**ICN Unilateral Conduct Working Group**

# PREDATORY PRICING ANALYSIS PURSUANT TO UNILATERAL CONDUCT LAWS

## Recommended Practices

1. Vigorous price competition is generally beneficial to consumers. However, low prices can raise competition law concerns where they are part of a pricing strategy entered into or undertaken by a firm that is dominant/has substantial market power and is aimed at excluding or weakening competition.[1] The purpose of competition law is to protect competition rather than individual competitors. The focus should therefore be on the impact of the pricing strategy on the competitive process and ultimately on consumers.

2. Predatory pricing involves a practice whereby a firm engages in low pricing with some or all customers, which causes the firm to incur avoidable losses or forego short-run profits, so as to enable it to eliminate or discipline one or more rivals or prevent entry by one or more potential rivals.

3. It is rational to employ a predatory pricing strategy only when a firm expects to acquire, maintain or strengthen market power as a result of that strategy. The predator expects not only to recoup the losses it sustained during the predatory period but also to enhance profits by holding its prices above what they otherwise would have been. Therefore, when a predatory pricing scheme is successful, competition is reduced and even though consumers benefit initially from reduced prices, on balance they suffer when accounting for both the initial reduced prices and the ultimate increased prices. Jurisdictions assess whether conditions of entry and reentry into the market make predation a potentially rational strategy. Some do the assessment as part of the analysis of dominance and anticompetitive foreclosure and others do it as part of a separate recoupment analysis.

4. Rational predatory pricing as described in paragraph 3 could occur in various scenarios including the following: A dominant firm facing recurring entry threats, or threats of entry in multiple markets, may seek to establish a reputation for price cutting to deter entry. A dominant firm may use price cuts to falsely signal to potential entrants that they would be unable to compete successfully. A dominant firm may engage in financial predation, using price cuts to reduce its (potential) rivals' cash flows, resulting in a tightening of the conditions for external finance and thereby reducing the funds that are available to these rivals for staying in or entering the market. A

[1] The concept of dominance pursuant to unilateral conduct laws is generally equivalent to the possession of substantial market power, and thus the terms are used interchangeably in this document. A detailed discussion of what constitutes dominance/substantial market power is contained in the ICN's *Unilateral Conduct Working Group Unilateral Conduct Workbook*, Chapter 3: Assessment of Dominance and *Recommended Practices on Dominance/Substantial Market Power Analysis*.

dominant firm also may engage in predation to foreclose more innovative small competitors before they can become efficient.

5. Determining whether the alleged predator is selling below a measure of cost is one of the central aspects of a predatory pricing case. Accordingly, virtually all jurisdictions use cost benchmarks/measures as part of the assessment of whether the alleged predator is selling at a loss or incurring an avoidable loss. In addition, jurisdictions often use cost benchmarks to create absolute or soft safe harbors. This reflects the view that pricing above some appropriate measure of costs will in general constitute competition on the merits, and responds to the concern that enforcement against low pricing risks chilling legitimate competition. No single cost measure is used by all jurisdictions and frequently agencies use more than one measure in different circumstances.[2]

6. To determine whether low pricing violates the law, agencies assess whether the pricing has caused or is likely to cause competitive harm, taking into account some but not necessarily all of the following factors in their assessments: whether the pricing is below some measure of cost, actual and likely competitive effects, intent, likely recoupment, and justifications and defenses.[3] Agencies differ in the way they assess these factors in part due to institutional and substantive differences among enforcement regimes.[4]

7. Based on the group's prior work and member experience, the ICN recommends the following practices for the assessment of predatory pricing in the context of unilateral conduct laws.

## I. General Framework

1. **Agencies should use a sound analytical framework firmly grounded in economic principles to determine whether low pricing is predatory.**

2. **Predatory pricing investigations require an assessment of the relevant market. These assessments can provide insight into whether the alleged predator's actions are capable of distorting, and likely to distort, the competitive process**.

3. **Agencies should construct a sound theory of harm against which to test the conduct of the alleged predator.**

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[2] For detailed discussion of the cost-measures, see ICN's *Unilateral Conduct Workbook*, Chapter 4: Predatory Pricing Analysis, prepared by the Unilateral Conduct Working Group, presented at the 11th Annual ICN Conference, April 2012.

[3] This is discussed in greater detail in ICN's *Report on Predatory Pricing* prepared by the Unilateral Conduct Working Group, presented to 7th Annual ICN Conference, April 2008.

[4] For example, in some jurisdictions it is legally required, as part of the proof of predation, to show likely recoupment. In other jurisdictions recoupment or the potential to recoup may be a relevant consideration in the assessment without being a legal requirement for proving predation.

4. **Agencies can determine, using an appropriate price-cost test, whether the alleged predator is making a sacrifice by incurring avoidable losses or whether its pricing is capable of excluding equally efficient competitors.**

   *Comment: Price-cost tests can be used to create presumptions of illegality for a dominant firm's pricing below a specified level of cost. Price-cost tests may also be used to provide a safe harbor for prices at or above the level of costs specified.*

5. **Applying price-cost tests is a complex and resource-intensive exercise. Thus, before moving to an assessment of the alleged predator's prices and costs, the agency should make an early determination of whether the alleged predator's prices are likely to cause competitive harm**.

   *Comment: Such an inquiry should focus on the nature and extent of the price cutting, the manner through which it might harm rivals and competition, the conduciveness of market conditions to successful predation, and possible legitimate reasons for price cutting. For example, the nature and extent of the price cutting may be such that it has no likely impact on competition. Moreover, to exclude actual or potential rivals by price cutting, a dominant firm normally must act to displace a significant proportion of its rivals' actual or potential sales.*

## II. Price-Cost Tests

1. **Agencies should base price-costs test on the costs of the dominant firm (the alleged predator).**[5]

   *Comment 1: Using the dominant firm's costs (or those of a hypothetical "equally efficient competitor") can avoid creating a "price umbrella" over less efficient firms. It also has the advantage that the dominant firm is better able to know the costs on which to base its assessment of whether the prices it sets may be below cost.*

   *Comment 2: A dominant firm unwilling or unable to supply suitable cost data should not, as a consequence, automatically escape a finding of infringement. A reasonable approximation of the dominant firm's costs should be used, and cost data from other firms can be useful in making the approximation.*

2. **The choice of a price-cost test should be guided by its intended use and the theory of harm. The following cost benchmarks are used in price-cost tests when assessing alleged predation:**

[5] For discussion, see ICN's *Unilateral Conduct Workbook*, Chapter 4, ¶75.

**Average variable cost ('AVC')** is the total variable cost divided by the number of units produced. Variable costs are those costs that vary with output, increasing when output increases and falling when output decreases (for instance, raw material or energy costs).[6]

**Average avoidable cost ('AAC')** includes all the costs that could have been avoided if a certain quantity of output had not been produced or a certain action (e.g., entry) had not been undertaken. AAC includes costs incurred before the predatory activity commenced but made only to enable the predatory activity. The relevant volume of output over which AAC is measured is typically the amount of (additional) output that is generated by the predatory strategy. Unlike variable costs, avoidable costs include both variable costs and any fixed costs that are incurred only as a consequence of the decision to produce some incremental amount of output.[7]

**Long-run average incremental cost ('LRAIC')** comprises all the costs of producing a given, discrete increment of output, usually a particular product in a multi-product context from a long-term perspective. LRAIC is thus the average of all the (variable and fixed) costs that a firm incurs to produce a particular product. Unlike AVC, it includes all fixed costs, including sunk costs, specific to producing the given product. LRAIC can include costs associated with the development of a new product or service and other product specific fixed costs made before the period in which the allegedly abusive conduct took place.[8]

**Average total cost ('ATC')** is total cost incurred divided by the number of units produced. It equals the sum of AVC plus average fixed cost.

*Comment 1: AVC and AAC are generally used to assess whether the dominant firm is incurring avoidable losses. If a dominant firm charges a price below either of these cost benchmarks for all or part of its output, it is not recovering the costs that could have been avoided by not providing that output. These cost benchmarks are thus most often used to establish a presumption of sacrifice.*

*Comment 2: LRAIC and AAC can be used to assess whether the dominant firm is incurring avoidable losses, when the alleged predation involves launching a new product for the specific purpose of the predation and that product will be phased out once the predation has been effective (i.e. the use of a fighting brand).*

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[6] For discussion, see ICN's *Unilateral Conduct Workbook*, Chapter 4, ¶¶50-54.

[7] For discussion, see ICN's *Unilateral Conduct Workbook*, Chapter 4, ¶¶55-57.

[8] For discussion, see ICN's *Unilateral Conduct Workbook*, Chapter 4, ¶¶58-61.

*Comment 3: LRAIC and ATC are more apt to assess whether the dominant firm's pricing is capable of excluding equally efficient competitors. LRAIC and ATC may be used to establish a presumption that prices above those thresholds are not predatory, or within a safe harbor, rather than showing a sacrifice and hence establishing a presumption that prices are predatory. In certain circumstances, a less efficient competitor can exert a competitive constraint on a dominant firm. Some jurisdictions that use a soft safe harbor may, in those limited circumstances, consider whether particular price-based conduct is likely to prevent the alleged prey from becoming efficient and thereby harm competition by removing a competitive constraint on the dominant firm.*

## III. Assessment of Harm to Competition

1. **To determine whether the alleged predatory pricing is likely to harm competition, agencies should obtain information about the market and the conduct of the alleged predator to assess several factors, which when considered together indicate whether the alleged predatory pricing strategy has harmed or is likely to harm competition.**

2. **Examination of the nature and extent of price cutting can provide insight into whether the alleged predatory pricing has harmed or is likely to harm competition by foreclosing rivals.**[9] **Both the potential to harm competitors and the potential to do so at a cost acceptable to the dominant firm can be informed by this examination.**

*Comment 1: To harm competition, low prices must deprive rivals of significant actual or potential sales in at least one market. An agency should consider whether the alleged predator has increased its sales to displace sales of rivals.*

*It may also be possible to assess whether the dominant firm's prices have risen to supra-competitive levels after the exit of rivals.*

*Comment 2: To harm competition, it is necessary for predatory pricing to foreclose or have the potential to foreclose rivals. An agency should consider whether the dominant firm's low pricing strategy is sufficient to foreclose the market now or in the future.*

*A few isolated instances of pricing below cost may have no meaningful impact on competition, but pricing below cost need not extend to all the dominant firm's sales to exclude competition.*

[9] Foreclosure occurs when conduct is likely to deny profitable expansion in or access to a market to actual or potential competitors.

*Comment 3: Predatory pricing can be very costly for a dominant firm, especially if it cuts price across the board. An agency should consider whether the dominant firm can target (and actually is targeting) its predatory pricing strategy on specific customers (i.e. those that might be more likely to switch to a competitor) while continuing to charge higher prices to other customers.*

*If the dominant firm is able to offer its predatory price only to those customers who are seriously considering buying from its rivals, rather than having to implement the predatory price across all of its output, then the cost of the predatory strategy can be significantly reduced.*

*If a dominant firm can fund its predatory losses made in one part of the market with supra-competitive profits from another part of the market, then its chances of sustaining predatory prices long enough to foreclose competitors are increased.*

*Comment 4: Agencies should treat with caution the contention of an alleged predator that it is merely meeting competition. The pricing of the alleged predator's rivals can be relevant in determining whether the predator's low pricing harms competition. However, low pricing found to harm competition cannot be defended on the basis that it is meeting competition*.

3. **Determining whether market conditions are conducive to predatory pricing can provide insight into whether the alleged predatory pricing is likely to harm competition. If barriers to entry and re-entry in the market are very low, it is unlikely that low pricing is a predatory strategy because the short-run "investment in predation" could not be recouped over the longer run by raising prices or preventing them from declining.**

    *Comment: Entry and re-entry barriers are part of the analysis of dominance and anticompetitive foreclosure. They can also be considered separately in an assessment of whether the dominant firm is likely to recoup its investment in excluding competition. Significant entry and re-entry barriers make it more likely that a predatory strategy can be successful, as it makes it more likely that the maintenance or strengthening of market power will be durable enough to allow recoupment.*

4. **Examination of evidence relating to the rationale of a pricing strategy may be useful in distinguishing between low pricing that harms competition and low pricing that reflects healthy competition**.

    *Comment 1: There is a difference between general evidence of intent to eliminate a competitor and a specific, detailed plan to absorb losses in the short term for the purpose of eliminating competition and reaping supra-competitive profit in the long term.*

*The latter type of evidence is more relevant as the detailed business plans may contain a firm's projections or calculations regarding the likelihood that its below-cost pricing will result in the elimination of a particular competitor or competitors and its eventual ability to recoup its short-run losses.*[10]

*Comment 2: Evidence of predatory intent cannot be the sole basis for a finding of predatory pricing. Evidence of intent may, in particular, be informative where it indicates a plausible strategy to harm competition, helping the agency to distinguish when the pricing is more likely to be anticompetitive. Evidence of intent may also be relevant when assessing the validity or credibility of any justifications or defenses.*

## IV. Justifications and Defenses

**Agencies should examine information relating to objective business justifications and defenses for the low prices.**

*Comment 1: Justifications for low pricing may include promotional pricing, pricing in response to a downturn in demand, pricing in order to penetrate a new market, pricing in order to increase sales and achieve greater economies of scale, and pricing to balance the two sides of a two-sided market.*[11]

*Comment 2: Agencies should make it clear that where there is a finding of predation it is highly unlikely that efficiency defenses apply as they would require that successful predation results in lower prices not just during the predation period but also over the longer term.*

## V. Agency Policies and Guidance

**Agencies can facilitate predation assessments by ensuring that:**

- **Enforcement standards are administrable both by the agency and firms, and are communicated clearly to firms to assist them in complying with the law.**

- **Any safe harbors adopted can easily be followed by companies wishing to ensure compliance with the law.**

- **When starting an investigation, the agencies work with the alleged predator to understand the records it keeps and how they might productively be used to compare prices and costs.**

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[10] However, absence of such evidence is not proof of lack of intent, because many predators may be reluctant to keep records that show reasons that underlie their pricing strategy.

[11] For further examples see ICN's *Unilateral Conduct Workbook*, Chapter 4, ¶145.