a service has been verified, the company's intention must be reviewed. In order to be punishable, the purpose of the conduct must be to eliminate competitors or prevent their entry or expansion in the relevant market.

According to the SIC doctrine, the conduct of selling at a price below costs must have a rational economic justification in order not to be illegal, such as for example the sale of perishable products, in order to avoid the loss of the merchandise; when the products are out of fashion or surpassed by a later, more technologically advanced generation.

> *In fact, there is no different economic condition that justifies having a product at a loss for more than 12 months in the market, because with it, Adams Company was not only failing to recover the total costs allocated to this line of business, but this predatory situation also generated a cost of opportunity, by not allocating those resources to another line of business that would be profitable. In addition, it is necessary to look at the parallel actions carried out by Adams to accompany Clarks' predatory strategy, such as offering the same presentation, the same flavor and coverage of Tumix's zones of influence.* (Resolution No. 36191 issued by the SIC on November 15, 2002) (Author's free translation).

As can be seen, in order to establish the subjective element of the conduct, the SIC relies on evidence to establish that the conduct had no economic justification, such as, for example, the prolongation of the sale below cost.

Regarding the period in which the Company sells below cost, the SIC, in Resolution No. 30835 of 2004 states: "*[t]he rules of experience indicate that whoever wishes to eliminate its competitors by means of price, apart from making a nominal decrease in the price of its product, requires more than one month to weaken and eventually bankrupt its rivals."*

By definition, promotions are temporary in nature. Therefore, it is possible to have promotional campaigns that imply having a price below the average variable costs. But as indicated by the SIC in the aforementioned Resolution, what cannot occur is that a company is below costs for long periods, since this is indicative of a strategy aimed at eliminating competitors or preventing their entry or expansion.

Although consumers are favored by the initial price drop, their interests will be violated when the dominant firm manages to acquire the power or market share it was hoping for. Once competition is destroyed or diminished, it is able to raise prices above the level they would have under competitive conditions, in order to obtain so-called monopolistic profits, which will allow it not only to make up for the losses it incurred during the period of the price drop, but will also bring it extraordinary profits over time.

C. Concept of Regional Predatory Pricing

This conduct is typified in numeral 5 of Article 50 of Decree 2153 of 1992, according to which it constitutes abuse of dominant position *"[t]o sell or provide services in any part of the Colombian territory at a price different from that offered in another part of the Colombian territory, when the intention or effect of the practice is to diminish or eliminate competition in that part of the country and the price does not correspond to the cost structure of the transaction."* (Author's free translation).

The conduct of regional predatory pricing, very similar to "dumping," has the same connotations as the general practice. However, in this case the dominant company leverages or finances the predatory price in the region where it intends to produce the anticompetitive price, with the monopolistic profits it obtains in the rest of the country

The explicit treatment of regional predatory pricing in Decree 2153 of 1992 is probably due to the difficulty of communication between the regions of our country, which could facilitate or encourage the application of this type of anti-competitive practice.

PREDATORY PRICING IN INDIA

BY ADITYA BHATTACHARJEA[1]

1 Delhi School of Economics, University of Delhi; aditya@econdse.org.

I. THE LEGAL FRAMEWORK

India's Competition Act, 2002[2] explicitly includes predatory pricing under Section 4, which deals with the "Abuse of a Dominant Position." Definitions of dominance and predatory pricing, which evolved through judicial interpretation in European and U.S. competition law, are carved into the Indian law itself.

In wording that seems to have been inspired by the *United Brands* judgment of the European Court of Justice, an "Explanation" appended to Section 4 defines a dominant position as "a position of strength, enjoyed by an enterprise, in the relevant market, in India, which enables it to (i) operate independently of competitive forces prevailing in the relevant market; or (ii) affect its competitors in the relevant market in its favour." We shall see that this definition has recently been decisive in a landmark verdict by India's Supreme Court.

Section 4 goes on to list some specific types of abuse, including imposition of an "unfair or discriminatory" price "in purchase or sale (including predatory price) of goods or service." A further "Explanation" defines predatory price as "a price, which is below the cost, as may be determined by regulations, of production of the goods or provision of services, with a view to reduce competition or eliminate the competitors."

The associated Regulations specify that the cost of production would be "average variable cost, as a proxy for marginal cost," but with a proviso "that in specific cases, for reasons to be recorded in writing, the Commission may, depending on the nature of the industry, market and technology used, consider any other relevant cost concept such as avoidable cost, long run average incremental cost, market value," each of which is defined in the Regulations.

In essence, then, India's Competition Act requires a three-pronged test for predatory pricing: the firm must be dominant in the relevant market, the price must be below an appropriate measure of costs, and it must be set with a view to reduce or eliminate competition. The Act also codifies other criteria that are usually left to courts in mature jurisdictions. Section 19 specifies multiple "factors," any or all of which the Commission "shall have due regard to" while investigating whether an enterprise is dominant, and while determining the relevant geographic and product markets.

If it veers towards excessive codification in some respects, the Act is egregiously deficient in another: unlike the adjacent sections on anti-competitive agreements and mergers, it does not require an effects-based test for any of the prohibited behaviors specified in Section 4. This allowed the Competition Commission of India ("CCI") to apply a form-based assessment and find them abusive *per se*.[3] Fortunately, it has not always gone down that road, and has followed the EU in increasingly adopting an effects-based approach.[4] This is illustrated by the jurisprudence on predatory pricing reviewed below

But first, a brief outline of procedures under the Competition Act might be helpful. The Commission can inquire into an alleged contravention of Section 4 either "on its own motion" or based on complaints from private parties (known as "Informants"), government departments or statutory bodies. If it believes that there is a *prima facie* case, it instructs its Director General ("DG") to undertake an investigation, otherwise it closes the matter.

The DG's report, containing both findings of fact as well as conclusions of law, is shared with the parties, and after reviewing their comments, the Commission can either close the matter (if the report found no contravention), or proceed with the inquiry. If the inquiry ultimately finds that Section 4 has been violated, then the concerned enterprise can be ordered to discontinue the abusive conduct, and pay a monetary penalty of up to ten per cent of its average turnover of the preceding three financial yearsfiscal years. Orders of the Commission (except those that initiate an investigation) can be appealed, first to an Appellate Tribunal and then to the Supreme Court. (Most of the CCI decisions reviewed below are at various stages in the appeals process.)

2 The enforcement sections of the Act were brought into effect only in 2009, along with the constitution of the full Competition Commission of India ("CCI"). The CCI is both an investigative and adjudicatory agency, so to avoid confusion I refer to adjudicatory decisions as those of the "Commission."

3 This was presciently pointed out before the Act came into force, in Subhadip Ghosh & Thomas Ross, *India's New Competition Law: A Canadian Perspective* 23 Canadian Competition Record 23 (2008).

4 See Payal Malik et al, *Legal Treatment of Abuse of Dominance in Indian Competition Law: Adopting an Effects-Based Approach*, 54 Rev Industrial Organization 435 (2019).

II. THE EARLY CASE LAW

The CCI's very first predatory pricing case, filed soon after it began accepting complaints in 2009, immediately confronted the young agency with the complexities of assessing predation in a digital platform market.[5] The informant, MCX Stock Exchange ("MCX"), alleged that the National Stock Exchange ("NSE") was abusing its dominant position by not charging fees for its recently-launched trading platform for currency derivatives ("CDs"). This forced MCX, which entered the CD segment a few months later, to incur losses by likewise offering free services. The Commission found a *prima facie* case for an investigation by its DG.

The investigation confirmed NSE's dominance in the broadly defined market of "stock market services in India," and zero-pricing of its services in the CD segment, cross-subsidized by its earnings from other segments (debt, equity and futures and options) in which it was the overwhelmingly dominant platform and did charge fees. The DG's report mentioned that the operation of a securities exchange involved network effects, as well as scale economies due to high fixed costs and low marginal costs. But the report argued that these characteristics had contributed to NSE's dominant position by making "consumers" dependent on it, and that such effects would enhance the anti-competitive harm of its conduct.

The six-member Commission handed down a split decision. The four-member majority defined the relevant market more narrowly, as that for exchange-traded CDs. It held that, even though there were by then three exchanges with almost equal shares of this market, NSE occupied a dominant position by virtue of its accumulated overall financial strength, which gave it the ability to incur sustained losses. MCX, whose only earnings came from its CD platform, could not match it in terms of resources, experience, nationwide presence, and scale of operations. The majority did not buy the argument that NSE's fee waivers amounted to promotional pricing in a "nascent" market, because the waivers had been continuing for nearly three years.

NSE had also argued that its variable costs were zero, and so zero prices were not predatory. The majority rejected this argument. It reiterated an argument in the DG's report that some operating costs, including those on "advertising, promotional activities, clearing and settlement, conveyance, communication and insurance expenses" could constitute variable costs, and the report's demonstration of how NSE's total costs could be allocated pro-rata to the CD segment. Average costs could not therefore be zero.

However, even after this detailed discussion, the majority order brushed aside the issue of what the appropriate measure of costs could be in this context, and shied away from a finding of predatory pricing. Instead, it concluded that "*the zero price policy of NSE in the relevant market is unfair*. In this case, the conduct of zero pricing by the NSE is beyond the parameters of promotional or penetrative pricing. *It can, in fact, be termed as annihilating or destructive pricing.*"[6] The majority order ventured deeper into dangerous territory when it scoffed at NSE's argument that the mandate of the Commission was to protect competition rather than competitors:

> While this may be an interesting and oft-used phrase, it is shorn of the practicality of competition regulation. Similarly, it is not possible to protect competition without in some way protecting the weaker competitor…. Competition in a market is afforded by competitors and harm to competition has to be assessed by evaluating harm to competitors or its consequential impact on consumers.[7]

Even more ominous was the way in which the majority dismissed NSE's argument that there had been no harm to consumers. They pointed out that the Act required only that dominance and one or more of the forms of conduct proscribed by Section 4 be established. "Once both are established, there is no statutory requirement to examine any other additional impact on competitors or consumers or the market."[8] NSE was ordered to desist from zero-pricing and to pay a penalty of 5 percent of the average of its turnover of the three preceding years.

The majority order mentioned network effects only while summarizing the DG's report, but not in its own assessment. In contrast, the dissenting order by the two-member minority (including the only professional economist on the Commission) set out a detailed exposition of such

5 *MCX Stock Exchange Ltd. v. National Stock Exchange of India Ltd. and Anr.*, Case No. 13/2009, order dated June 23, 2011. (CCI decisions — known as "orders" — are accessible from the official website, www.cci.gov.in.).

6 *Id.* paras 10.76-10.77, emphasis in the original.

7 *Id.* paras 24.3-23.4.

8 I*d.* para 25.1.

effects, and their implications for pricing behavior. The dissenters also held that NSE was not dominant, because within two years of its entry into the CD segment, the entry of MCX and another exchange had reduced its market share from 100 percent to less than a third.

The dissenters asserted that allegations of predatory pricing must be analyzed carefully, in order to avoid false positives and chilling of competition. Significantly, they insisted on evidence that the alleged predator's foregone profits could be recouped — a concept that the majority had completely ignored. Based on their analysis of pricing in a network industry, the infeasibility of recoupment in an industry which had seen entry despite zero pricing, and lack of any evidence of intent to reduce competition, the dissenters held that NSE's pricing was not predatory.

NSE appealed against the Commission's order to the Competition Appellate Tribunal ("COMPAT"), which defined the relevant market as that of all securities exchanges in India. NSE was indubitably dominant in this broader market as well as in the CD market, in which it could leverage the financial strength derived from its dominance of the other segments. The strength of the promoters of MCX was not relevant, because they constituted a distinct corporate entity.

The COMPAT held that NSE had failed to provide any evidence that its variable costs in the CD segment were zero, so its zero-pricing clearly satisfied the definition of a predatory price. The COMPAT did not address the issue of recoupment, nor did it pay heed to the NSE counsel's pointing out that its imposition of fees in compliance with the Commission's order had harmed consumers and halved trading volumes. NSE's appeal was dismissed.[9] It appealed to the Supreme Court, which stayed the penalty, but has not yet given its judgment.

The next three predatory pricing cases were dismissed at the threshold, with the Commission holding that there was no *prima facie* case. These decisions indicated that the dominance and pricing prongs could be applied in either order, and failing either one would lead to dismissal. In the first case, the Commission did not go into the issue of dominance, because the informant could not provide evidence of below-cost pricing.[10] In another case, evidence was reviewed to find that the respondent was not dominant, but the Commission went on to hold that, even presuming dominance, the informant had provided no evidence of the respondent's costs.[11]

The third case deserves slightly more elaboration. Reliance Jio, a part of the huge Reliance conglomerate, disrupted the Indian telecommunications sector by offering free voice, data, and messaging on its new 4G network, at a time when all incumbents offered mainly 2G or 3G services. In response to Jio's rapid penetration of the sector, Bharti Airtel (the largest incumbent) filed a case of predatory pricing.

The Commission pointed out that Jio had a share of less than 7 percent of all wireless telecommunications subscribers, with the rest divided among several other established players, many of them large firms — including multinationals — with comparable reputations and financial strength. Jio was therefore not dominant, and its zero-pricing was not anti-competitive, but a short-term market penetration strategy.[12]

III. THE TAXI WARS

The final set of cases is perhaps the most important, for two reasons. First, they involved platforms which cater to two distinct sets of users, with the attendant problem of assessing two-sided pricing and platform dynamics. Second, an appeal to the Supreme Court resulted in an interpretation of Section 4 that turned earlier jurisprudence on its head.

Traditionally, as in other countries, taxis in India were owned by individuals and could be hired from a stand or on the road. From around 2007, a number of radio taxi companies began operating in the major Indian cities. They set up call centers which dispatched their own taxis to riders on the basis of bookings made via telephone or internet. From 2011, this business model was severely disrupted by the entry of taxi aggregators Ola and Uber, who do not own any vehicles but only provide a platform to connect owner-drivers with passengers, using smartphone-based apps to identify their locations.

9 *National Stock Exchange of India Ltd. v. Competition Commission of India and Anr.*, Appeal No. 15 of 2011 with IA Nos. 25/2011, 26/2011, 27/2011, 10/2012, 27/2012, order dated August 5, 2014.

10 Case No. 80/2012, *HLS Asia Limited v. Schlumberger Asia Services Ltd.*, order dated February 6, 2013.

11 Case No. 09/2013, Transparent Energy Systems Pvt. Ltd. v. TECPRO Systems Ltd, Case 09/2013, order dated June 11, 2013.

12 Case No. 03/17, *Bharti Airtel Ltd v. Reliance Industries Ltd and Reliance Jio Infocomm Ltd*, order dated June 9, 2017.

Beginning in 2015, three radio taxi operators (Meru, Mega Cabs and Fast Track) whose business had been severely affected, filed multiple cases alleging predatory pricing by Uber and ANI Technologies (owners of the Ola brand) in different cities. Three auto-rickshaw drivers also filed individual cases against Ola, which also provided aggregation services for auto-rickshaws. The CCI clubbed some of these cases for consideration, resulting in five separate verdicts.[13]

In all five cases the informants claimed that the respondent (Ola or Uber, depending on the city) was dominant because it had within a few years captured over 50 percent of the relevant market, by offering very low fares to passengers and multiple incentives to drivers. Access to vast amounts of international venture capital and private equity funding enabled them to run their services at a loss. There were disputes over the exact definition of the relevant markets, but even on the narrowest definition the Commission held that neither Ola nor Uber was dominant. Each had entered and captured a substantial market share in each city where the other had earlier established its presence, and their fluctuating market shares indicated vigorous competition between them. Drivers as well as riders could multi-home by installing both Ola and Uber apps on their phones; several other radio taxi services also survived as fringe players in each city.

Thus, dominance was not established, and the Commission did not have to decide on the question of predatory pricing. In four of the five cases, the Commission held that *prima facie* there had been no contravention of the Act; in the fifth, it ordered an investigation by its DG, and then gave a much more detailed order which arrived at the same conclusion, neatly summarized in the following paragraph:

> [B]ased on collective consideration of the facts that the competitive process in the relevant market is unfolding, market is growing rapidly, effective entry has taken place thereby leading to gradual decline in [Ola's] market share, entry barriers are not insurmountable, there exist countervailing market forces that constrain [its] behaviour… and the nature of competition in dynamic, innovation-driven markets, the Commission is of the considered view that [Ola's] dominance in the relevant market remains unsubstantiated.[14]

In its earlier decisions, the Commission had required dominance to be established before addressing the allegation of predatory pricing, so the matter could have ended there. Nevertheless, the Commission concluded its order with a discussion of pricing strategy in platform markets characterized by network externalities, benefits to consumers, and equal access to venture capital funding for potential rivals. This perspective seems to suggest that, contrary to the Commission's earlier MCX order, anti-competitive intent and effects should not be readily inferred in a platform market even if a dominant incumbent is shown to be pricing below costs.

This position ran into difficulties on appeal, leading to a completely new interpretation of the test for predatory pricing. Deciding on Meru's appeal against one of the earlier CCI orders, the COMPAT questioned the Commission's definition of the relevant geographical market, its reliance solely on market shares to determine dominance, and the contradictory evidence on market shares which should have called for further investigation. COMPAT remained agnostic on whether Uber's pricing reflected "phenomenal efficiencies" or "an anti-competitive stance."[15] It ordered an investigation by the CCI's Director General. This would probably not have fundamentally changed the jurisprudence, but the Supreme Court's reasoning for upholding the COMPAT order when Uber appealed against it certainly did.

In a very brief verdict, the Court cited a single piece of evidence proffered by Meru: data on Uber's dealings with four cars for less than a month. It showed that Uber was on average losing a substantial amount per trip by paying incentives to drivers. The Court referred to the definitions provided in the "Explanation" in Section 4 of the Act, according to which a dominant position would include "a position of strength enjoyed by an enterprise…, which enables it to … affect its competitors or consumers or the relevant market in its favour." Losing money on each trip, the Court opined, would *prima facie* satisfy this definition, *as well as* the definition of predatory pricing.[16]

The immediate applicability of this order was limited to affirmation of the COMPAT's finding of a *prima facie* case for investigation by the DG. But if the Supreme Court's interpretation determines the outcome of this and other similar cases, the law on predatory pricing will be transformed beyond recognition. Thus far, the accepted position in all such cases has been that the dominance and pricing tests were to be applied

13 Cases 81/2015, *Meru Travel Solutions Pvt Ltd v. Uber India Systems Ltd*, order dated December 22, 2015; 82/2015, *Mega Cabs Pvt Ltd v. ANI Technologies Pvt Ltd*, order dated February 9, 2016; 96/2105, *Meru Travel Solutions Pvt Ltd v. Uber India Systems Pvt Ltd and Others*, order dated February 10, 2016; 21/2016, *Mr Vilakshan Kumar Yadav and Ors. v. ANI Technologies Pvt Ltd*, order dated August 31, 2016; 6&74/2015, *In Re: Fast Track Call Pvt Ltd and Meru Travel Solutions Pvt Ltd v. ANI Technologies Pvt Ltd.*, order dated July 19, 2017.

14 *Fast Track Call* (*supra* note 11), para 105.

15 *Meru Travel Solutions Pvt Ltd v. Competition Commission of India, Uber India Systems Pvt Ltd and Ors.*, Appeal 31/2016, order dated December 7, 2016, at para 18.

16 Civil Appeal No. 64/2017, *Uber (India) Systems (P) Ltd. v. Competition Commission of India and Ors.* (2019) 8 SCC 697, order dated September 3, 2018.

independently, based on separate criteria laid down in the Act. Failing either test would result in dismissal. If complainants can now satisfy both tests by providing evidence of an isolated instance of below-cost pricing, the chilling effect on competition would be obvious.[17]

This denouement is not inevitable, however. The DG's investigation went over much the same evidence as in the earlier case, looked at more recent developments, and arrived at the same conclusion: Ola was providing effective competition to Uber in the relevant market. He also reported that both had followed below-cost pricing strategies for many years, but absent a finding of dominance, this could not be regarded as a violation of Section 4. After hearing the parties, the Commission has very recently reiterated its earlier decision, restating the same arguments.

To reinforce its focus on the "strength of competitive constraints faced by players in a relevant market," it even quoted its earlier order in a similar case, which is worth quoting here as well for its forthright stance:

> *[As] long as there is competition in and for the market satisfying these outcomes, regulatory intervention is not warranted to either protect the existing players or to increase the number of players in the market. Towards that end, Competition and competition law is not about counting the number of firms in a particular relevant market to determine whether or not that market is competitive [….] There can be markets which may not be competitive even with large number of players and equally possibly there can be markets which can work perfectly well with fewer players, constraining the conduct of each other. What is significant is that the existing firms are effective enough to constrain the behaviour of one another so as to dissuade independent abusive conduct by any of them.*[18]

Therefore, the Commission concluded, Uber was not dominant. The matter could have ended there, but once again the Commission quoted its earlier order, this time on the importance of early-stage penetrative pricing to generate network effects. It went on to refer to the DG's more recent evidence of below-cost pricing by both Ola and Uber initially, but their margins turning positive in the last few years—a pattern that the Commission accurately recognized as one "typical to a platform market operator seeking to reap on [*sic*] network effects *i.e.* initial low-cost pricing to create network/scale and once a viable scale is achieved, per unit profit."[19]

Furthermore, even though Section 4 of the Act does not provide for an efficiency justification or any effects-based analysis, the Commission identified efficiencies in the reduced downtime for drivers and waiting times for consumers. With this commendably modern treatment of pricing in platform markets, the Commission closed the case. Clearly, it treated the Supreme Court's judgment as a limited directive to investigate, and not the basis for adjudication on the merits. It will be interesting to see how the Court reacts when Uber's appeal, and appeals on several cases now pending before the CCI that involve deep discounting by e-commerce platforms, inevitably reach it. Other issues that may get resolved include: whether consumer welfare trumps other considerations; whether predatory intent needs to be established independently; whether the possibility of "winner takes all" and recoupment of profits sacrificed during the predatory campaign is relevant; and the role of accumulated data as an entry barrier.

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17 A more recent appellate decision points in the same direction. For reasons that are not relevant here, COMPAT was abolished in May 2017, and the National Company Law Appellate Tribunal ("NCLAT") was empowered to decide on appeals against CCI orders. In November 2018, the CCI held that the e-commerce giants Amazon and Flipkart were not dominant in the market for services provided by marketplace platforms. The reasoning was similar to that in the taxi cases. But here too, NCLAT remanded the case for a DG investigation, solely on the basis of evidence (adduced in an unrelated income tax proceeding) that Flipkart was selling goods at a loss on its platform. Competition Appeal (AT) No.16 of 2019, *All India Online Vendors Association v. CCI and Ors.*, order dated March 4, 2020. This order was subsequently stayed by the Supreme Court.

18 Case No. 96/2015, Meru Travel Solutions Pvt. Ltd. (Meru) v. Uber India Systems Pvt. Ltd., order dated July 14, 2021, para 128 (emphasis in the original), citing Fast Track Call, as note 11 *supra*. The Commission also dismissed other claims by Meru, including joint domination by Ola and Uber; the possibility of coordination between them because of common minority shareholding by institutional investors; and incentive schemes for drivers amounting to exclusivity agreements.

19 *Id.* para 147.

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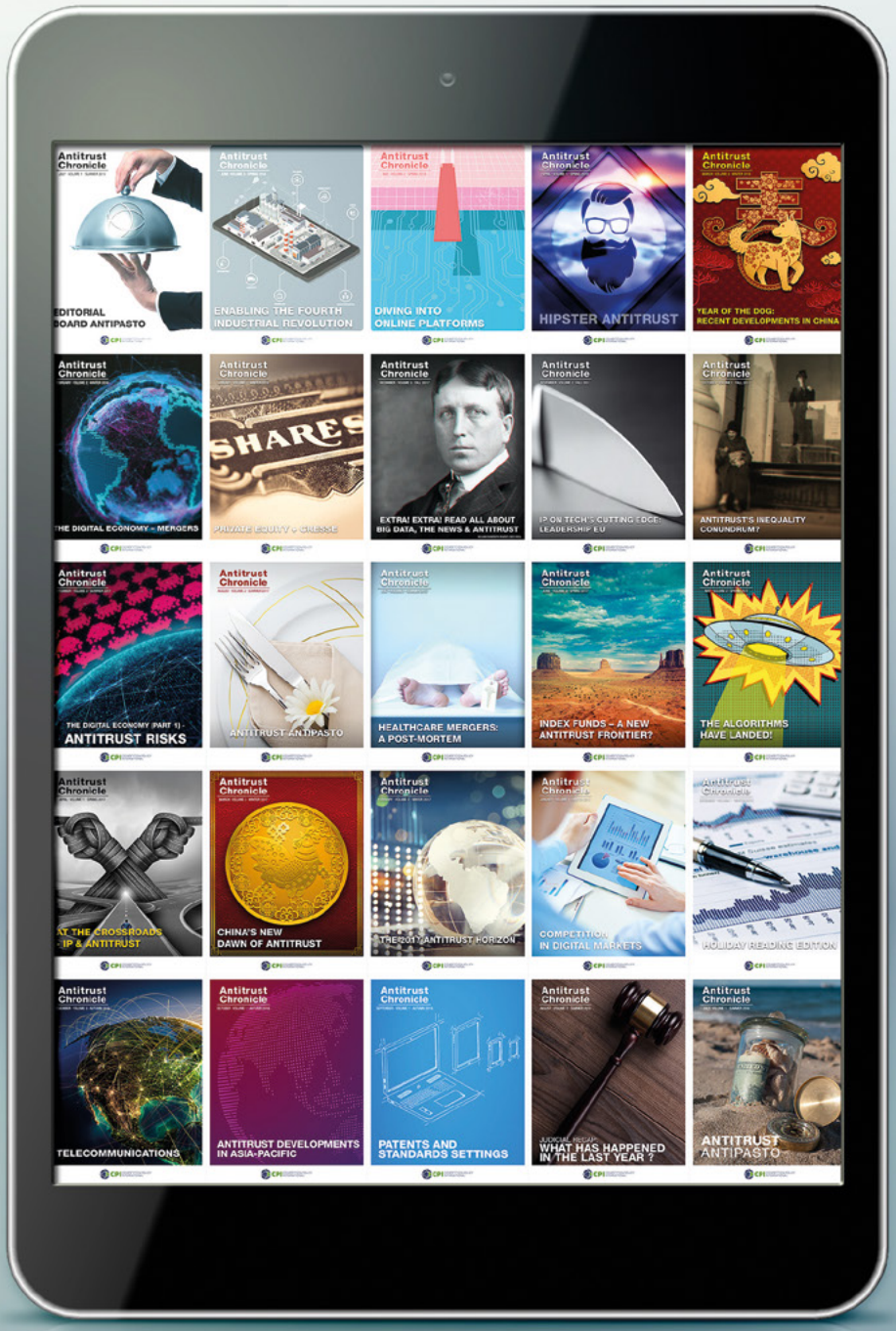


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