

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**

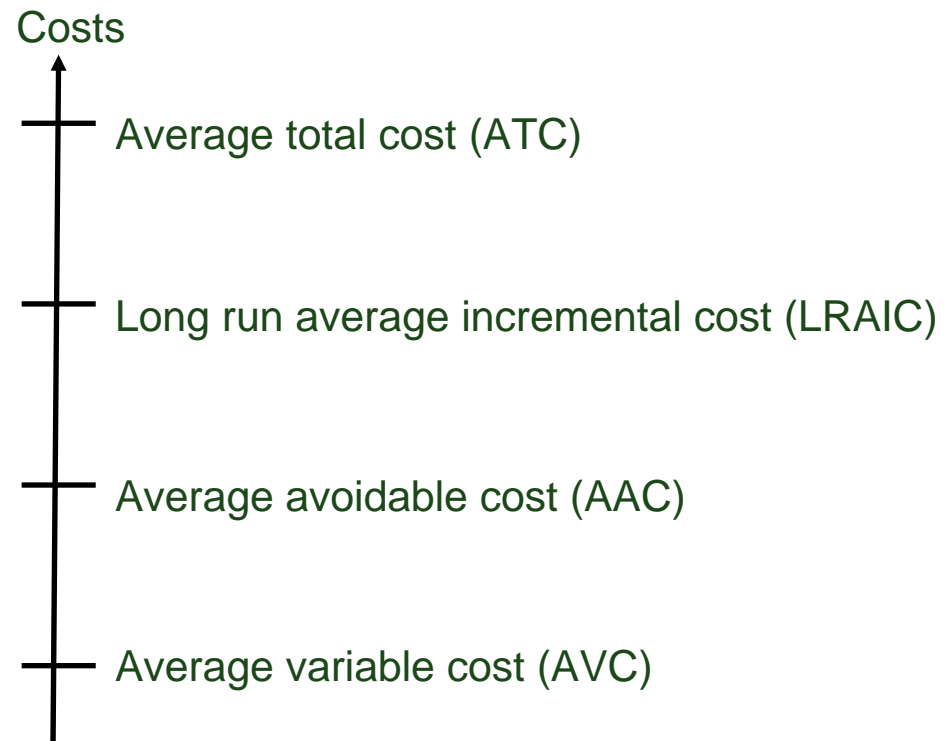
Price Cost Tests in EC Competition Law



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



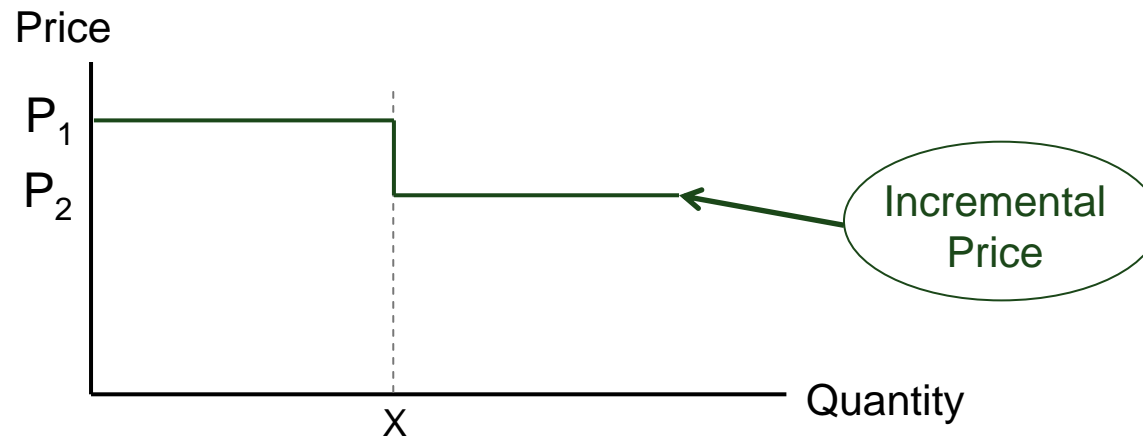
Predatory pricing

Predatory pricing

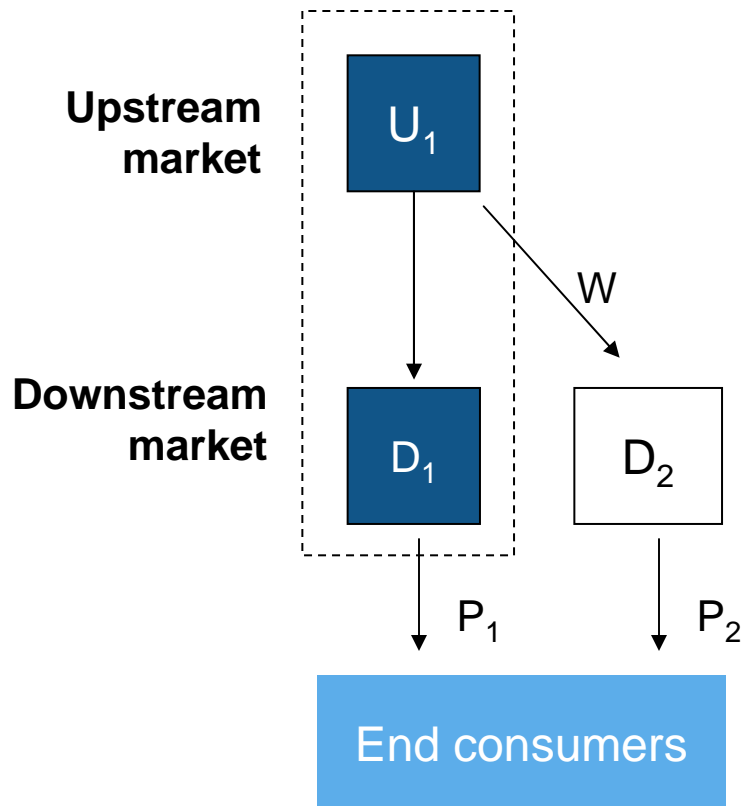
- Price v. Average Avoidable Cost
- Price v. LRAIC (+ evidence of intent)

Incremental rebates

- Similar to predation: Incremental price v. AAC/LRAIC



Margin squeeze



- 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



Incremental price of the movie channel



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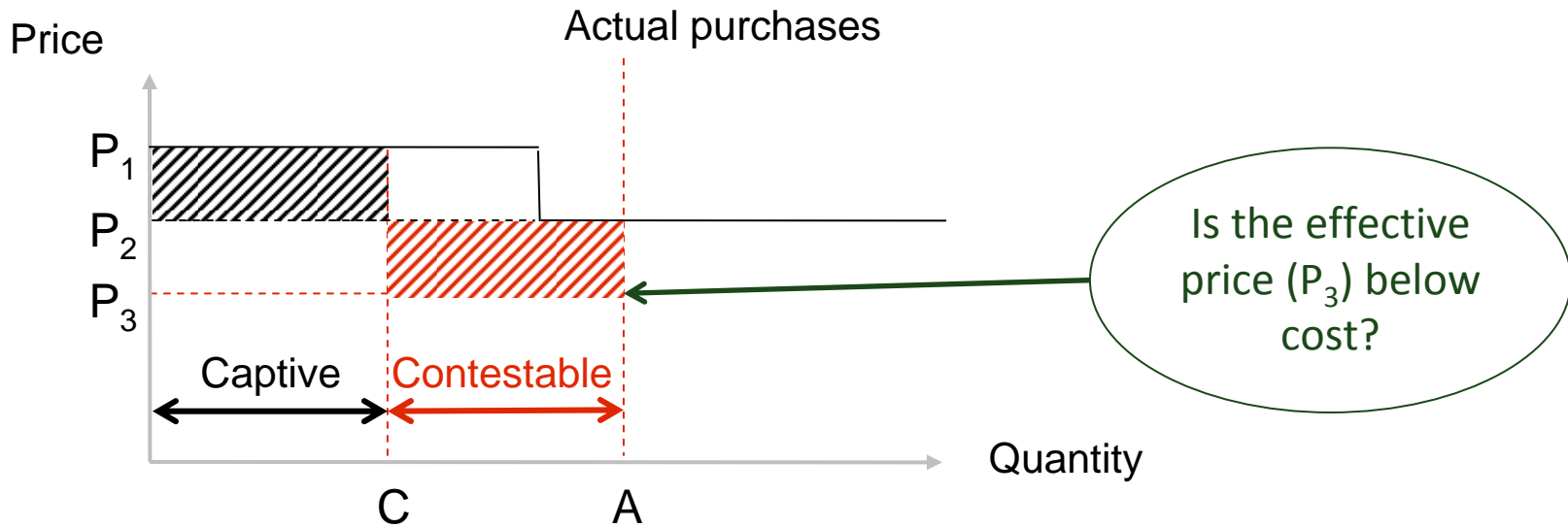


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- Incremental price v. LRAIC

Retroactive rebates



- 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

Shipment volume	Rebate
0 – 299 999	0
300 000 –	0.20 SEK on entire shipment

- 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

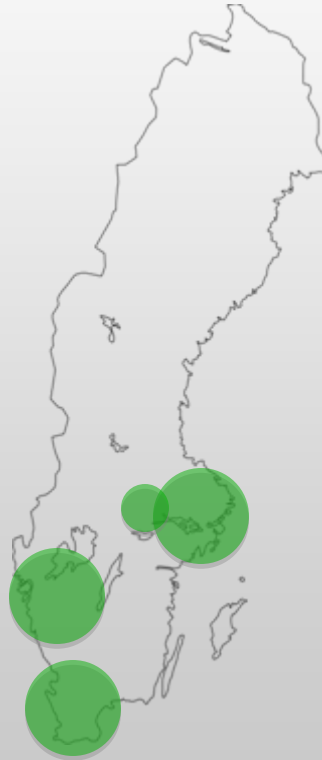
5. Develop theory of harm

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

Service Areas

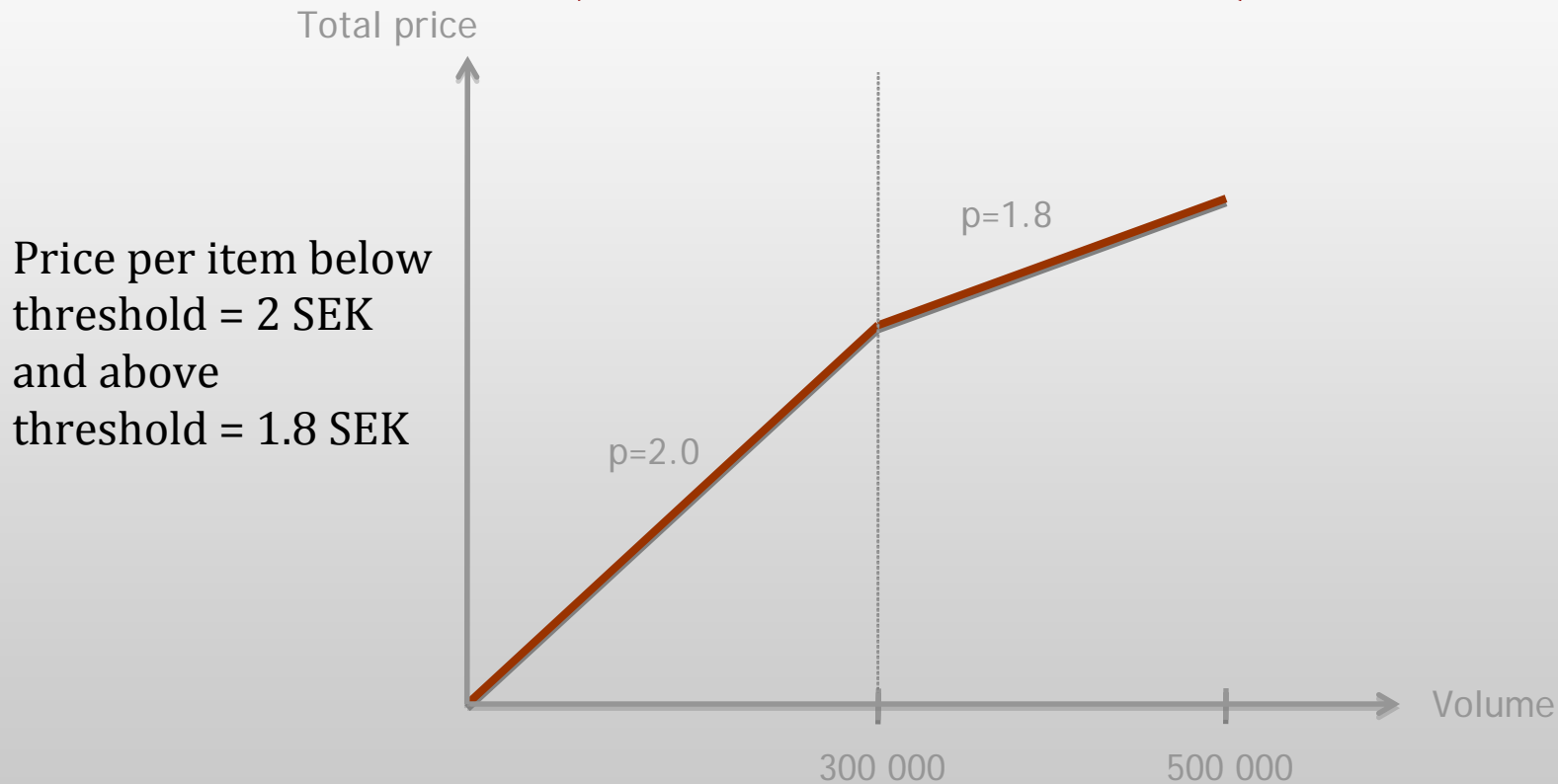


Universal Service
100 percent of households



Metropolitan Areas
50 percent of households
(contestable demand)

Calculating the Effective Price (Incremental Rebate)



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

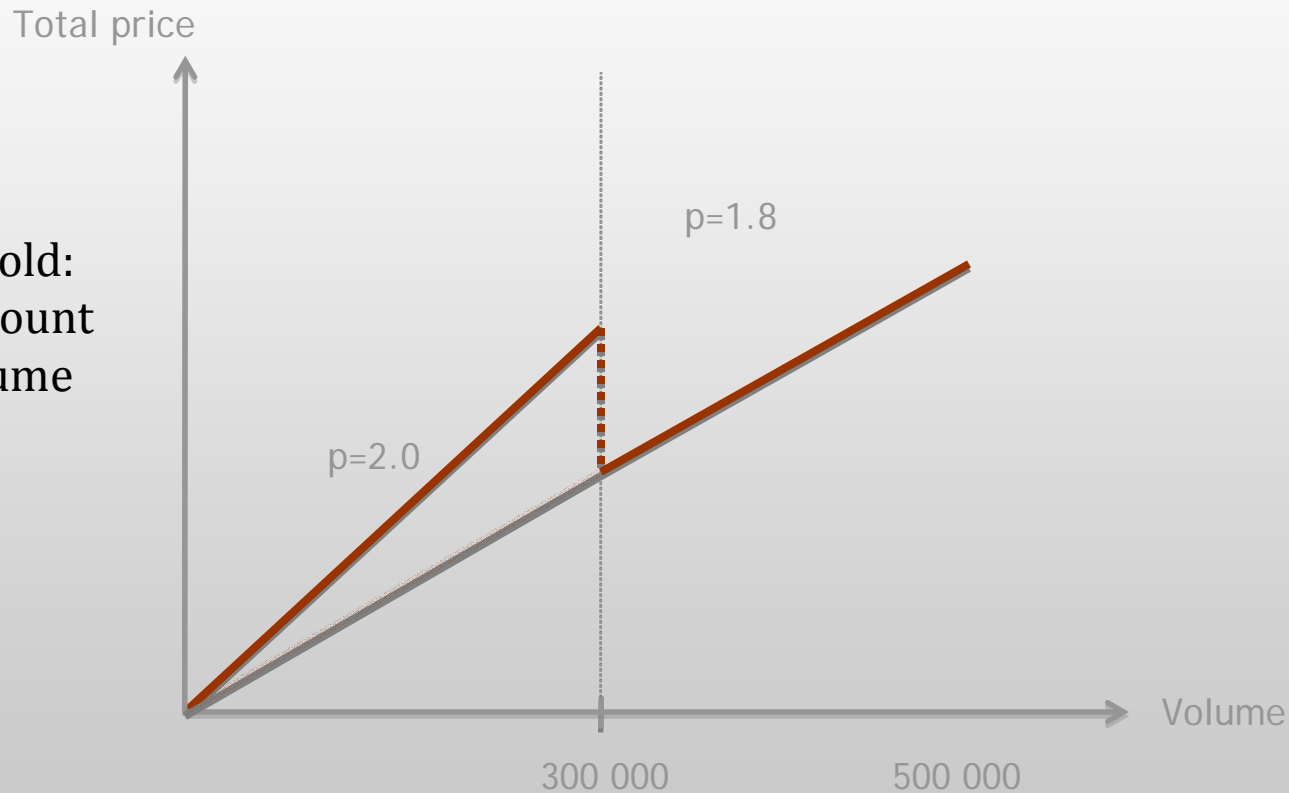


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Calculating the Effective Price

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

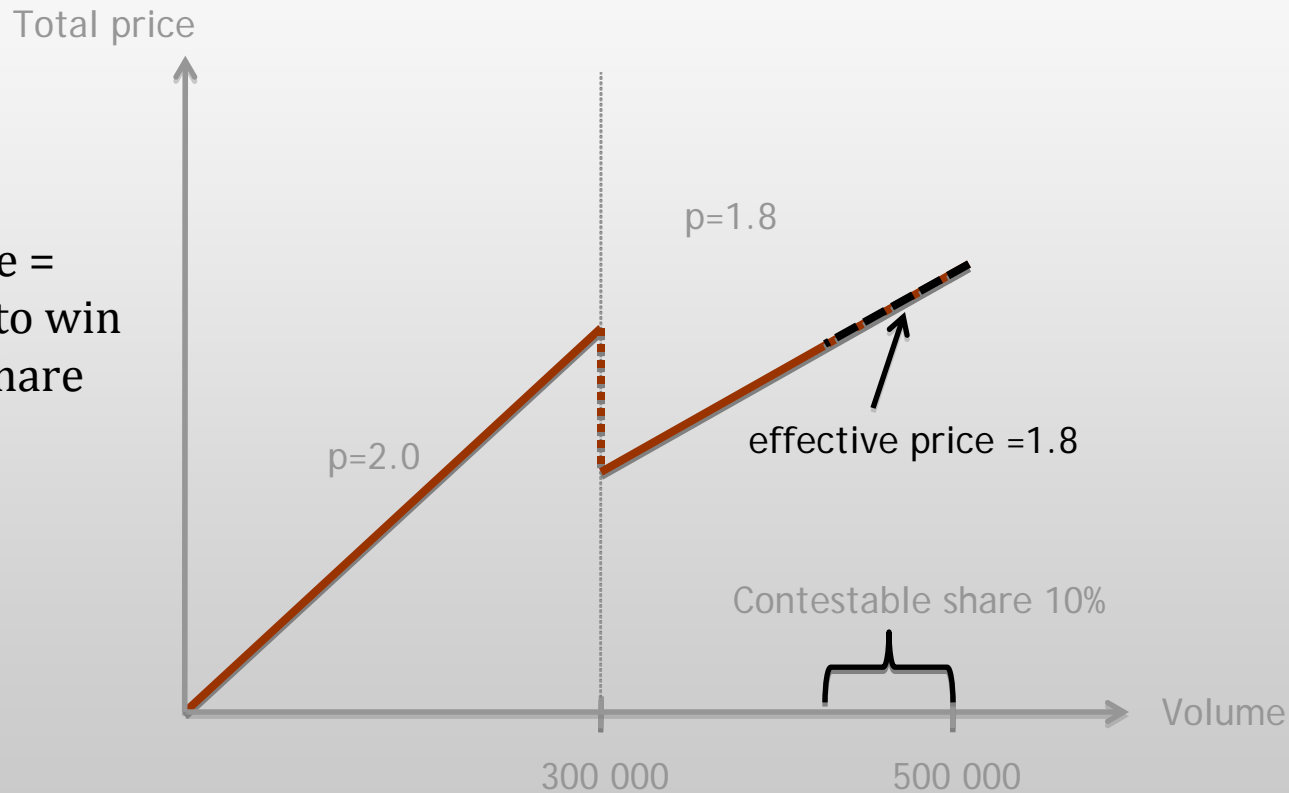


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Calculating the Effective Price

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

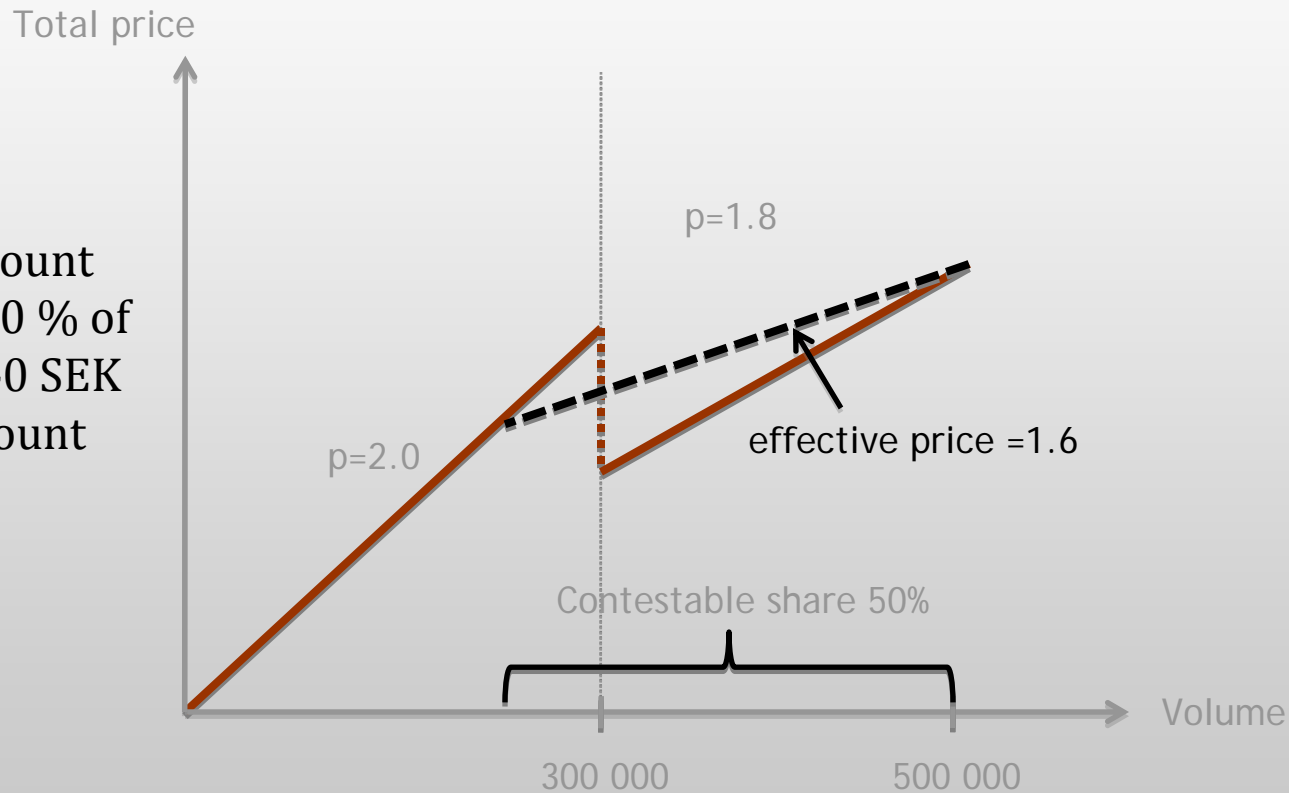


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Calculating the Effective Price

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

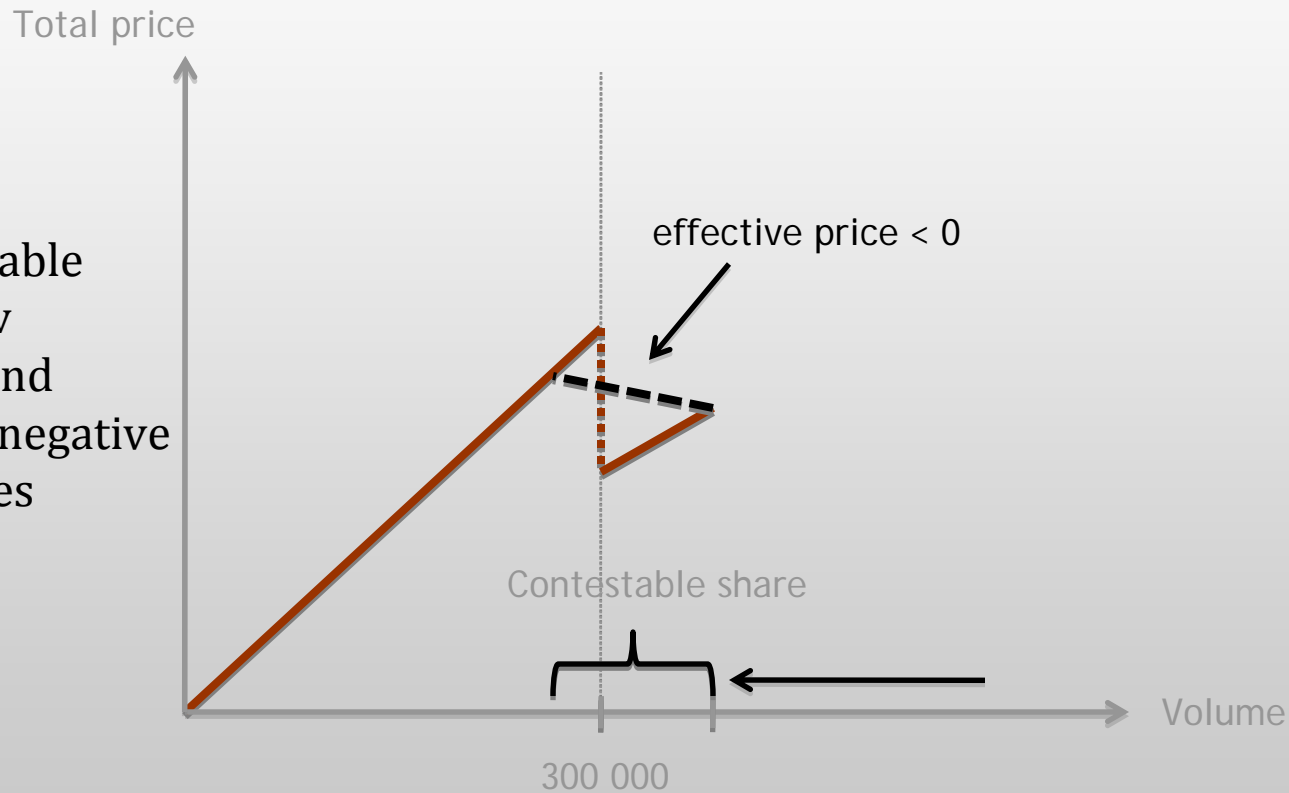


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Effective Price

- Effective price determined by contestable share & shipment volume

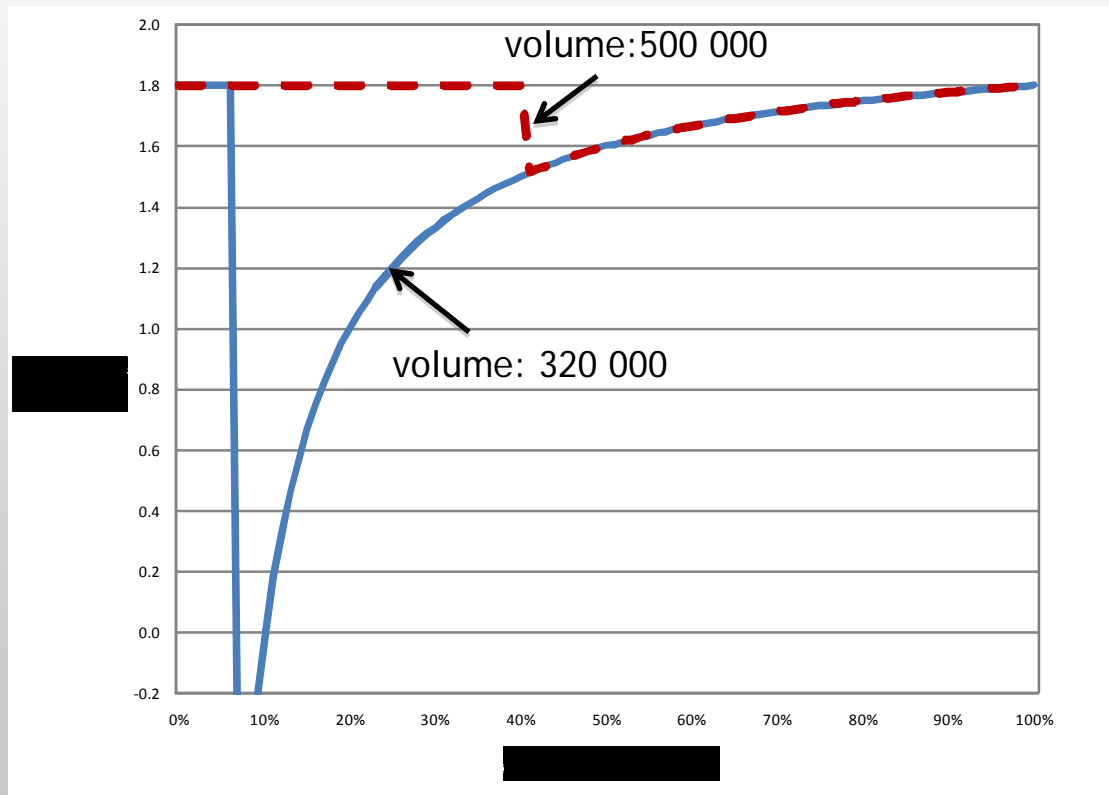


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Effective Price

- Effective price determined by contestable share & shipment volume

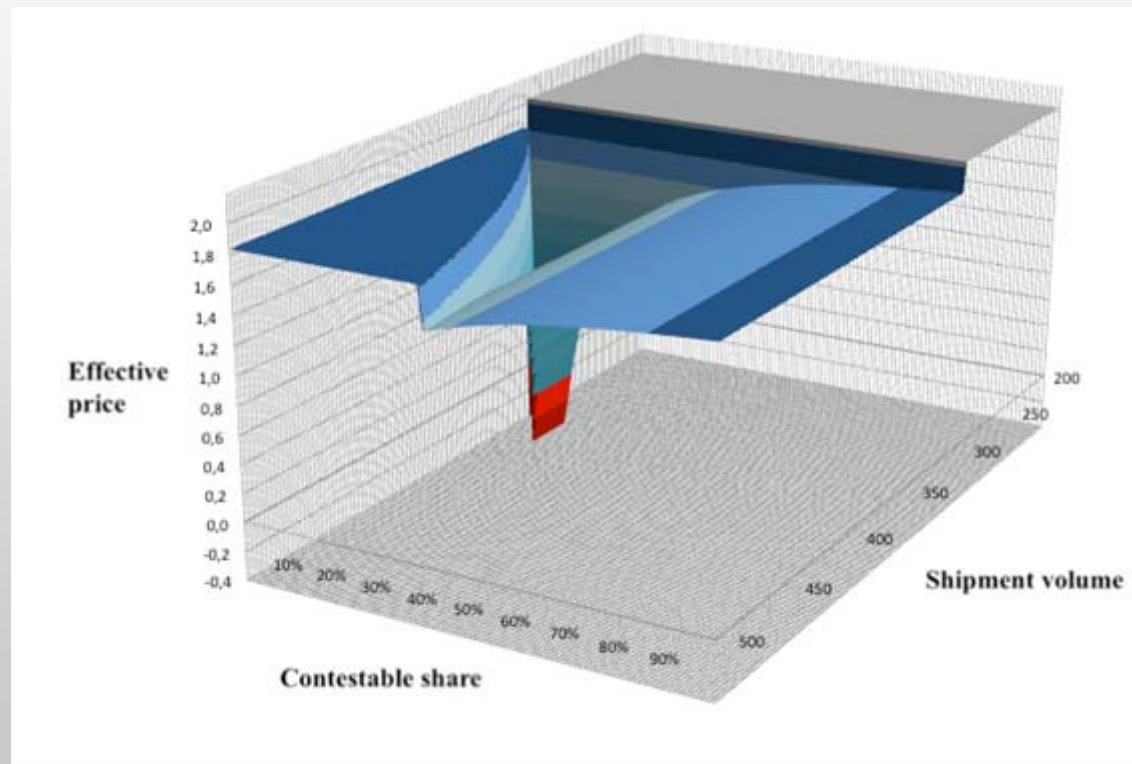


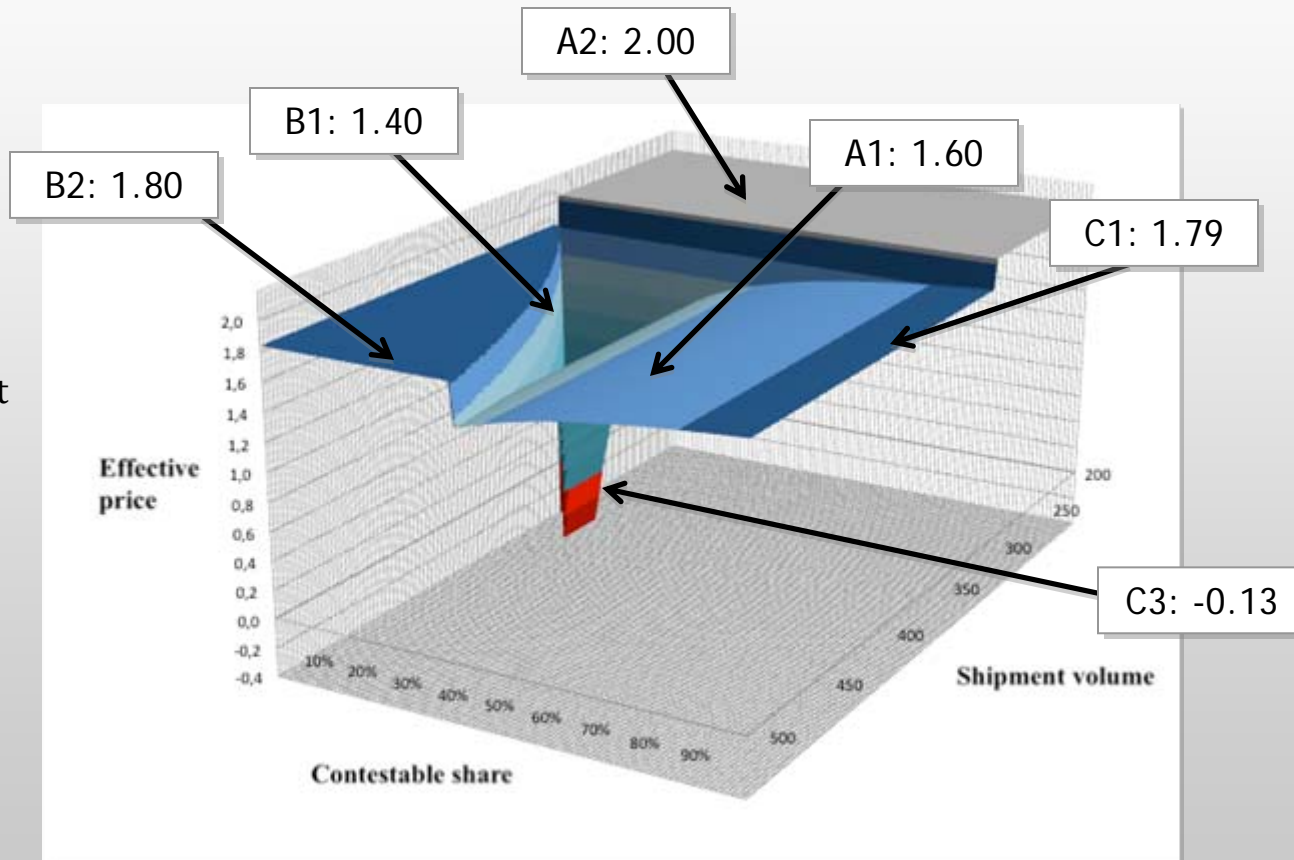
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Actual Customer Demand

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

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Effective Prices



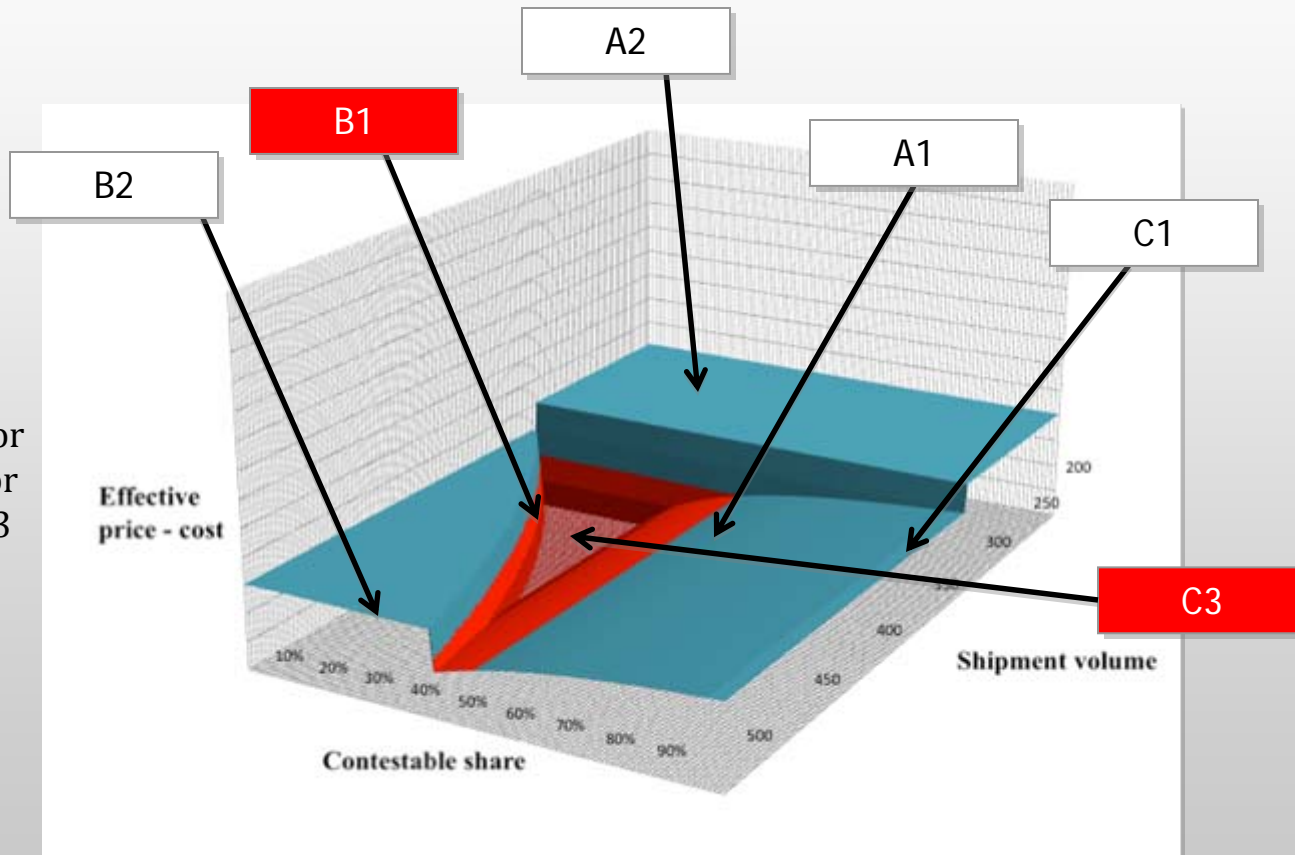
Competitor meets different effective prices for different shipments

Illustration only

Cost Measure

- EU Commission Guidance
 - Effective price above LRAIC or AAC ($LRAIC \geq AAC$)
- Data obtained from Posten
 - Average Total Cost (ATC), where $ATC \geq LRAIC$
 - 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

Illustration only

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