

# Evaluating the U.S Policy Tradition on Predatory Pricing

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*As Owen Graham-O'Regan notes, the “robber barons” of the American industrial age have now been replaced by much more modern counterparts in the form of big tech companies such as Google, Facebook, Microsoft and Amazon. Just as the unscrupulous behaviour of the robber barons had to be reined in, so too must authorities begin to clamp down on modern anticompetitive behaviour. Graham-O'Regan evaluates the current policy employed to punish those who participate in anticompetitive behaviour, finding it to be sorely deficient in its scope and ability to charge misbehaving firms. His paper focuses specifically on predatory pricing policy, which employs the “cost” and “recoupment” criteria to gauge whether or not a firm is acting anticompetitively. However, as is argued, the cost and recoupment criteria both often overlook predatory behavior that harms consumer welfare. The flaws in the criteria are especially visible as today's firms increasingly engage in nonprice competition and operate in multiple markets. Graham-O'Regan seamlessly interweaves both economic and legal theory to produce a compelling argument for the requirement for much improved anticompetition policy in the United States. It is for this reason that his paper has been recognized as the “Best Freshman Paper” of the Student Economic Review XXXIV.*

## **I. Introduction**

In the United States, probes into the anticompetitive behavior of firms have reemerged at state and federal levels (Stucke & Ezrachi, 2017). Over the summer of 2019, the Department of Justice and the Federal Trade Commission (FTC) began investigating market-dominating firms such as Google, Facebook, and Amazon: firms akin to the 19th Century “robber barons” (McKinnon, 2019). Today, politicians, such as presidential candidates Elizabeth Warren and Bernie Sanders, warn that the foundations of the U.S economy are once again held by a powerful few (Meisenzahl, 2019). Steel and oil trusts have been replaced by internet and technology giants. Firms with mounting market dominance are readily able to abuse positions of power and stifle efficient markets. U.S. antitrust policy evolved to prioritize consumer welfare. The FTC outlines policy goals that “protect consumers by stopping unfair, deceptive or fraudulent practices in the marketplace” (Federal Trade Commission, n.d.). Consumer welfare is robust when markets optimize overall efficiency: both static and dynamic efficiency. Statically and dynamically efficient markets optimally allocate resources in the short run and reduce price while increasing quality of goods over the long run (Gundlach & Moss, 2015: 92-93). To protect consumer welfare, courts must protect these market efficiencies. Competition amongst firms drives market efficiencies by rewarding firms that effectively employ resources to create the best consumer product (Brozen, 1969: 659). Harm to the competitive nature of a market inhibits the efficiencies that benefit consumers. To combat inefficiency, the U.S Supreme Court passed multiple acts intended to extinguish anticompetitive behavior. The Sherman Antitrust Act of 1890 prohibited anti-competitive agreements or attempts to artificially monopolize a market [15 U.S.C. §§ 1-7 (1890)]. This was followed by the Clayton Act of 1914, banning price discrimination along with anti-competitive mergers and acquisitions [15 U.S.C. §§ 12-27 (1914)]. These acts curbed a multitude of harmful business practices, but one practice in particular still causes great confusion amongst judges and policymakers. The practice of predatory pricing has faced inconsistency and controversy in both law and academia. As the Justice Department and Congress revive dormant antitrust policy, they must examine the current state of the legislative tradition addressing predatory pricing. The current tradition is insufficient, omitting numerous forms of inefficient predatory behavior.

## II. What is Predatory Pricing?

In competitive markets, prices fall as firms enter a market. When competitors enter, incumbent firms must decrease their prices to operate at a profit-maximizing output (see Figure 1). Marginal revenue decreases as the incumbent firms' consumer demand shifts from  $D(p)$  to  $D_1$ . Their new profit-maximizing output represents a lower price, shifting from  $P^m$  to  $\hat{P}_1$ . This is the desired outcome for consumers, who gain surplus from lower market prices.

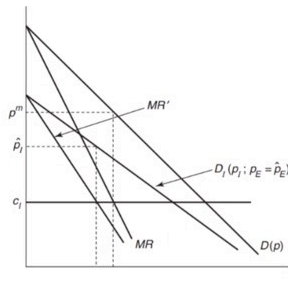


Figure 1 Post-entry situation with normal competition. Graph from (Viscusi et al., 2018: 335).

Not all price decreases, in response to competition, are considered beneficial to consumers. Predatory pricing (henceforth, PP) occurs when an incumbent firm specifically focuses on reducing the number of entrants or competitors in a market. The incumbent firm employs PP by lowering prices beyond the profit-maximizing point where marginal cost is greater than marginal revenue (see Figure 2). This is represented by the shift from  $\hat{P}_1$  to  $\bar{P}_1$ .

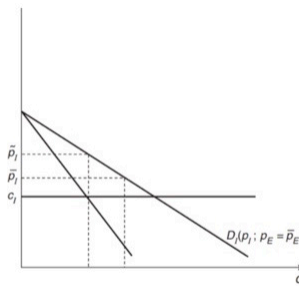


Figure 2 Post-entry situation with predatory pricing. Graph from (Viscusi et al., 2018: 336).

To remain competitive, rival firms must match the price decrease, possibly incurring losses for every unit sold. This potentially forces firms into bankruptcy or deters them from continuing investment in the market. The incumbent firm continues predation until all current or potential competition exit the market. At this point, the predator increases prices to a supracompetitive level, gaining monopoly profits. This behavior harms consumers by potentially driving out firms operating as or more efficiently (operating at an equal or lower marginal cost) to the predatory firm. While equally or more efficient, these firms may lack sufficient reserves to outlast the predatory period or be discouraged by low investment returns in the market (Viscusi et al., 2018: 336). The removal of these firms decreases the market's overall efficiency, causing consumer surplus to fall. Facing supracompetitive prices, consumers must pay more than in an efficient market. This anti-competitive behavior is illegal because it artificially monopolizes a market, falling under section 2 of the Sherman Antitrust Act [15 U.S.C. §§ 2 (1890)].

*The Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.* case of 1993 set the precedent for Supreme Court policy on PP over the last three decades. The case required the plaintiff to prove prices were below an appropriate measure of the predator's costs and demonstrate a "reasonable prospect" of the predator recouping all profits lost during predation (*Brooke Group v. Brown & Williamson Tobacco, 1993*). This policy design fails to avoid type 2 errors, overlooking realistic and harmful forms of predation.

### **III. The Cost Rule**

Post-Brooke policy requires the demonstration of both below-cost pricing and a strong probability of recoupment for a firm to be convicted for PP. We can examine each criterion independently to observe the legitimacy of the post-Brooke tradition. First, we will inspect the cost rule: a criterion derived from Areeda and Turner's (1974) predation test, which attempted to provide a convenient rule for courtroom analysis. They believed pricing below a firm's short-run marginal cost was sufficiently predatory (1974: 712). Their argument stipulates that if a firm chooses to price below "avoidable" or "incremental" costs, it is clear "the firm cannot rationally plan to maintain this low price; if it does not expect to raise

its price, it would do better to discontinue production” (*Barry Wright Corp. v. ITT Grinnell Corp.*, 1983).

Pricing below one’s cost is considered harmful to consumer welfare because it can drive an equally or more efficient firm from the market (Gifford, 1994: 448). To use accessible data, Areeda and Turner (1974: 716) substituted short-run marginal cost with a firm’s short-run average variable cost. The post-*Brooke* decisions continue the tradition of requiring price to fall below a similar “measure of incremental cost” for liable predation (*Brooke Group v. Brown & Williamson Tobacco*, 1993). However, the below-cost rule may not always allow for legitimate rulings as Areeda and Turner believed.

Asymmetric information game (AIG) models involving predation suggest the predator’s costs are irrelevant. For those assuming markets have perfect information, a predator must sacrifice sufficient revenue by cutting prices to drive their competitors out of the market (McGee, 1958: 140). The predator would only harm efficiency if it forced competitive firms to incur losses and drove them to bankruptcy. However, AIG models realistically assume markets have amounts of asymmetric information (Giocoli, 2014: 292). In predatory campaigns, it is unlikely the prey has full knowledge of the predator’s costs. They are unaware if price cuts are due to increased efficiency or predatory campaigns; it is unclear whether the predator can maintain low prices. Under conditions of asymmetric information, a predator will not have to drive competition to bankruptcy, but simply “discourage competitors from entering, or remaining in the market by manipulating their beliefs” (Giocoli, 2014: 295).

Examples of manipulation strategies include signaling predation and test-market predation. Signaling predation occurs when a firm signals to competitors that their costs are low and that they can aggressively respond to market entrants (Milgrom & Roberts, 1990: 125-126). In AIG, firms may be discouraged from continuing operations if the predator signals the ability to aggressively cut prices in response to competition. This type of predation shows little relation to the predator’s real marginal costs, but simply aims at artificially manipulating “rivals’ expectations of future profits” (Giocoli, 2014: 296). The second form of a manipulation strategy is test-market predation. Before entering a market, firms employ market tests to gain information on potential profitability. Incumbents can utilize PP to manipulate the entrant firm’s test data, causing the prey

to face prices much lower than natural market settings. The manipulated data suggests the market has limited profitability, deterring the prey's entrance and artificially limiting competition in the market (Bolton et al., 2000: 2311-2312). Again, the success of predation does not depend on the predator's costs, but rather the manipulation of the prey's expected profitability in the market. The use of predator's costs to determine predation seems irrelevant in real-world markets where information is often asymmetric. Firms can deter competition simply by manipulating market information. Since this strategy of predation involves distorting known market conditions (prices), the predator's real unknown costs tell us little about the harm to competition. Rivals leave the market due to beliefs of unprofitability relating to their own costs and not the real, unknown costs of the predator.

A predator can even harmfully manipulate market conditions without pricing below their costs. A low-cost monopoly may fight competition by cutting prices below the costs of entrant firms but above their own costs. If a market provides economies of scale, entrants can reduce market prices as their marginal costs fall, increasing consumer welfare. However, if the low-cost monopoly adopts such a pricing strategy, new firms may be deterred or forced from the market before developing economies of scale (Edlin, 2002: 956). The monopoly will be able to reinstate high supracompetitive prices, recouping any forgone profit from the price cut. This harmful predation goes unrecognized if courts continue to rely on below-cost pricing.

#### **IV. The Cost Rule & Consumer Data Predation**

The below-cost rule is also irrelevant when competition does not involve the pricing of goods. Increasingly, consumers interact with firms that offer "free" products. Consumers pay in other ways, such as by providing their personal data which firms sell to advertisers (Esayas, 2018: 1). Companies like Facebook and Twitter do not compete using product pricing and instead "compete in a market for information about users" (Waller, 2012: 1784). These firms could employ predatory campaigns by limiting or stopping their sales of data to clear the market of competition. Consumers predominantly value online privacy, meaning firms can enhance privacy policies "as a way to attract and retain users" (Harbour

& Koslov, 2010: 793). Consumer surplus expands when a firm increases the consumer's data privacy and limits the sale of data. A firm offering the product with greater consumer surplus may be able to capture consumers from their competitors and drive competitors from the market. While they initially forgo data sales, the firm is able to demand and sell supracompetitive amounts of consumer data once the market clears of competitors. This would force consumers to provide greater quantities of personal data than in a competitive market. The monopoly gains their position through inefficient means, injuring consumer welfare. Predatory firms cannot be charged with this harmful business practice if below-cost pricing is considered a necessary criterion. No recognizable price change occurs in the consumer market and the predator is not undercutting prices of data in the advertiser market. While this model exhibits both predation and recoupment, the below-cost rule fails to reveal these predatory intentions.

## **V. The Recoupment Rule**

The post-*Brooke* rulings require evidence of a “reasonable” or “dangerous probability” of the predator recouping all losses incurred during predation (*Brooke Group v. Brown & Williamson Tobacco, 1993*). Predatory firms must raise prices to supracompetitive levels after their predation extinguishes competition. The price increase and the duration of monopoly conditions must be sufficient to recoup all losses the predator incurred during the price-cutting period. Several scholars and judges believe PP “is only harmful when the predator succeeds in recouping the losses it suffered by its earlier below-cost pricing” (e.g. *W. Parcel Express v. UPS, 1998*). Below-cost pricing is only considered damaging once the predator erases any consumer surplus derived from price-cutting and begins creating a net loss in total consumer surplus by charging supracompetitive prices (Leslie, 2013: 1708).

Recoupment tests are used prior to the below-cost pricing rule, as analysis of below-cost pricing is resource-intensive. The recoupment tests are utilized to filter illegitimate cases, limiting the expense of court resources (Leslie, 2013: 1706). Necessary conditions for probable recoupment include high market concentration, high barriers to entry, and the predator's capacity to supply the demand once rivals have left the

market (*Cargill, Inc. v. Monfort of Colorado, Inc.*, 1986). A defendant firm only needs to disprove one condition (*AA Poultry Farms, Inc. v. Rose Acres Farms, Inc.*, 1989). Since probability of recoupment is necessary to prove PP, court analysis requires accurate results. However, courts can make poor rulings through the recoupment test, overlooking certain predatory strategies that injure the consumer.

Similar to the cost rule, the recoupment rule often fails to recognize strategies attempting to manipulate beliefs and expectations of rival firms. A prominent oversight occurs when analyzing a market's barriers to entry. The recoupment rule specifies that recoupment requires sufficient barriers to entry in the market. These barriers inhibit new competition from entering the market after the predatory campaign, allowing the predator to maintain monopoly conditions and fully recoup their losses. The current policy is deficient in its scope of possible barriers to entry. It fails to recognize the manipulation of the prey's beliefs as a real barrier to entry. For example, the reputation of price-cutting derived from predatory behavior can discourage new firms from entering a market during the recoupment period (Trujillo, 1994: 821-822). Entrant firms face the threat of possible future predation which would force them to incur losses. Even if a market lacks structural barriers, entrants can be sufficiently deterred given the predator's reputation of acting aggressively towards competition. The threat of predation itself acts as a barrier to entry and may increase the profitability of PP through greater probability for recoupment. If courts fail to recognize reputational strategies as sufficient barriers to entry, predator firms may be found innocent of PP even when they successfully recoup their losses by maintaining an artificial monopoly.

Some courts have narrowed their assumptions of how recoupment occurs. They assume predation and recoupment occur in the same market (Leslie, 2013: 1720). However, the predator may operate in multiple markets: cutting prices in one market and recouping losses in another. Robert Bork (2003) outlines an example of this behavior in the case of Microsoft. Microsoft held monopoly power in the operating system market, however increasing competition and innovation in the internet browser market would mean consumers would become less reliant on Microsoft's operating system. Microsoft created its own browser, Internet Explorer, and gave it away for free. By undercutting the browser market, Microsoft



faced losses of over \$100 million a year. However, this quelled competitive advancement in the internet browser market which would have led to the obsolescence of Microsoft's operating system. Thus, Microsoft was able to recoup losses from Internet Explorer by protecting its monopoly position in the operating system market (Bork, 2003: 47-56). In this case, recoupment would be unrecognizable if courts only observed the internet browser market where price-cutting occurred.

Courts may make the wrong assumptions on the probability of recoupment. However, it is also possible that the probability of recoupment is irrelevant to consumer injury. Courts outlaw anti-competitive monopolization because it harms efficient competition and consumer welfare. If so, courts should fight any predation harmful to consumer welfare even if it fails to result in monopolization. The current policy requires a strong likelihood for successful monopolization shown through the probability of complete recoupment. This overlooks the negative effects of PP that does not completely recoup losses. During predation, consumers are initially better off when the price of a normal good decreases. After predation, the predator increases prices, producing at a monopoly level of output. Consumer surplus shrinks, making consumers worse off than in a competitive market. It is irrelevant whether the duration of the post-predatory period is sufficient for the complete recoupment of losses. As soon as the firm increases prices to a supracompetitive level, consumers are injured by decreasing consumer surplus. By fabricating a monopoly, the predator limits the market's dynamic efficiency: the optimization of prices and quality for consumers in the long run (Gundlach & Moss, 2015: 93). The initial consumer surplus created by price cuts is irrelevant to the current consumers who are harmed during the recoupment period, facing the damages of an inefficient market (Leslie, 2013: 1742).

Even the initial consumers, appearing to benefit from the low prices, can be harmed by the inefficient effects of below-cost pricing. Below-cost pricing results in overconsumption of a good as consumers change consumption patterns based on erroneous beliefs of a good's scarcity and the market demand. This causes consumers to divert resources from more efficient allocations. Consumers may also be willing to adopt fixed costs to consume at these low prices if they assume the current price level will continue (Leslie, 2013: 1743). This can be seen as a damage to static efficiency: the optimal allocation and cost-effective

utilization of resources.

Below-cost prices of the predatory period and supracompetitive prices of the recoupment period both potentially harm consumers independent of the predator's ability to fully recoup losses. Thus, the recoupment criteria of PP policy can lead to uncharged, yet harmful predation. This represents a type II error in the current policy whereby predators who do not fully recoup losses can still harm consumer welfare.

## **VI. Conclusion**

The current policy tradition of U.S courts inadequately addresses all forms of predatory pricing behavior. The cost and recoupment criteria both overlook predatory behavior that harms consumer welfare. Flaws are especially visible as today's firms increasingly engage in nonprice competition and operate in multiple markets. This demands a re-evaluation of what courts consider to be evidence of liable behavior. However, in this endeavor, it is important that courts avoid chilling legitimate competitive behavior by constricting the capabilities of efficient firms.

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