Price-Cost Tests in Unilateral Conduct Cases

Presented by ICN Unilateral Conduct Working Group

Tuesday, July 19, 2011
Introductory Remarks

- This Teleseminar will be recorded and posted on the ICN website
- Audience will be muted during the presentation portions of the teleseminar
- Audience lines will be unmuted during Q&A sessions following the opening presentations and case studies
Program

• **Moderator: Simon Roberts**, Chief Economist & Manager, Policy and Research Division, South African Competition Commission

• **Presentation by David Gilo**, Director General, Israeli Antitrust Authority on the appropriate role of price – cost tests

• **Presentation by Dr. Jorge Padilla**, Compass Lexecon, on Price-Cost Tests in EC Competition Law

• **Case Study - Swedish Post** - applying price-cost tests in a retroactive rebate case, presented by Martin Mandorff, Acting Deputy Chief Economist, Swedish Competition Authority

• Applying price-cost tests in predatory pricing and bundled discounting cases, **A U.S. Approach, presented by Joseph Angland**, Partner, White & Case LLP
The Appropriate Role of Price - Cost Tests in Predation Cases

David Gilo
Director General
Israeli Antitrust Authority
The Basic Policy Question

- What is the rationale for the prohibition of predatory pricing by dominant firms?

- Why examine whether price was below cost rather than whether profits were sacrificed?

- What is the most appropriate measure of cost? ...
Types of Cost Measures

• A few types of possible cost measures:
  
  – Marginal Costs
  
  – Variable Costs
  
  – Fixed Costs
  
  – Avoidable Costs
Policy Issues re the Cost Measure

- What is the rationale for preferring marginal or variable costs?
- Are fixed costs ever an appropriate measure?
- How should a court cope with ancillary benefits to below cost prices?
- How should a court cope with predatory investments in capacity? (see later in this webinar...)
Implementation Issues

• Should below cost pricing by a dominant firm be illegal “per se”?

• Ideally, who should determine the appropriate measure of cost -- the legislator or the court?

• What are the pros and cons of a financial statements approach?

• The case of multiproduct firms
Price Cost Tests in EC Competition Law

Dr. Jorge Padilla
ICN Seminar, 19 July 2011
Principles

- Assessing likely effects
- The as efficient competitor test
- Avoidable costs / Incremental costs v. Variable costs / Fixed Costs
- Beyond the price-cost tests

Costs

- Average total cost (ATC)
- Long run average incremental cost (LRAIC)
- Average avoidable cost (AAC)
- Average variable cost (AVC)
Predatory pricing

Predatory pricing
- Price v. Average Avoidable Cost
- Price v. LRAIC (+ evidence of intent)

Incremental rebates
- Similar to predation: Incremental price v. AAC/LRAIC
In a margin squeeze, the margin between the retail price ($p_1$) and wholesale price ($w$) is too small to allow downstream rivals to compete.

- $P_1 - W$ v. LRAIC
Bundled Rebates

Prices of sports and movie channels

- Sport: £15
- Movie: £15
- Sport + Movie package: £20

Incremental price of the movie channel

- Sport + Movie package: £20
- Sport: £15

Incremental price of movie channel = £5

- Incremental price v. LRAIC
Retroactive rebates

Is the effective price ($P_3$) below cost?

- Note that an efficient competitor could be foreclosed even if $P_2$ is above cost
- Effective price v. LRAIC
A few practical considerations

Deriving relevant cost measures requires

- Good understanding of the theory of harm
- Good understanding of cost accounting data
- Ability to adjust accounting data to derive economically meaningful cost measures

Good cost accounting data

- A necessary but not sufficient condition
  - Example: customer acquisition costs
- Accounting documents are like sausages, it is better not to see them being made ... but we must understand how they were made

Economists or accountants?

- You need both species
Q&A

Question & Answer Period
Analysis of Posten’s Retroactive Rebate Scheme

Martin Mandorff
Swedish Competition Authority
Case Background

- Sweden - one of world’s most liberalized mail markets
- Incumbent: *Posten* (89%), challenger: *Bring CityMail* (9%)
- In 2008, *Posten* introduced a retroactive rebate on pre-sorted bulk mail

<table>
<thead>
<tr>
<th>Shipment volume</th>
<th>Rebate</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 – 299 999</td>
<td>0</td>
</tr>
<tr>
<td>300 000 –</td>
<td>0.20 SEK on entire shipment</td>
</tr>
</tbody>
</table>

- Complaint filed by *Bring*; case investigation in 2009
- Analytical framework: ”As-efficient competitor” analysis
Analytical Steps

1. Dominance (EU requirement, art. 102)
2. Calculate the effective price
3. Determine relevant cost
4. Analyze risk of foreclosure: Effective price < Relevant cost?

   Effective Price = Price competitor has to beat to win contestable portion of customers’ demand

5. Develop theory of harm

   Objective: Sort out anti-competitive from pro-competitive rebates
Service Areas

Universal Service
100 percent of households

Metropolitan Areas
50 percent of households
(contestable demand)
Calculating the Effective Price (Incremental Rebate)

Price per item below threshold = 2 SEK and above threshold = 1.8 SEK

Note: all data in the following is for illustrative purposes only and do not represent actual data from the case
Calculating the Effective Price (Retroactive Rebate)

Above threshold: 0.20 SEK discount on entire volume
Calculating the Effective Price

Effective price = Price to beat to win contestable share of demand
Calculating the Effective Price

0.20 SEK discount allocated to 50% of demand = 0.40 SEK effective discount

effective price = 1.6

Illustration only
Calculating the Effective Price

Small contestable share and low enough demand can generate negative effective prices

Total price

effective price < 0

Contestable share

Volume

300 000

Illustration only
Effective Price

- Effective price determined by contestable share & shipment volume
Effective Price

- Effective price determined by contestable share & shipment volume
### Actual Customer Demand

<table>
<thead>
<tr>
<th>Customer</th>
<th>Shipment</th>
<th>Volume</th>
<th>of which in Metropolitan</th>
<th>Contestable share</th>
<th>Effective discount</th>
<th>Effective price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer A</td>
<td>1</td>
<td>400 000</td>
<td>200 000</td>
<td>50 %</td>
<td>0.40</td>
<td>1.60</td>
</tr>
<tr>
<td>Customer A</td>
<td>2</td>
<td>250 000</td>
<td>100 000</td>
<td>40 %</td>
<td>0.00</td>
<td>2.00</td>
</tr>
<tr>
<td>Customer B</td>
<td>1</td>
<td>360 000</td>
<td>120 000</td>
<td>33 %</td>
<td>0.60</td>
<td>1.40</td>
</tr>
<tr>
<td>Customer B</td>
<td>2</td>
<td>500 000</td>
<td>150 000</td>
<td>30 %</td>
<td>0.20</td>
<td>1.80</td>
</tr>
<tr>
<td>Customer C</td>
<td>1</td>
<td>330 000</td>
<td>320 000</td>
<td>97 %</td>
<td>0.21</td>
<td>1.79</td>
</tr>
<tr>
<td>Customer C</td>
<td>2</td>
<td>320 000</td>
<td>32 000</td>
<td>10 %</td>
<td>2.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Customer C</td>
<td>3</td>
<td>320 000</td>
<td>30 000</td>
<td>9 %</td>
<td>2.13</td>
<td>-0.13</td>
</tr>
</tbody>
</table>

Illustration only
Effective Prices

Competitor meets different effective prices for different shipments.

Illustration only
Cost Measure

- EU Commission Guidance
  - Effective price above LRAIC or AAC (LRAIC ≥ AAC)
- Data obtained from Posten
  - Average Total Cost (ATC), where ATC ≥ LRAIC
  - Cost savings from pre-sorting
- Cost Measure Used
  - ATC minus cost savings
Cost Coverage (Efficient Price – Cost)

Subtracting cost from effective prices: Equally efficient competitor cannot compete for shipments B1 & C3 without incurring losses.
Theory of Harm

- Rebates (low prices) are in general pro-competitive
- Method identifies shipments for which an equally efficient competitor cannot compete (for contestable share)
  - if identified: rebates are potentially anti-competitive
  - note: ATC biased towards finding anti-competitive effects
- Does firm have the ability to foreclose without incurring cost (i.e. no need for recoupment, naked exclusion)?
- Do identified shipments represent significant share of relevant markets?
  - since not: low risk of anti-competitive effects (case closed)
Predatory Pricing
The U.S. Approach

Joseph Angland
White & Case LLP

Tuesday, July 19, 2011
THE BASIC RULES

• *Brooke Group* holds that a predatory pricing claim requires proof that:
  – Prices are set below some measure of relevant cost
  – The predator has a good chance to recoup its lost profits
• Courts generally use average variable cost as the measure of cost
  – But, in *Northwest Airlines* a court approved use of full cost
• Since *Brooke Group*, predatory pricing cases have rarely succeeded
• Bundled pricing most commonly judged using a predatory pricing approach after attributing all of the bundled discount to the product as to which the dominant firm seeks to obtain or enhance monopoly power (See Exhibit A)
  – But, the much criticized *LePage’s* decision found bundled pricing illegal without applying any price-cost test
American Airlines

- In 2001, the DOJ challenged alleged predatory investment/pricing by American Airlines on certain routes from its Dallas hub, where it began with about a 70% share
  - Low cost carriers entered, lowering prices and taking some share
  - AA responded by adding additional capacity (more and larger planes) on some routes at prices matching those of the new entrants, leading to many empty seats
  - AA documents stated that the approach made sense only if new entrants withdrew

- DOJ theory: The incremental revenues that AA realized by adding capacity did not cover the costs resulting from such expansion.
American Airlines

- DOJ lost in district court and on appeal:
  - District court concluded that DOJ had to prove that prices were below AVC for all routes at issue, taken collectively. DOJ agreed it could not satisfy that test.
  - Court of Appeals:
    - did not reject DOJ’s theory that even if revenues for a particular route covered the associated costs, the pricing/investment could be predatory if the revenues attributable to the incremental capacity (essentially, avoidable costs) on the route did not cover the incremental cost of adding and using that capacity. (See Exhibit B)
    - Found that AA’s cost accounting data did not establish that incremental costs exceeded incremental revenue
    - seemed to accept DOJ’s position that recoupment could occur in other markets – e.g., when passengers stayed on AA for another leg of the flight
Exhibit A: Bundled Pricing Illustration

- Assume that the question is whether a firm with monopoly power in product M is improperly monopolizing product C (where it currently faces competition) by selling M and C together at a discount.

- Monopolized product (“M”): price = $14, AVC = $8
- Competitive product (“C”): price = $10, AVC = $7
- Bundle of M and C: price = $20, AVC = $15
- Bundle discount: ($14 + $10) - $20 = $4

- If one looks at the entire bundle, the $20 price exceeds the $15 AVC, so no predation
- Under a price-attribution approach, the $4 discount for buying the bundle instead of buying each product separately is attributed entirely to C
- Thus, the effective price of C is $6 ($10 stand-alone price less the $4 bundle discount), which is below C’s AVC of $7 and thus may be predatory
Exhibit B: Hypothetical Based on AA

- Before expansion 100 passengers would have paid $500 each for a ticket
- The $50,000 of revenue would have exceeded the $30,000 AVC of the flight
- Adding a second flight (with same AVC) would lead to 50 new passengers paying $500 each, for $25,000 of additional revenue
- Thus:
  - **Overall**, route has revenues of $75,000 and AVC of $60,000, so not predatory
  - But, if only 50 passengers fly on second flight, the $25,000 of revenues are less than the $30,000 AVC, so perhaps the addition of the second flight is predatory
  - Query: should the result be different if 20 passengers who would have flown on the first flight choose the second now that it is available?
    - Revenues for each flight ($40,000 and $35,000) now exceed its AVC
    - But, the addition of the second flight increases cost by $5,000 more than revenues
Q&A

Question & Answer Period