Abuse of dominance: Predatory Pricing

Submitted by:

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## CASES

1. **Aerospatiale-Alenia/de Havilland Decision 91/619 [1992] 1 CEC 2,034**


9. **Deutsche post AG OJ 2001L 125/27**


24. *Standard Oil Co. of California and Standard Stations Inc. vs. United States* (337 US
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30. *United States v. United States Steel Corp.* 251 US 417...........................................21


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| 10. | Einer Elhauge and Damien Geradin, *Competition Law and economics*, Hart Publishing |

24. Patrick Bolton,* Joseph F. Bradley** and Michael H. Riordan, PREDATORY PRICING: STRATEGIC THEORY AND LEGAL POLICY.


30. William L. Greene, American Bar, Predatory Pricing (Monograph / American Bar Association, Section of Antitrust Law), Section of Antitrust Law

31. W. KIP Viscusi, Joseph E. Harrington Jr. , John Vernon


### LIST OF STATUTES REFERRED

1. Indian Competition Act 2002: Section 4, Section 2 (r) (s) & (t), Section 19 (7)

2. EC Treaty- Article 82

3. United Kingdom Competition Act, 1998 - Section 18 (1)

4. Sherman Act U.S.A- Section 2
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CHAPTER 1: BACKGROUND

Competition law exists to ensure competition in a free market, and states adopt it because it is considered to bring great benefits to society. Competition is believed to bring efficiency, low prices and innovation\(^1\). Massimo Motta defines of the term ‘competition policy’ as “the set of policies and laws which ensure that competition in the marketplace is not restricted in a way that is detrimental to society\(^2\)”. The objective of Anti-Trust Legislation is the protection of competition on the market as a means of enhancing consumer welfare and of ensuring an efficient allocation of resources, what this essentially indicates is that any antitrust legislation is aimed at protecting Competition and not Competitors and must use economic methods to help such Competition and in turn the consumers. In ideal circumstance no abuse of any sort must occur however practical circumstances have shown that companies in intensely competitive markets resort to immoral practices to eliminate or even leave behind competition.

One such form of abuse of dominance which is proscribed in almost all markets across the world is predatory pricing (E.g.: Article 82 EC Treaty; Section 4 Indian Competition Act both of which prohibit abuse of dominance, monopolization, predatory etc.)

Indian position on the same is given in the Competition Act which was enacted in 2002 (and amended significantly in 2007). Through this paper I seek to elaborate upon the concept of Predatory Pricing (PP) and its treatment under the Competition Act,

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\(^{1}\) Jones, Alison and Sufrin, Brenda, EC Competition Law-Text, cases and materials, Second edition, 2004, Great Britain, p. 1

2002. The basic purpose underlying this analysis is to understand how the CCI will examine and investigate charges of PP under the new regime once the enforcement provisions of the Act are notified and the CCI commences its activities.

The key limbs of the Act are as follows:

1. Prohibition of Anti-Competitive Agreements (Section 3);
2. Prohibition of Abuse of Dominant Position (Section 4);
3. Regulating Combinations (Sections 5&6);
4. Competition Advocacy (Section 49).

Predatory pricing is classified under Section 4 as an abuse of dominance.

Dominance per se is not considered bad under competition law in any jurisdiction, however it has been universally accepted that abuse of such dominance constitutes an anti competitive practice. Predatory pricing is one such ‘abuse of dominance’. It is a specific form of exclusionary pricing conduct in which the predatory firm sacrifices short term profits in order to achieve long term gains. Predatory pricing is generally considered as a strategy that entails a temporary price reduction in order to injure competition and thereby reap higher profits in the long term.

This paper is essentially aimed at providing a conclusive proof of such acts actually being economically feasible in market conditions, also the paper aims at analyzing the factors which constitute such predation. I hope to provide a brief introduction to the concept of Predatory Pricing (PP) and its treatment under the Competition Act, 2002. The basic purpose underlying
this analysis is to understand how the CCI will examine and investigate charges of PP under the new regime.

By the end of this research paper I hope to have not only ascertained the practical possibility of predatory pricing but also hope to identify at what instance of price reduction, would predation occur. Since predation is a form of abuse of dominance, this paper shall elaborate upon the concept of abuse of dominance and also indicate the requirements for there to be ‘dominance’ in a certain market by any firm.

The latter half of the paper shall deal with the economics of predatory pricing. For a long time now there have been strong voices against legislative restrictions on predation since there has been no convincing evidence indicating its economic feasibility, In his book the ‘Antitrust Paradox’\(^3\), Bork has rendered it “unwise, therefore, to construct rules about a phenomenon that probably does not exist.” Through this paper I shall seek to provide answers to the aforesaid concerns and also finally I shall indicate how, although the consumers may benefit from reduced prices initially, it shall invariably result in an injury to the consumers interests.

CHAPTER 2: ABUSE OF DOMINANCE

The ‘abuse of dominance’ is proscribed in almost all markets across the world (E.g.: Article 82 EC Treaty; Section 4 Indian Competition Act both of which prohibit abuse of dominance, monopolization, price fixing etc.).

a. Article 82 of the Treaty of the European Communities states, “Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States”.

b. Section 18 (1) of the Competition Act, 1998 of the United Kingdom provides “…any conduct on the part of one or more undertakings which amounts to the abuse of a dominant position in a market is prohibited if it may affect trade within the United Kingdom.”

c. Section 4 (1) of the Indian Competition Act states, “No Enterprise shall abuse its dominant position”.

Dominance per se is not considered bad under competition law in any jurisdiction\(^4\), however it has been universally accepted that abuse of such dominance constitutes an anti competitive practice\(^5\). All concepts relating to abuse of dominance, at the basic level ‘pertain to the


\(^5\) “A Framework for the Design and Implementation of Competition Law and Policy” (page 69) by R. Shyam Khemani, World Bank; See also Section 18 (1) of the Competition Act, 1998 United Kingdom, Section 19 (1) of the German ‘Act against Restraints on Competition’; Section 4(1) Indian Competition Act 2002, Section 2 Sherman Act U.S.A
exploitation by a single firm or group of firms of their market power or use of improper means for attaining market power.  

Establishing dominance is of paramount importance if the Commission has to invoke any liability for anti-competitive conduct. Dominance is an essential pre-requisite under Article 82 EC and Section 4 Competition Act 2002, and if dominance is not proven there can be no abuse. Three questions typically arise in such cases:

I. What is the relevant market in which the dominance/abuse is alleged?

II. Is the enterprise dominant in the relevant market?

III. What are the specific indicted practices and do these amounts to abuse?

2.1 Relevant Market:
Without a definition of that market, there is no way to measure a defendant’s ability to lessen or destroy competition. The determination of the relevant market is, therefore, a key to most abuse of dominant position cases. In a case before the High Court of Bombay, the issue was as to the stage at which the relevant market has to be identified by the CCI. It was held that “it was not necessary for the Commission to first find out the relevant geographic market, relevant products market or relevant market. Such things can be found or concluded upon investigation and not necessarily before that.” Several cases of the ECJ such as NV Nederlandsche Banden

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7 Defined under sub-sections (r), (s) and (t) of Section 2, Competition Act, 2002


9 See Kingfisher Airlines Limited v. Competition Commission of India [2011] 100 CLA 190 (Bom).
observed that it is essential to define the relevant market and it must be defined both from the geographical and the product points of view. The Indian Competition Act 2002 under Section 2 (r) (s) & (t) clearly defines

"Relevant market" means the market which may be determined by the Commission with reference to the relevant product market or the relevant geographic market or with reference to both the markets;

   a. "Relevant geographic market" means a market comprising the area in which the conditions of competition for supply of goods or provision of services or demand of goods or services are distinctly homogenous and can be distinguished from the conditions prevailing in the neighboring areas;

   b. "Relevant product market" means a market comprising all those products or services which are regarded as interchangeable or substitutable by the consumer, by reason of characteristics of the products or services, their prices and intended use.

The relevant market has also been defined as “the area of effective competition, within which the defendant operates."
The relevant market defines the market in which one or more goods compete. Therefore, the relevant market defines whether two or more products can be considered substitute goods and whether they constitute a particular and separate market for competition analysis.\(^\text{14}\)

For instance in a “relevant product market” it would comprise of goods and services that are interchangeable by the consumers, i.e. to say consumption of drinks, relevant market would be one that can be classified together, juices cannot be substituted by alcoholic drinks or even aerated soft drinks for that matter hence they in a class would comprise a relevant market, similarly alcoholic drinks and soft drinks would constitute separate markets where the actions of the enterprises shall affect the market concerned. The juice market shall remain unaffected by the actions of company in the soft drinks industry. The decisive test for determining a product market is assessing ‘interchangeability’ or ‘substitutability’. Quite simply, products that can be substituted for one another form competitive constraints for each other, and such, lie within the same product market.

The Competition Act 2002 provides a list of considerations to be taken into account while determining Relevant Product Market.\(^\text{15}\) More specifically relevant product market needs to be determined subject to;

1. Demand substitutability,
2. Supply Substitutability
3. Potential competition.\(^\text{16}\)

\(^{14}\) Volkswagen AG v Commission of the European Communities [2000]ECR II- 2707

\(^{15}\) As per Section 19 (7) of the Competition Act, 2002.

\(^{16}\) Appendix A of the Commission’s Notice on the definition of relevant market for the purposes of Community Competition Law (97/C 372/03)
While considering the responsiveness of consumers to price changes, if a change in pricing of a commodity causes enough consumers to switch from the relevant product, then *demand substitution* is occurring and the market it relevant. Further factors such as physical characteristics or end-use of goods; difference in price of goods or service; consumer preferences; Classification of industrial products

The ‘relevant geographic market’ comprises the area where the conditions of the competition are distinctly homogeneous. The Competition Act lists several factors which the Commission must consider in determining the relevant product and geographic markets. The geographic market is an area in which the conditions of competition applying to the product concerned are the same for all traders. The elements to be taken into consideration when defining the relevant geographic market include the nature and characteristics of the concerned products, the existence of entry barriers, consumer preferences, differences among the market shares of undertakings in the neighboring geographic areas amongst other costs.

It becomes important to note that a relevant market, thus, must have both a product and geographical aspect, and the former must be defined clearly, in order to arrive at geographical boundaries. Hence, by definition, a relevant market must be “a collection of products in a given area.”

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17 Aerospaziale-Alenia/de Havilland Decision 91/619 [1992] I CEC 2,034
18 Nestle/Perrier Decision 92/553 [1993] I CEC 2,018
19 Sanofi/Sterling Drug M072, 1991
There have been numerous US Abuse of Dominance cases where the case has been dismissed because of a failure to specify a relevant market in terms of 'reasonable interchangeability'. In particular, in *E. & G. Gabriel v Gabriel Bros., Inc*\(^21\), the case was dismissed for failure to plead a valid relevant market when the proposed relevant market contained items which was not a substitute. Finally, In *Walker Process Equipments Inc. v. Food, Machinery and Chemical Corp.* 382 US 172\(^22\), it was observed that without a definition of the relevant market, there is no way to measure the defendants’ ability to lessen or destroy competition.

**2.2 Dominant Position:**

a. **Indian Position on indentifying “dominance”**

Under the Indian Competition Act dominant position is defined as “position of strength, enjoyed by an enterprise, in the relevant market, in India, which enables it to

1. operate independently of competitive forces prevailing in the relevant market; or

2. Affect its competitors or consumers or the relevant market, in its favor.\(^23\)”

Analyzing the above definition, it can be construed that a dominant firm is a firm having substantial market power, substantial enough to act independent of the competitive forces that prevail in the market and further has sufficient power to influence competitors or consumers. The same can be due to deep pockets, larger market share etc. but it is imperative for such dominance to be abused to constitute an offence.

The Competition Act, 2002 (hereby referred to as the Act) displays a marked shift from the Monopolies and Restrictive Trade Practices Act (MRTP) as regards the definition of

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\(^{22}\) *Walker Process Equipments Inc. v. Food, Machinery and Chemical Corp.* 382 US 172

\(^{23}\) Section 4 (2) a – Explanation, Competition Act, 2002
‘dominance/ dominant position’ goes. Under the MRTP, a dominant undertaking was defined as one which “supplied, produced or controlled not less than one fourth of the total supply of that good or service in India”. That is to say that market share was the basic criterion on which the MRTP based the definition of ‘dominance’. The dominance had to be determined on the basis of figures published by such authority as would be specified by the Central Govt. and is to be reckoned in terms of the M.R.T.P. (Classification of Goods) Rules, 1971. Contrary to the MRTP, under Competition Act 2002 there has been a more case to case basis analysis and a flexible approach towards determining dominant position has been adopted. Under Competition Act 2002 an enterprise with a share of say less than 25% of the market could possibly be determined to be the “dominant” if it satisfies the criteria under the Act; on the other hand, an enterprise with higher market share may not be considered as “dominant” if it does not meet the criteria mentioned in the Act.

The Act also lays down a number of factors which the Commission needs to take into consideration in determining whether an enterprise enjoys a dominant position or not\textsuperscript{24}. In summation factors such as:

1. Market share of the enterprise
2. Size and resources of the enterprise
3. Size and importance of competitors
4. Commercial advantage over competitors
5. Service network
6. Dependence of consumers
7. Barriers to entry

\textsuperscript{24} Section 19 (4), Competition Act, 2002
Amongst others are indicative of the efficiency of the enterprise; and greater the efficiency, greater the dominance.

**DEFINITION OF DOMINANCE AND KEY ELEMENTS:** In *United Brands v. Commission*\(^{25}\) the courts defined the term dominant position as a “position of economic strength enjoyed by an undertaking which enables it to prevent effective competition Being maintained on the relevant market by giving it the power to behave to an Appreciable extent independently of its competitors, and ultimately of its Consumers.” In essence what seems the crux of the constitutive conduct indicating dominant position is the ability of such enterprise to act Independently of the consumers/ market forces; and the ability to prevent competition is an additional description and not a constitutive element\(^{26}\). Courts have reiterated the same in Hoffman-La Roche\(^{27}\) case. In summation the two constitutive elements are:

1) **Ability to prevent effective competition.**

2) **Power to behave to an Appreciable extent independently of its competitors, and ultimately of its Consumers**

However the definitions in both the above cases fail to recognize that the discipline of the demand curve precludes any firm from operating entirely independently of the market forces like consumers or more significantly competitors.\(^{28}\)


\(^{26}\) Richard Whish, Competition Law 179-80 (5th Ed. 2003)

\(^{27}\) *Hoffmann-La Roche v Commission* [1979] ECR 461

IMPORTANCE OF MARKET SHARE IN DETERMINING DOMINANCE: Another factor considered important in determining ‘Dominant position’ is the Market Share held by the enterprise. The courts in Hoffman stated that except in exceptional circumstances, having significant portion of market shares leads to a presumption of dominance. This is a fairly obvious presumption which although may vary due to value of market shares in various markets but the fact that a large portion of market shares are controlled by a company and over a period of time, is indicative of its “position of strength”. In Office of Fair Trading v W. Austin & Sons & Ors29, it was observed that whether a dominant position exists may be established by many factors, including high and persistent market shares. The ECJ however has clarified that although market share is not determinative if dominance it is definitely a consideration30. As regards a “cut-off” percentage of market the courts have as of this date failed to draw a line which is permanent therefore the decisions have varied from declaring firms with 50 percent or more31, to 45 percent32, 39.7 percent33 and even 20- 40 percent34. Under the Indian Competition Act, there is no specific provision with regard to the presumption of dominance where an undertaking has a very large market share. As the relevant provisions in this context have not been given effect to yet, the position on this point is unclear.


30 Section 19(3) Gesetz gegen Wettbewerbsbeschrankungen (GWB); See Also, Australian Position in Australian Competition & Consumer Commission v Australian Safeway Stores Pty Limited [2003] FCAFC 149 (30 June 2003)


33 Virgin/British Airways, 2000 O.J. (L 30) 1, 4 C.M.L.R. 999(2000)

34 EUROPEAN COMMISSION, TENTH REPORT ON COMPETITION POLICY 150 n.4 (1981)
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<th>S.no.</th>
<th>Country</th>
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<td>1.</td>
<td>Brazil</td>
<td>20%</td>
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<tr>
<td>2.</td>
<td>Canada</td>
<td>60%</td>
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<td>3.</td>
<td>Denmark</td>
<td>40%</td>
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<td>4.</td>
<td>Germany</td>
<td>50%</td>
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<td>5.</td>
<td>Israel</td>
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<td>6.</td>
<td>Poland</td>
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<td>7.</td>
<td>Norway</td>
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<td>8.</td>
<td>Russia</td>
<td>65%</td>
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<td>9.</td>
<td>South Africa</td>
<td>45%</td>
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<tr>
<td>10</td>
<td>United Kingdom</td>
<td>40%</td>
</tr>
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<td>11</td>
<td>U.S.A</td>
<td>70%</td>
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However, a OECD Paper on competition law and policy in the European Union has indicated that dominance may be contingent on other factors too, such as the number of competitors, barriers to entry etc. A finding of dominance is more likely if entry is difficult or there are no other firms of comparable size or with capacity to counter the leader’s strategies”. The determination of domination is contingent upon many factors aside from the ones included in the definitions and the concept of market shares such as; Innovation, by virtue of having a superior product\(^{35}\), affordable price, efficient distribution system\(^{36}\) amongst other factors also are by virtue of being evidences of efficiency are factors which help determining dominance.

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\(^{36}\) *United Brands Company and United Brands Continental BV v. Commission of the European Communities*, 1 CMLR at 487-488
ECONOMIC FEASABILITY
Legally the definition under Section 4 Competition Act seems to be conducive for the purposes of delimiting actions that shall constitute dominance however such a definition cannot be dealt as exclusive of any economic considerations, it is an absurd proposition economically that a firm may in ANY circumstances act independent of its consumers. The discipline of the Demand curve mandates that any enterprise act in consonance with its consumers.

Demand curve of a firm indicates the number of units of any commodity a firm may sell at a particular price. Typically the downward curve indicates that a firm shall sell more units of a certain commodity at a lower price. It is not generally possible for a firm to sell more units of a commodity at a raised price. This is equally applicable to both dominant and non dominant firms. Keeping in mind this economic consideration the legal definition in Section 4 and Hoffman case can be have such a classification i.e. a dominant firm would be one that could raise its prices higher than a non dominant firm without considerable effect to its demand, an example for the same would be company involved in the gasoline market or any other essential goods for that matter, where consumers may not significantly reduce consumption in case of price rise.
However, the 2nd part of the definition of Dominant Position i.e. the Power to *behave to an appreciable extent independently of its competitors, and ultimately of its consumers* seems economically incoherent therefore the essential focus on determining dominance must be the *ability to prevent effective competition*. In the practical sense dominance will essentially be the ability of any firm to price their goods above market price and still get the desired demand or have relatively lower impact on demand.

An example of such firm in a dominant position can be a firm enjoying a monopoly in a certain market.

### 2.3 ABUSE OF DOMINANT POSITION

In *United States v. International Harvester Co*[^17^], the Court citing the case of *United States v. United States Steel Corp*[^18^] observed that the law does not make mere size of a corporation, however impressive, or the existence of unfettered power on its part, an offence, there needs to be a misuse of such power for there to be any liability imposed on such firms. Different conducts have been expressly declared to amount to abuse of dominance under the competition laws of different jurisdictions. Legislators have merely included such acts as illustrations and not as an exhaustive list[^39^]. For instance The Competition Act lists specific practices as abuse; these include unfair or discriminatory prices or conditions, limiting or restricting production or technical or scientific development, denying market access, imposing supplementary contractual obligations


[^18^]: *United States v. United States Steel Corp*. 251 US 417

unconnected to the subject of the contract, and using dominance in one market to enter/protect another market. It is only if the enterprise’s behavior counts as ‘abuse’ in the five clauses of section 4 of the Act, that it is considered as abuse of dominance.

Conduct amounting to an abuse of dominant position may also be such that it affects its competitors or consumers or the structure of the market in its favor. This results when abuse of a dominant position would impair the ability of the competitors to compete as they would and consumers would, as a consequence, have to accept higher prices or reduced quality. Where the freedom of those constituting a market is eroded in this manner, the structure of the market is deemed to have been altered in favor of the dominant enterprise abusing its position.

In *Europemballage Corporation and Continental Can Company Inc. v Commission of the European Communities*[^40^], it was observed that, “Abuse may occur if an undertaking in a dominant position strengthens such position in such a way that the degree of dominance reached substantially fetters competition, i.e. That, only those undertakings remain in the market whose behaviour depends on the dominant one”. The behaviour of an undertaking may be considered as an abuse of a dominant position where the company through recourse to methods different from those used in normal circumstances, hinders the maintenance or development of competition and may affect trade conditions in a market[^41^].

[^40^]: *Europemballage Corporation and Continental Can Company Inc. v Commission of the European Communities* [1973] EUECJ C-6/72

[^41^]: *NV L’Oréal and SA L’Oréal v PVBA* Judgment of the Court of 11 December 1980.
The Indian Competition Act 2002 does not define abuse of dominance. According to Section 4 (2) of the Act,

“There shall be an abuse of dominant position under sub-section

1) If an enterprise—

   a) directly or indirectly, imposes unfair or discriminatory—

      i) condition in purchase or sale of goods or service; or

      ii) price in purchase or sale (including predatory price) of goods or service,

Explanation. — For the purposes of this clause, the unfair or discriminatory condition in purchase or sale of goods or service referred to in sub-clause (i) and unfair or discriminatory price in purchase or sale of goods (including predatory price) or service referred to in sub-clause (ii) shall not include such discriminatory condition or price which may be adopted to meet the competition; or

   b) Limits or restricts—

      i) production of goods or provision of services or market therefore; or

      ii) technical or scientific development relating to goods or services to the prejudice of consumers; or

   c) Indulges in practice or practices resulting in denial of market access

   d) Makes conclusion of contracts subject to acceptance by other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts; or

   e) Uses its dominant position in one relevant market to enter into, or protect, other relevant market”.
In the Microsoft case, for example, the allegation was that Microsoft which was dominant (having 95% share) in the operating software market abused its position to gain advantages in the market for applications software viz. internet browser and MP3 player. In the famous United Brands case in Europe, it was alleged that the company abused its dominance by refusing to supply to a long standing distributor and indulged in discriminatory prices by charging excessively in Denmark where it was dominant while it charged much less in Ireland where it faced effective competition. In another case, Rome Airport was held to be in abuse by refusing access to a competing airline caterer.

It is important to understand what actions shall constitute an abuse since, predatory pricing, which is the crux of this paper has been listed as an abuse of dominance. Under the Indian Competition Act ‘Predatory pricing’ is classified under Section 4 as an abuse of dominance.
CHAPTER 3: PREDATORY PRICING – Introduction

In the Indian context, predatory pricing is classified under Section 4 of the Indian Competition Act 2002 as an abuse of dominance. Predatory Pricing (PP) simply refers to a practice of driving rivals out of business by selling at a price below the cost of production.\textsuperscript{42} It is a commercial strategy by which a dominant firm first lowers its price to a level which will ultimately force its rivals out of the market. When the latter have been successfully expelled, the company can raise the prices again and reap the rewards.\textsuperscript{43} It is the use of short-run price cutting in an effort to exclude rivals on a basis other than efficiency in order to gain or protect market power and as pricing so low that competitors quit rather than compete, permitting the predator to raise prices in the long run. However what is important is what cost is too low? The exact meaning of the expression “too low prices” has always been difficult to establish. The question remains “Too low” with respect to what?

What are the costs that provide the relevant threshold limits; the predator’s profit-maximizing price? The predator’s costs? The prey’s costs?

Predatory pricing is “an investment in future monopoly, as sacrifice of today’s profits for tomorrow”\textsuperscript{44}. Generally a dominant company is the one that is likely to have both the inclination


\textsuperscript{44}Maher M. Dabbah; EC and UK Competition Law:-Commentary, Cases and Materials, Cambridge University Press.
and the resources to finance such strategy. Such pricing can be equally ‘unfair’ to competitors\textsuperscript{45}. PP is analyzed under antitrust/competition laws as illegal monopolization or attempt to monopolize\textsuperscript{46}. It is a form of abuse of dominance.

Predatory conduct is generally defined as conduct aimed at excluding business rivals on some basis other than efficiency\textsuperscript{47}. It is a specific form of exclusionary pricing conduct in which the predatory firm sacrifices short term profits in order to achieve long term gains.

The predator may cause injury by:

a. Exclusion of a rival from concerned market.

b. By disciplining rival enterprises.

c. Deterring parties from being able to enter the relevant market.

d. Lowering business of the competitor to the level that its acquisition cost may significantly reduce.

For the predation to be rational, the subsequent profits must mandatorily make up the losses incurred in the initial phase. Therefore there must be an alternative method by which the predator can outlast the other competitors through deeper pockets, cross subsidization etc. Such a precondition ensures:

(a) The alleged predator will be able to influence the market price; and

\begin{itemize}
\item \textsuperscript{45} Joanna Goyder and Albertina Albors –Llorens,Goyder’s EC Competition Law, Oxford University Press, pp319.
\item \textsuperscript{46} Matsushita Elect. Industrial Co. vs. Zenith Radio 475 US 574 (1986)
\end{itemize}
(b) Will have sufficient market power in the post-predation phase to charge supra-competitive prices.

Notably, predatory pricing is prohibited by Art.82 in the EC jurisdiction while under US law it is caught by S.2 of the Sherman Act\(^4\) and by the Clayton Act as amended by the Robinson-Patman Act\(^5\). The concern with this concept is the fact that price reduction may in fact be a bonafide act by the enterprise concerned\(^6\). In the age where companies are facing cut throat competition and the market is filled with companies and offering a plethora of choices for the consumer, it is hard to distinguish between fair, aggressive pricing (which is an essential ingredient of competitive markets) and unfair, predatory pricing.\(^7\) Pricing is not predatory merely because a company is lowering its price.\(^8\)

Price predation prima facie is irrational and should therefore be rare. It means compromising on even covering up the cost of production of the goods/services in question; therefore to sustain a loss for such a long period in an intensely competitive environment shall be significantly difficult. The skepticism with regard to predatory pricing being a practical threat was clearly echoed by the US Supreme Court in cases addressing predatory pricing such as the *Matshushita*


\(^6\) Einer Elhauge and Damien Geradin, *Competition Law and economics*, Hart Publishing, pp314


case stating that; “there is a consensus that predatory pricing schemes are rarely tried, and even more rarely successful.” The Court repeated this passage in its decision in *Brooke Group*.

First, a decision to engage in below-cost pricing is very costly, as it is unclear how long the prices have to be set below cost in order to drive out competitors. Second, the last firm standing must be able to raise prices to an anticompetitive level so as to recoup the losses it has suffered. Almost inevitably high prices invite new entrants, reducing the predator’s profits, making the strategy unworkable. The next few chapters shall elaborate upon how predation is in fact economically feasible and occurs in the markets.

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CHAPTER 4: FEATURES OF PREDATORY PRICING

Predatory business behavior has various forms, of both price non-price predation. Non-price predation often involves making excessive investments (in advertising, capacity building etc.) that have the sole purpose and likely effect of weakening or eliminating competition. The scope of this paper however is related to a specific category of predatory conduct, which is of pricing.

4.1 USP’S OF PREDATORY PRICING; WHY WOULD FIRMS RESORT TO PREDATION.

1) Recoupment -. The term recoupment in the grammatical sense means “to receive an equivalent for; make up for”. This is exactly what the predator aims to accomplish in the long run. The predator must have rational ground for expecting to recoup the losses that occur during the first phase of predation when he is selling below costs. Without such an expectation or pre planned method for recovery of losses (which are certainly going to be incurred through the course of predation) in absence of such expectation the entire concept of predation shall be rendered moot. The consumers shall certainly benefit from such reduction in prices; however a company with insufficient market power to sustain such losses in anticipation of future profits shall itself be ejected from the competition. Market power is a determinative factor to ascertain whether a firm is capable of recoupment at all. Recoupment can also be defined more broadly than merely retrieving the initial monetary losses. It could also be seen as a reputational benefit that occurs not only in the market where the predation
has taken place but in other markets where the predator is active. The predatory campaign could be, seen as an investment in reputation which could pay dividends in other geographic or product markets by deterring entry or disciplining rivals.  

2) **Alternative to mergers**: Predation remains the more preferred method of establishing a monopoly regime in a market by a dominant entity. This is because mergers shall result in significant loss of independence as the company shall have to share profits, and all benefits of a larger market share with the company with which merger has been done. Despite no losses being invoked in merger to gain monopoly. Firms prefer to adopt a “no sacrifice – no victory approach” and are willing to sustain initial losses because predation although an illegal practice, guarantees that the firm upon successfully eliminating competition can have exclusive market control.

### 4.2 PRECONDITIONS TO PREDATORY PRICING

Predatory pricing has been classified as an abuse of dominance in all significant jurisdictions, therefore for predation to occur, it is important that all the elements constituting abuse are met, i.e.; there must be dominance, the dominance must have been abused. Other significant requirements of Predatory pricing include Deep pockets, Barriers to entry, capacity. The preconditions are dealt in detail below.

1.) **Dominance**: Theoretically any enterprise may enter into predation for seeking a monopolistic position in the market, however what is important to analyze is whether it is

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55 Strategy, Predation and Antitrust Analysis (1981, S. Salop, ed.) at 640

56 Refer to chapter on “Abuse of dominance” for detailed analysis
practically feasible for entities to indulge in such practices. Practical analysis shall indicate a set of preconditions that necessarily need to be fulfilled before predation occurs, as has already been discussed, Predation results in significant losses for a sustained period of time, and if the companies do not fulfill the requirement of dominance, sustenance of these losses shall be next to impossible. There is a need of large capital reserves in order to sustain the losses during the below-cost selling period, which is most likely only present within large dominant firms. Secondly, it would make little sense for a company to sustain these losses and invest its capital when the market would remain relatively competitive as it would have no expectation of recoupment. This is a case when an already dominant firm can strengthen its position in the market and eventually have monopoly power in order to dictate the prices. Analysis of dominance must be with respect to relevant product and geographical market with regards to demand and demand substitutability of the product or services. Even if prey has a significant market power in which predatory pricing is taking place, the economic strength of the predator may derive from its position in other markets.

2.) **Barriers to entry and re-entry**: The practice of predatory pricing is an exclusionary practice by definition, as such for fulfillment of such exclusion, there must exist a certain level of entry barriers to the market. In absence of such barriers a victim of predation or other potential rivals would immediately re-enter the market once the predator raises its prices and by adding their output to that of the predator drive prices back to competitive level. The absence of such barriers shall hinder the recoupment expectations of the predator and it shall hinder its attempt to maintain supra competitive levels. Entry barriers exist when a new
market entrant faces costs that the incumbent predatory need not bear or no longer faces\(^{57}\), i.e., fixed cost investments etc. The entrant on the other hand must incur such costs and hence faces the risk of under-pricing by an incumbent with sunk costs, the latter acting as a barrier to entry, giving the incumbent the power to raise prices above the competition level. Re-entry barriers on the other hand exist when a firm that has left a market bears significant costs in seeking to reopen its business. In the absence of re-entry barriers the firm which has been forced to exit the market because it was unable to sustain the artificially low prices dictated by the predator could enter the market again once prices are raised to monopoly level, thus being able to undermine the predator’s pricing policy.

3.) **Deep Pocket requirement**: Having sufficient finances is imperative for predator to sustain practice of predatory pricing, deep pocket requirement is a part of dominant position, although deep pocket is not determinative of dominance it is a relevant consideration. Firms with multi-market operations can indulge in the practice of cross subsidization and hence continue funding the predation in one market based on finances acquired in another market\(^{58}\). Since in the first phase of a predatory scheme, i.e. when selling at artificially low prices, the predator will incur losses over a substantial period of time, it becomes clear that the predator’s financial resources must be greater than the ones of his rival and the latter will may not be as able as the predator to withstand losses.

4.) **Excess Capacity**: Increased demand is a characteristic response to reduced price, which is why a predator must necessarily have excess capacity to sustain the increase in demand. This

\(^{57}\) Bolton, Brodley, Riordan, Predatory pricing: Response to critique and further elaboration, Georgetown Law Journal, August 2001

\(^{58}\) Deutsche post AG OJ 2001L 125/27
is a fundamental prerequisite, because if the predator cannot accommodate the excess demand, there can be no recoulement of losses incurred. Also if he cannot increase supply to match demand then demand shall exceed supply and prices shall rise, which can reduce pressure off the competition in the market.

5.) **Additional Requirements:** Demand elasticity is an important though not essential condition to determine the success of predation. This statement is based on the premise that, the ultimate objective of predation shall be subsequent recoupment; a low price elasticity of demand facilitates recoupment as demand will decline relatively less when the firm raises the market price. If a predator enjoys greater brand popularity, the predatory pricing campaign shall be that much more plausible. The relative efficiency of the incumbent firm can also be examined. The more efficient the incumbent is to its rivals, the less expensive it will be conduct a predatory pricing campaign.

### 4.3 Working Mechanism of Predatory Pricing

1) **Deep Pocket Theory:** The classical theory of predation indicated a mandatory requirement of having deep pockets for a company to manage predation successfully; the same has been discussed in chapter 3 in detail. The theory regarding deep pockets however has been largely discredited as researches have indicated that firms having no substantial financial resources too may be successful predators; an instance of the same maybe when a firm is backed by investors.

2) **Financial market predation:** Modern analysis is more scientific and focuses at the origin of such predatory practices i.e by the relation between the prey and its investors. Suppliers of
capital can mitigate these agency problems by extending financing in staged commitments, thereby imposing an explicit or implicit threat of termination in case of poor performance\textsuperscript{59}. If the investors are debt-holders, they threaten to liquidate the firm or deny new credit in the event of default. If they are venture capitalists they refuse to extend additional financing when early performance is poor. And if they are shareholders, they decline to purchase additional equity if expected returns are low due to disappointing initial performance. Predatory pricing in product markets thus becomes possible when a predator exploits these termination threats to dry up the financing of a rival firm\textsuperscript{60}. The predator can reduce the prices so much that the profitability of the prey reduces so much that the investors stop providing funds to the prey. In summation investors who invest in the prey shall withdraw their investment owing to its poor performance. The target of the predator therefore is not just the prey; it includes the source of revenue of the prey.

3) **Reputation predation**: Other mechanism by which predatory pricing works is by establishing a reputation for aggressive pricing. For example, if a competitor is uncertain of a dominant firm’s cost, it knows, however, that firms with lower cost tend to price lower\textsuperscript{61}. Hence, if the dominant firm prices low in response to entry, this may suggest that its cost is low, and thus one can anticipate similar aggressive behavior in the future\textsuperscript{62}. This creates a ‘reputation’ in the market of a firm which is merely pricing its product low due to

\textsuperscript{59} Patrick Bolton,\textsuperscript{*} Joseph F. Bradley\textsuperscript{**} and Michael H. Riordan, PREDATORY PRICING:STRATEGIC THEORY AND LEGAL POLICY, pp56

\textsuperscript{60} Ibid

\textsuperscript{61} Malcolm R. Burns, Predatory Pricing and the Acquisition Cost of Competitors, Journal of Political Economy 94(April 1986), pp266-96

\textsuperscript{62} Ibid
low production cost. This not only gives the appearance of a legal setup but also deters new entrants in the market who may be skeptical about managing at such low costs.

4) **Signaling strategy** – Signaling is a market strategy by which firms can gauge the market conditions, however the same can be used to mislead firms into false analysis of market conditions. Using such signaling strategy, the predator lowers prices in order to mislead the prey and potential entrants into believing that market conditions are unfavorable. These strategies maybe extensively used to advance the predatory practice since a firm's decision to enter or to leave a market is necessarily based on its evaluation of expected future revenues and costs. By providing misleading market conditions the incumbent firm shall deter other entrants who may be of the opinion that entry into such a market will not be profitable. To the extent that an incumbent firm is better informed than others about cost or other market conditions, or can manipulate and distort market signals about profitability, it may be able to influence the expectations of its rivals through its pricing decisions or other actions.

4.1 **Cost signaling** - In cost signaling, a predator drastically reduces price to mislead the prey to believe that the predator has lower costs and to exit the market. More specifically, a predator trying to establish a reputation for low costs, cuts price below the short run profit-maximizing level. Observing the predator’s low price, the prey rationally believes that there is at least some probability that the predator has reduced costs. This lowers the prey's expected return and causes the prey to exit.
4.2 **Demand signaling** - In demand signaling, a better informed predator reduces price to convince the prey that market conditions are unfavorable and that aggregate demand is too low to justify either the continued presence of both firms in the market or a major expansion drive by the prey. The prey, falsely inferring a weak level of demand from the predator’s low price, may be deterred from expanding or even induced to leave the market. Demand signaling generally is implausible because it is unlikely that one firm can have superior information about aggregate demand, or that, even if that were so, a less informed firm could not retrieve this information from price and market share information.

5. **Test market predation** - The predator has better information than the potential entrant about the market and it makes the potential entrant believe that the situation is not favorable for it to enter. The predatory firm can charge a lower price for its product and leading the new entrant to believe that the demand is too low to justify entry into the market. The entrant believes that to be true and exit the market or enters the market on a smaller scale. By contrast, in signal jamming the predator openly cuts price in order to distort the test market results. As a result the entrant cannot ascertain market demand under normal conditions, but instead is able to observe demand for its product only under the exceptional circumstance of an ongoing price war. Thus, the entrant’s market test is foiled, and the entrant is unable to determine whether market demand for its product is sufficient to support entry.
CHAPTER 5: TESTS TO DETERMINE PREDATORY PRICING

Mc Gee a renowned scholar in the field of competition policy provided the economic theory for the identification of predatory behaviour by a firm. Mc Gee however has been significantly cynical with regards to the idea of predation being a real threat. However, examples of actual predation clearly existed. Stimulated by the growing number of observed instances of predatory pricing and the emergence of modern game theory which provided the tools to analyze complex strategic situations, economists developed new economic theories beginning in the early 1980's. It has been established through such economic analysis that the significant element in the determination of ‘predatory pricing’ is that of costs. Predatory pricing happens on below cost pricing, which brings before the authorities a significant dilemma of ascertaining, what kinds of costs must be considered in determination of predatory pricing. The CCI has therefore, after consultations with the ICWAI, put up the Draft CCI (Determination of Cost of Production) Regulations 2008 (‘Cost Regulations’) to determine the cost in predatory pricing cases under Section 4 of the Competition Act. It is essential to look at what types of costs may arise in an enterprise and, so, the basic cost definitions have been provided below.

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63 Mc Gee; By scrutinizing the case Standard Oil Company of New Jersey v US 221 U.S. 1, 47, 76 (1911) in 1958
65 Alison Jones and Brenda Sufin, EC Competition Law: Text, Cases and Materials, Oxford University Press, pp445
GENERAL COST PARAMETERS:

1) **Variable, fixed and total costs** – A firm’s cost can be divided into those that vary with output and those that don’t. Costs that do not vary with output are fixed costs; those that do are variable costs. The sum of fixed and variable costs are called total costs. Cost can be averaged over output and is termed as average cost.

2) **Marginal and incremental costs** – Marginal cost is the cost of producing an extra unit of output. It is a function of variable costs only, as fixed cost remains fixed with change in output. But a firm is rarely concerned with just the cost of one extra unit of output. It would be concerned with a larger increment in output, which is referred to as incremental cost. Formally, MC assumes a continuous cost function, whereas incremental cost is more generic and allows for increments that are larger than a single additional unit of output.

3) **Avoidable and sunk costs** – Fixed costs can be divided into recoverable or avoidable, or non-recoverable or sunk costs. For example, a lease on an office may be a sunk or avoidable cost. It could be made recoverable if the firm could sublet the lease of office to another firm for the rest of the contract period.

4) **Common and joint costs** – A final cost measure is unique to multi product firms, where a firms produces two or more products, it will need common costs, that is, costs that need to be incurred for the production of both products. It will also have joint costs where the production of one product will require production of another, inseparable product.
TERMS RELEVANT FOR DETERMINATION OF PREDATION

1) **TOTAL COST** According to Regulation 4(1) of the Cost Regulations “Total cost” means “the actual cost of production including the finance, administrative, selling and distribution overheads attributable to the product during the period of alleged predation”.

What this effectively includes are costs such as cost of material consumed, direct wages and salaries, direct expenses, work overheads, quality control cost, research and development cost, packaging cost, finance and administrative overheads attributable to the product during the referred period. The total cost is the sum total of the fixed and variable costs incurred by the company during production.

2) **TOTAL VARIABLE COST:** Regulation 4(2) states that the TVC means “the total cost referred to in sub-regulation (1) minus the fixed cost and share of fixed overheads, if any, during the period of alleged predation”.

Effectively what this cost includes are costs that vary with output, such as labor investments etc.

3) **AVERAGE VARIABLE COST:** Total variable cost divided by total output during the period of alleged predation” and finally the CCI states that the “‘Cost’ in Explanation (b) to Section 4 of the Act shall mean average variable cost unless the Commission decides otherwise”.

These are the economic definition of costs to be taken into consideration while accounting for predatory pricing.
The application of the definitions and terms as have been elaborated above is to test whether the behaviour of a certain firm is predatory in nature.

**BELOW COST TESTS:**

| ATC & AVC |

I. **AREEDA TURNER RULE**\(^{66}\)

This is the most widely used rule of below-cost price-cutting. Areeda and Turner (1975) suggested that pricing below short run marginal cost was inconsistent with normal profit maximizing behavior\(^{67}\).

i) Short run costs

ii) Prices shouldn’t be below **Short Run Marginal Costs**\(^{68}\) of providing product or service, else they shall be deemed predatory, unless it is higher than ATC.

iii) Since marginal costs are difficult to determine, they would substitute them with AVC as a more practical alternative\(^{69}\).

The rule proposed a single per se standard based on average variable cost—the average unit costs of producing the product excluding fixed costs. The advantage of such a rule, focusing solely on price-cost comparison, is its simplicity which avoids complicated structural analysis or


\(^{67}\) Alison Jones and Brenda Sufin, pp319

\(^{68}\) Marginal cost is the marginal increase in expenditure for the increase in output by one unit. Marginal cost is relatively high at small quantities of output; then as production increases, marginal cost declines, reaches a minimum value, then rises.

\(^{69}\) Jean Tirole , *The theory of industrial organization*, MIT Press,pp373
subjective enquiries about the intent of the alleged predator. It establishes an objective, uniform test for all kinds of predatory behaviour.

A firm with ‘market power’ in a purely static setting will always set output so the market price exceeds short run marginal cost. In these circumstances, if a firm is observed setting price below short run marginal cost then this may reflect a predatory intent. On the other hand it is this simplicity that has been criticized for not taking into account the broader economic and strategic aspects of predatory pricing and for only achieving rough justice by relying merely on cost data.

**SUMMARY:**

Commodity priced below Short Run Marginal Cost (AVC) indicates that Cost of production is not being compensated for therefore it indicates predatory intent. Predatory conduct is possible where an undertaking price above its AVC and below its ATC.

For example prices can fall below ATC due to sudden fall in demand. While the sales do not cover the ATC, they still cover all variable costs and a part of the fixed costs. In AKZO, the European Court held that if prices are above AVC and below ATC, conduct is to be regarded as predatory where it can be established that the purpose of the conduct was to eliminate a competitor.

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70 William L. Greene, American Bar, Predatory Pricing (Monograph / American Bar Association, Section of Antitrust Law), Section of Antitrust Law

71 Maher M. Dabbah, PP401

PRICING BELOW AVERAGE TOTAL COST

Greer (1979) proposed an alternative to the Areeda-Turner rule based on average total cost. Pricing below average total cost should be viewed as predatory only if it is accompanied by “substantial evidence of predatory intent” 73.

An average total cost test is clearly stronger than one based on average variable costs, and is often stronger than one based on short run marginal costs. A firm makes a loss if price is below average total cost but the firm is still profit maximizing by continuing production so long as price does not fall below average variable cost 74. Intent therefore becomes fundamental in such circumstances.

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73 (Greer 1992, Business, Government and Society, p166)

74 Indeed, and in contrast to Greer, Carlton and Perloff (1994, p390) note that “[a] strength of the Areeda-Turner rule is that it explicitly recognizes that pricing below average total cost is not, by itself, proof of predatory behavior. Indeed price often is below average total cost in competitive industries such as agriculture due to short-run demand or supply fluctuations”.
Although the above test rationally indicates the AVC standard as the threshold below which pricing of commodities shall not be feasible for any company and in fact shall indicate predatory intent. However the courts must consider certain exceptional circumstances under which pricing below the AVC shall be legitimate. Some legitimate commercial reasons for pricing below AVC are⁷⁵:

a. **Loss leading**- it occurs where a retailer cuts the price of a single product in order to increase sales of other products. It would not be considered illegal unless it was clear that the intention was to eliminate the competitor.

b. **Short run promotions**- this involve pricing below AVC for a limited period of time to introduce a new product in the market. However a series of short term promotions could, taken together amount to predation.

c. **Network effects**- there are some services where the addition of more customers to the network adds to the value of the service sold to existing customers⁷⁶. In these circumstances, it can be beneficial to sell the part of the service to the customer at below AVC. This will encourage the expansion of the network and the undertaking can recoup the losses by charging higher prices for other related services. Example: Gas agencies.

d. **Economies of scale and new products**- In some cases an undertaking may introduce a new product to the market at a loss making price in order to build up a large enough customer base to allow it to achieve the benefit from economies of scale, at which point the price would become profitable.

⁷⁵ *International and Comparative Competition Law* Maher M. Dabbah, pp400-401

⁷⁶ Network effects may also be relevant for goods as well as services
e. **Unanticipated shocks**- in some markets demand or costs can be volatile and difficult to anticipate. For e.g. in some cases an undertaking may temporarily fail to cover its AVC because of unanticipated increase in input costs, or unanticipated reductions in demand.

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**Pricing below AAC- Average avoidable Costs**

Problems with calculating fixed and variable costs and the problem of allocating fixed and variable costs between products led to the greater use of average avoidable for below-cost testing. Avoidable costs is that cost that will not be incurred if an activity is suspended; also called escapable cost. For example, it is the cost that can be saved by dropping a particular product line or department (e.g., salaries paid to employees working in a particular product line or department). All costs are avoidable, except (1) sunk costs and (2) costs that will continue regardless of the decision. The idea behind the avoidable cost test is like that behind an average variable cost test. A firm may engage in predatory pricing if any combinations of its products generate revenue that fails to cover the avoidable cost of the combination, even if every product in the combinations priced above its average avoidable cost. This can occur whenever there are common costs of producing the group of products. These common costs do not enter any individual products avoidable costs, but are part of the product group’s avoidable cost.

What this means is that the company can be alleged of carrying out predation when if the combination of products generates lesser revenue than in case when such combination was avoided. Common costs exceed revenue generated via combinations.

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Often the AAC benchmark is the same as the AVC benchmark because only variable costs can be avoided\(^79\). A rational firm would not like to sell at prices below the AAC, as it makes more economic sense to exit the market than to remain in it at current prices. AAC would include the variable costs and all fixed costs that are not sunk, so they can be escaped if the firm exits the market.

Avoidable costs generally include:

1) Labor, materials, energy, use-related plant depreciation, promotional allowances and other variable costs;

2) The non-sunk portion of product-specific fixed costs, otherwise known as quasi-fixed costs; and

3) Incremental fixed and sunk costs associated with sales generated by the firm during the period the low pricing policy is in place.

The AAC test has the advantage of no segregation between fixed and variable cost, and also that includes additional fixed cost from the alleged predatory campaign.

\(^79\) Einer Elhange & Damien Geradin, pp336
INDIAN STANDARD
The Indian competition law has adopted AVC as the appropriate measure of cost, which is by and large the measure of cost adopted in all jurisdictions. There is a presumption in most cases that where the enterprise sets its sale price below its AVC, it has engaged in a predatory pricing practice. However, prices falling between the ATC and AVC are also subject to inquiry, but in such case specific intent would have to be shown. Prices set above the ATC are unlikely to be challenged. The CCI also has proposed certain regulations with respect to determining cost in cases of multi-product enterprises (Reg. 5), Joint products and By-products (Reg. 6), transfer pricing (Reg. 7) And captive consumption (Reg. 8). Once a predatory price allegation is established, the enterprise would be said to have abused its dominant position. Where after inquiry, the CCI finds that an enterprise in a dominant position is in contravention of the provisions of Section 4, it may pass any of the orders specified under Section 27 of the Act and may further under Section 28 of the Act direct the division of an enterprise enjoying a dominant position to ensure that such an enterprise does not abuse its dominant position.
CHAPTER 6: RECOUPMENT

Paul Joskow and Alvin Klevorick suggested using a two stage approach to identifying predatory pricing.\(^{80}\) The first stage would require an examination of the market structure to determine if the structure is likely to permit predation to be successful. For example, if the entry barriers are low, the finding would be that predation is not likely to be a viable strategy, and the case would not be pursued.\(^{81}\) The second stage would use the cost-based or pricing behavior tests as described above.\(^{82}\)

The term recoupment essentially means “To receive an equivalent for or, to make up for”. Study of predatory pricing essentially can be said to revolve around this concept alone. Competition administrators across jurisdictions seek to prevent practices having adverse effect on competition, to promote and sustain competition in markets, and at the same time protect consumer interests. In the most simple terms what the main concern of competition administrators is that MC=AR= P i.e price levels in the markets are maintained.

Predation involves a company which voluntarily prices its commodity below a competitive price. What is more important to note is that predation is generally the domain of dominant firms, therefore these firms have the capacity of charging well above the competitive price. The real question arises that; why then, do these companies sacrifice all the profits by selling at abnormally low prices?

\(^{80}\) Paul L. Joskow and Alvin K. Klevorick, A Framework for Analyzing Predatory Pricing Policy, Yale Law Journal 89 , pp213-70

\(^{81}\) Alison Jones and Brenda Sufin,PP319

\(^{82}\) Ibid
The real test remains for predatory pricing to be rational is whether a company can recoup its losses, and if so how. The same is dealt with under the recoupment test.

This test assumes that predatory pricing is happening and questions whether it is likely to succeed in light of the characteristics of the relevant market, the predator firm and its target(s).\(^\text{83}\) Specifically this test aims to determine whether a firm’s predatory pricing campaign would be likely to eliminate and deter competition, and whether it is likely that the predator firm will then be able to amass at least enough supra-competitive profits to recover the losses it sustained during the attack.\(^\text{84}\).

In the United States, recoupment is deemed the ultimate object of an unlawful predatory pricing scheme. “[I]t is the means by which a predator profits from predation. Without it, predatory pricing produces lower aggregate prices in the market, and consumer welfare is enhanced.”\(^\text{85}\)

This raises the question of how any price-cutting can constitute taking advantage of market power.

Canada also uses recoupment as a screen (along with price-cost screens) to avoid over-deterrence and chilling legitimate price competition.\(^\text{86}\) Even in the case of alleged predatory pricing the Irish

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\(^{83}\) In the AKZO judgment recoupment of the loss by the dominant firm occupies an important place, though the ECG did not indicate that it is necessary to show that it was possible for the dominant firm to recoup the loss to prove the existence of predatory pricing.

\(^{84}\) Some US courts have required proof of recoupment as a key component of the offence of predation; Joskow and Klevorick ‘A framework for analyzing predatory pricing policy’ (1979) 89 Yale Law Journal 213


\(^{86}\) Canadian Competition bureau the agency has investigated and will continue to investigate allegations of predatory pricing when it appears likely that competition has been or will be lessened or prevented substantially as a result of the practice
Competition Authority incorporates a recoupment test into its analysis\textsuperscript{87}. The European Commission states that recoupment is relevant to the assessment of predation cases under Article 82 EC when examining whether the dominant firm will increase its market power through predatory pricing. The European Commission will examine whether there is a deliberate sacrifice and whether the dominant firm’s conduct increases or maintains prices above the anticompetitive level afterwards and thereby harms consumers. The latter reflects likely recoupment.

Fact remains that EC has time and again down played the role of recoupment in establishing recoupment as a requirement for proving predatory pricing. Additionally even the Community Courts do not apply the recoupment test (they do not necessarily require evidence that the predator will be able to recoup its losses through monopoly pricing after having driven out its competitors) and focus primarily on the relationship between the prices charged and costs, combined with an element of intent\textsuperscript{88}.

On 2 April 2009, the European Court of Justice (ECJ) dismissed as partially inadmissible and partially unfounded France Telecom's appeal against the Court of First Instance's (CFI's) judgment of 30 January 2007, which upheld the European Commission's (the Commission) finding that France Telecom had abused its dominant position on the French market for high-speed internet access between March 2001 and October 2002 (the Judgment).

The Judgment is of importance in two principal respects. First, it confirms that in EC law it is unnecessary to show that a dominant undertaking must have a reasonable prospect of recouping

\textsuperscript{87} The Irish Competition Authority’s approach to the assessment of predation complaints is outlined in the Irish Competition Authority’s Drogheda Newspapers Note.

\textsuperscript{88} Bloch, Robert E. et al : A Comparative Analysis of Article 82 and Section 2 of the Sherman Act’
its losses in order to prove the abuse of predatory pricing, which is contrary to the position under US law. Secondly, it clarifies that it will not be a defence to an allegation of abusive conduct in all circumstances for a dominant undertaking to show that it was aligning its prices with those of its rivals, and therefore meeting competition in the market.

However in this regard, the author seeks to put the stand of the US courts as more prudent, than that of the ECJ, this is because what the ECJ judgments fail to consider is that the mere elimination of competition by price reduction, although anti competitive in nature shall not serve any purpose in terms of business strategy of the so called ‘predator’. Even if the predator manages to eliminate competition in the market but fails to recoup the losses, the predation would have been unsuccessful as the company self destructs in the process. It is therefore the authors’ opinion that test such as "selling below cost plus recoupment" is not merely relevant, but in fact an important factor, because intent is at the heart of the offence. Market Power has been regarded as important in determining dominance of the firm, which is fundamentally important to establish abuse. A firm does not possess "substantial market power" if it does not have the power to recoup all or a substantial part of the losses caused by price-cutting by later charging supra-competitive prices. Therefore recoupment is a fundamental element in determining a claim of "predatory pricing". It enables a court to avoid getting into the messy area of cost analysis, examination of various accounting figures and competing expert evidence on the question of what are the relevant costs".
The proposed three-step structured rule of reason is the following:

1) The sacrifice of short-run profits (actual sacrifice)

2) The negative impact on rival profitability which may induce a prey to exit, reduce its scale or stay out of the “sacrifice” market or closely related markets (likely exclusion)

3) The ability to recoup the initial profit sacrifice by exercising increased market power after the predatory phase (likely recoupment).

**Case laws supporting the recoupment requirement:**

1. **Brooke Group Ltd. v. Brown and Williamson Tobacco Corp**\(^{89}\): Courts held that “First, a plaintiff seeking to establish competitive injury resulting from a rival's low prices must prove that the prices complained of are below an appropriate measure of its rival's costs. … The second prerequisite to holding a competitor liable under the antitrust laws for charging low prices is a demonstration that the competitor had a reasonable prospect or a dangerous probability, of recouping its investment in below-cost prices.”

2. **Cargill, Inc. v. Monfort of Colorado, Inc**\(^{90}\): It was observed that predatory pricing may be defined as pricing below an appropriate measure of cost for the purpose of eliminating competitors in the short run and reducing competition in the long run. It is a practice that harms both competitors and competition. In contrast to price cutting aimed simply at increasing market share, predatory pricing has as its aim the elimination of competition. Therefore for it to be successfully established both conditions, elimination of competition and recoupment must be taken into consideration.

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\(^{90}\) *Cargill, Inc. v. Monfort of Colorado, Inc* 479 U.S. 104 (1986)
"For the investment to be rational, the [predator] must have a reasonable expectation of recovering, in the form of later monopoly profits, more than the losses suffered." Recoupment is the ultimate object of an unlawful predatory pricing scheme; it is the means by which a predator profits from predation. Without it, predatory pricing produces lower aggregate prices in the market, and consumer welfare is enhanced.  

**ECONOMIC CONSIDERATIONS**

Predatory pricing is defined in economic terms as a price reduction that is profitable only because of the added market power the predator gains from eliminating, disciplining or otherwise inhibiting the competitive conduct of a rival or potential rival. More precisely a predatory price is a price that is profit maximizing only because of its exclusionary or other anticompetitive effects. The anticompetitive effects of predatory pricing are higher prices and reduced output (including reduced innovation), achieved through the exclusion of a rival or potential rival. But such a definition does not state an operational legal rule. It is therefore necessary to base the legal rule on tractable measures such as cost, market structure, and recoupment.

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92 Patrick Bolton,* Joseph F. Brodley** and Michael H. Riordan,pp94-96

93 Ibid
Pre and Post Entry situations\textsuperscript{94}

\begin{figure}[h]
\centering
\includegraphics[width=0.5\textwidth]{figure.png}
\caption{Pre entry situation with normal competition}
\end{figure}

In the above figure consider a monopolist facing a market demand curve $D(p)$. Initially the firm is pricing at the profit maximizing level of $P(m)$ where $MR$ is equated with $MC \left[ C(I) \right]$. The entrant prices at $P^\wedge(I)$, so the incumbent firm’s demand is now $D(I) (p(I); P(E) = P^\wedge(E))$, which is less than its demand before entry as part of the incumbent firm’s demand has been taken by the competitor. As the competitor lowers its price more the more part of incumbent firm’s demand it takes. Therefore, the incumbent’s demand is dependent on the price charged by the entrant. Now with new demand, the new marginal revenue curve is $MR'$ where the new profit maximizing price is $P^\wedge(I)$.

\textsuperscript{94} W. KIP Viscusi, Joseph E. Harrington Jr. , John Vernon, pp306-307
The above figure depicts the situation of the entrant after it has entered into the market. Now with the entrant’s demand curve $D(E)$ ($P(E); P(I) = P^*(I)$) the optimal price level that it can charge is $P^*(E)$. Therefore in equilibrium each firm charges the price which maximizes its profit given by the rectangle under the price and the AC curve.

Above two situations indicate the situations that exist in ideal competition scenarios, it is but obvious that as per Figure 1: When there is a new entrant in the market then the reduced prices of such and entrant to squeeze their way into the market shall diminish demand of the existing firm in the market. The diminishing demand of the existing firms in the market is directly attributable to the diminished prices being offered in the market by the new Entrant.

Figure 2 indicates the entrants’ perspective in the market in terms of profit maximization in the new market; the entrant has his profit amount subject to market forces.
I- Incumbent Firm

II- E- Entrant Firm
In figure A as is evident the incumbent firm is proceeding with an aggressive pricing policy to drive the entrant’s profits low by pricing at $P'' (I)$ which is below $P^*(I)$. The demand curve has shifted to $D(E), (P(E); P(I)=P''(E))$ as depicted in figure (B) and the profit maximizing price $P''(E)$ is lower than $P^*(E)$ and the entrant now incurs a loss as the price is below the AC curve, indicating that the incumbent firm has successfully reduced the demand of the entrant firms.

Also the incumbent’s profit maximizing price $P'(I)$ [figure (A)] is higher than the price $P''(I)$, which maximizes the current profit. Now this situation is a case of possible predation as the incumbent is charging a price which is below its profit maximizing price to drive the entrant out of the market and to earn monopoly profits later on.

**SUMMARY:**

I. **Figure 1:** When there is a new entrant in the market then the reduced prices of such and entrant to squeeze their way into the market shall diminish demand of the existing firm in the market. The diminishing demand of the existing firms in the market is directly attributable to the diminished prices being offered in the market by the new Entrant.

II. **Figure 2:** Indicates the entrants’ perspective in the market in terms of profit maximization in the new market; the entrant has his profit amount subject to market forces.

III. **Figure 3:** Incumbent firm (Possible Predator) aggressively prices below the ideal profit maximization level to drive out the competitors, in other words the Incumbent firm sacrifices potential profit to dent the Demand of the entrant (Figure B), which is accompanied by price below AC
PROFIT UNDER PREDATION

![Profit Pattern Under Predatory Pricing](image)

The above figure shows the profit pattern under the predatory pricing. In response to an entry an incumbent has two options, either to accommodate or to price aggressively to drive the entrant out of the market. Under accommodation the incumbent can maximize current profits and under aggressive pricing its current profits are reduced but the future profits will be higher after the exit. Now predation is preferred over accommodation as the value of the near term forgone profit is smaller than the value of the long term profit again.\(^9^5\)

\(^9^5\) W. KIP Viscusi, Joseph E. Harrington Jr., John Vernon, pp309
CONCLUSION

Predatory pricing is a very perplexing and puzzling topic for the anti-trust communities of many countries. Critics of predatory pricing argue that it is not a rational strategy to be pursued by the firms. The problem is that it is very hard to distinguish predatory pricing from other desirable competitive price cutting. The antitrust laws should adequately curb the predatory pricing without overly deterring competitive price cutting.

SUGGESTIONS

1. Antitrust courts should make use of the economic evidences in detecting predatory pricing. Also economic evidences are now able to show the rationality of predatory pricing like the possibility of recoupment which is an essential element in determining the rationality of predatory strategy of a firm.

2. It is also necessary for the anti-trust authorities to make sure that the market structure supports the prospects of predatory pricing. This requires a complex analysis of the markets where anticompetitive effects have occurred or are probable. This includes defining the dominance of the predatory firm, the barriers to entry, and the market power of the competitors.

3. As in the AKZO test the intention of the firm becomes the crucial factor when the prices are between AVC and ATC. Since such pricing is considered to be non-predatory as the firm is covering its variable costs and some parts of its fixed cost. However the anti-trust authorities should make a difference between intention of eliminating the competitors on the basis of performance which is the case under normal competition and
elimination of competitors by anti-competitive practices such as predatory pricing. The courts should also consider direct and indirect evidences in proving the act of predation. Direct evidences include documents from the company such as a detailed plan demonstrating the use of predatory prices to exclude a rival, to prevent entry or evidence of concrete threats. Indirect evidences include the scale, duration and continuity of the low pricing, the possibility of recoupment etc.

As per the Competition Act, 2002, predatory pricing has been clearly defined but it is jurisprudence that will decide the workable method of assessing predatory pricing claims. The provisions of the Act on predatory pricing have been provided again as follows - sale of goods or provision of services, at 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 competitor. Regulations on cost also need to be made by the Commission under the powers conferred under Section 64 (2) (a) of the Act.96

Since these regulations will be made on the cost of production of the enterprise, these will be Imperative in determining how a cost-based test will be applied in India and according to the cost of production and we will see what relevant cost benchmark is taken into consideration while looking at below-cost pricing. Pricing below this benchmark determined by the Commission when accompanied with intent (with a view to reduce competition or eliminate the competitors) provides to the Commission a prima facie case of predatory pricing. Now, the statutory provisions provided under Article 82 EC bear striking resemblance to the provisions of the new Act. This resemblance is in terms of the necessity of intent and below-cost pricing which are

96 S.64. (2) In particular, and without prejudice to the generality of the foregoing provisions, such regulations may provide for all or any of the following matters, namely:— (a) the cost of production to be determined under clause (b) of the Explanation to section 4
seen as the two necessary conditions for the predatory pricing claim to succeed. However, like the EC, predatory pricing is dealt with under the provision of ‘abuse of dominance’. This means that dominance is a pre-requisite at the time of executing a predatory pricing strategy. Hence, dominance as a result of the predatory pricing strategy escapes this Provision, as does ‘attempt at monopolization’. To catch this out, the Commission should try a weighted study of factors suggesting dominance as under Section 19 (4) and pay more attention to factors like ‘financial strength of an enterprise’ and less attention to factors like size, market share etc. An analysis of market structure and the dominance of the incumbent enterprise seems to be a useful starting point for assessing alleged predatory pricing. This analysis would serve to eliminate from further inquiry many situations where successful predation is unlikely to occur. Once this is proved, cost-based analysis obviously must play an important role but other factors relating to the firm’s overall strategy should also be taken into account when judging whether, on balance, a pricing strategy can be considered to be monopolization or an abuse of dominant position.