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DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE

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ROUNDTABLE DISCUSSION ON PREDATORY FORECLOSURE

-- Note by the United States --

This note is submitted by the Delegation of the United States to the Competition Committee FOR DISCUSSION at its forthcoming meeting (14-15 October 2004).

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1. Types of Predatory Foreclosure.

1. For the purpose of this discussion, we will define predatory foreclosure as a unilateral act in which one firm seeks to impose costs on its rivals with the aim of reducing competition. The instruments chosen by a firm to accomplish this may or may not involve its own price. A wide class of predatory foreclosure strategies involves acts that lose money, in some relevant sense, in the short term. The classical example of this is, of course, predatory pricing, which involves setting price below marginal cost, at least conceptually. The presumed goal of doing so is to induce rivals to exit, making the market less competitive and allowing the "predator" to more than recoup the short-term losses associated with its predatory conduct.

2. To prove a predatory pricing claim, the plaintiff must be able to show that the defendant firm has priced below a good estimate of marginal cost. In addition, a predatory pricing claim must pass the recoupment test. The need for a recoupment test may not be self-evident, yet it serves as a valuable safeguard against confusing aggressive, pro-consumer competition with anticompetitive conduct. The recoupment test demands, in effect, that the plaintiff demonstrate that predation is plausibly a rational strategy. In particular, if the plaintiff cannot demonstrate that the short-term losses associated with its actions will be recouped by supracompetitive pricing in the long run, we are left with several unanswered questions, none of which bode well for the plaintiff. Among these questions are the following: Does the plaintiff's theory imply that the defendant firm is irrational, losing money in the short run for no apparent long run gain? Is the measure of cost presented by the plaintiff flawed? Is the plaintiff's theory of the case itself incorrect? For these reasons, predation claims in the U.S. are disciplined by the recoupment test.

3. That said, classical predatory pricing theory, which involves below-cost pricing by the predator, has come in for a great deal of criticism. Three of the more fundamental criticisms are (1) it may be hard to define the appropriate measure of cost; (2) even apparently below-cost pricing can at times have efficiency justifications (as with penetration, or promotional pricing) and (3) there must exist long run entry barriers that will make recoupment possible.

4. Apart from acts of predatory foreclosure that involve short run losses, there may exist strategies that are exclusionary, that reduce competition, but do not involve short run losses. Recently, competition authorities have been focusing their attention on types of foreclosure that are likely to be less costly methods of foreclosure than predatory pricing, which may be termed "cheap exclusion." Examples of "cheap exclusion" include abuse of government processes, abusive litigation, and possible misuse of standard setting processes by one firm in ways that make rivals less able to compete.

5. In this discussion, we will cover both predatory foreclosure related to pricing and what have been called "cheap" foreclosure activities.

2. Predation at the Margin.

6. One fairly recent case involving predatory foreclosure was a determined effort by the Department of Justice (DOJ) in *Unites States v. American Airlines.* In this case, the Division argued that certain actions undertaken by American Airlines involved incremental short run losses. To make such conduct rational, the Division further investigated whether these incremental losses could be recouped in the long run. As we will see, the American Airlines conduct at issue did not involve losing money on a market-wide basis, but rather on its incremental additions to capacity. In that sense, it can be distinguished from a textbook predatory pricing case. Nonetheless, the main elements of the case are useful illustrations of how such a case might proceed.

7. In the mid-1990's, American Airlines ("AA") had a large hub at the Dallas-Fort Worth, Texas airport ("DFW") and, the Division contended, substantial power to set rates on at least 30 city-pair routes. Competition from so-called low-cost carriers ("LCCs") began to surface. LCCs can pose a competitive threat to dominant carriers, such as AA at DFW, because they have significantly lower operating costs than the major airlines. For example, when ValueJet created a mini-hub in Atlanta, Georgia, Delta Airlines lost $282 million in annual revenue from its Atlanta hub. Delta's experience in Atlanta so worried AA that it created an internal Task Force to develop a strategy to make LCCs unprofitable at DFW. The Task Force concluded that any such strategy would be very expensive in terms of AA's short-term profitability because it would include adding capacity to significantly reduce the amount of traffic an LCC could capture. Nonetheless, because AA had determined that a successful LCC hub at DFW would jeopardize at least $252 million of AA's annual DFW revenues, AA went ahead and added significant extra capacity on routes threatened by nascent LCC competitors.

8. The Division's investigation concluded that, in five separate episodes, AA added excess capacity in order to drive a competing LCC off the route. AA overrode its own capacity planning models and added at least 3 - and in some cases as many as 5 - seats for each additional passenger that AA gained on these routes. And in each case, after the LCC exited the route, AA reduced capacity and increased its prices. Using AA's accounting system data, the DOJ staff was able to determine that the cost of the additional capacity exceeded the revenues generated by that capacity, demonstrating a money-losing sacrifice indicative of predation.

9. In developing its theory of the case, the staff was faced with the Court's decision in *Brooke Group Ltd. V. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993). *Brooke Group* holds that in a predatory pricing case the plaintiff must show that the defendant priced below an "appropriate" measure of cost and also has a dangerous probability of recouping its predation losses. These prerequisites presented two major challenges. First, how does one show price below cost, at least for the marginal unit of capacity? Typically, this analysis employs marginal cost and, because marginal cost is so difficult to compute, usually its proxy - Average Variable Cost ("AVC"). In this case, it was undisputed that AA's route-wide performance on the five routes at issue was profitable, *i.e.* that price exceeded route-wide AVC in each instance. But because the addition of capacity was AA's mechanism for predatory foreclosure, the Division argued for an incremental analysis. In particular, did the cost of the capacity additions exceed the revenues generated by that added capacity?

10. The second *Brooke Group* challenge was demonstrating AA's likelihood of recouping these incremental losses. The Division argued less that AA's "investment" in predatory foreclosure was profitable on the individual routes subject to the predatory acts, and more that it was designed to deter future entry on numerous other, "out-of-market" routes. Part of the payoff, that is, would be from deterring formation of an LCC-hub that would threaten as much as $250 million of AA's annual DFW revenues. Significantly, most of the recoupment would have come from markets <u>other</u> than the ones in which the acts of predatory foreclosure took place.

11. The district court, unfortunately, refused to accept the incremental analysis of AA's capacity additions and concluded that route-wide AVC was the only "appropriate" measure of cost. It held also that each of the Division's four alternative cost tests (each of which were based on AA's accounting data) was unreliable for one or another reason, including that none measured actual incremental costs. Finally, the court rejected the government's out-of-market recoupment theory and held instead that recoupment must be shown on each individual predation route.

12. The Division appealed and argued that predation is conduct that makes no business or economic sense except for its ability to exclude competition. It explained that adding costly, largely unfilled capacity was the mechanism AA used for stealing passengers from the target LCCs and that AA

expected this strategy to prove successful. Moreover, AA knew that this process would be very costly in the short run, but that the losses on the five routes where foreclosure occurred (which were quantified at $41 million) were acceptable because AA was protecting $250 million in annual revenue.

13. Although the court of appeals affirmed the district court, it did not disagree with DOJ's theory. It agreed with the DOJ's broad position that although courts should continue to approach predation cases with caution, they should not treat them with the incredulity that once existed. In making this proclamation the court relied on recent literature that explains predatory pricing can make sense in a multi-market scenario. The court also rejected outright the district court's holding that route-wide AVC is the only appropriate cost measure, because in certain circumstance a market-wide approach could mask a particular predatory scheme (as we had argued it did in the AA case). The court also recited uncritically the Division's incremental cost test and then proceeded to consider whether each of the proposed cost tests were valid as a matter of law. Ultimately, it affirmed the district court on the narrow ground that all of our cost tests were factually flawed because they relied on cost allocations and, therefore, were not "precise" in computing AA's "actual" cost of adding the challenged capacity.

14. Significantly, the court did not address the Division's recoupment theory at all. The court easily could have affirmed if it agreed with the district court's in-market only theory. The fact that it did not do so, in conjunction with the court's own statement that a multi-market scenario of predatory foreclosure can make sense, appeared to signal acceptance of the Division's theory of recoupment.

15. In sum, in addition to the court of appeals express rejection of market-wide AVC as an exclusive measure of cost, the Antitrust Division believes that the court of appeals' decision is a precedent from which to argue, at least through inference, that incremental cost analysis is a correct measure in appropriate foreclosure cases (although a solid basis for accurate and reliable cost computation will likely be required), and that multi-market recoupment is a viable legal theory.

3. Cheap Exclusion.

16. Another type of predatory foreclosure has been called "cheap exclusion." This often involves some form of misuse of regulatory or legal processes. The Federal Trade Commission (FTC), in particular, has focused on such activities over the past few years. These activities are likely to be fairly easy to distinguish from procompetitive ones. The FTC has looked for cases where predatory foreclosure activities are (1) cheap, (2) effective in yielding durable market power, and (3) unlikely to generate plausible, cognizable efficiencies.

17. Many anticompetitive activities of this type occur in one of the following settings, although the list is by no means exhaustive: (1) Abuse of governmental processes – such as lying to obtain a patent; incumbents taking advantage of laws that require potential entrants to obtain government permits by such tactics as filing objections to applications; or acting through regulatory boards that are dominated by incumbents; (2) Abusive litigation – where dominant firms file lawsuits for the sake of exclusion rather than on the merits; (3) Opportunistic abuse of a standard setting process – such as by strategic falsification of representations regarding patents held and applied for to groups setting standards for evolving technology goods. This is not to say that a dominant firm commits an antitrust offence every time it seeks a patent, invokes a franchising law, files a lawsuit against a rival, participates in a standard setting organization, or inflicts monetary harm on a rival. These behaviours violate the antitrust laws where and only where they lead to or maintain durable market power and reflect inefficient (such as opportunistic or fraudulent) conduct, rather than competition on the merits.

18. A cheap exclusionary strategy that causes a firm to gain or to maintain market power can be especially pernicious where it makes the resulting market power durable. If, for example, incumbents are

able to restrict entry into a regulated industry merely by filing objections to applications by potential entrants, this can be virtually costless, but highly effective. Moreover, it can be much cheaper for incumbents to object than for entrants to surmount the objection, and the mere fact of the objection creates a very powerful barrier to entry. Also, if a standards setting organization is powerful and is respected, its standard may define a relevant market, so that a firm that is able to manipulate the process may gain market power at small direct cost to itself. This is especially true given the potentially large costs of changing a standard once an industry is locked into it.

4. Additional Comments.

19. Under the category of predatory foreclosure, other activities deserve mention. One of them is what might be called "predatory excess capacity." Obviously, many factors determine the amount of capacity that a firm chooses to construct, and most are consistent with the promotion of efficiency. These factors include projected demand growth and technological change. Capacity investment can, however, in certain limited circumstances, facilitate monopolization. As a practical matter, an enforcement agency is going to have a very tough time disentangling these effects, particularly in view of the possibility that what looks like excess capacity once it has been built may simply have been the result of honest errors in forecasting demand, rather than a device to threaten low-prices to deter entry (or threaten credibly to punish rivals for deviating from a high-price strategy).

20. Entry to discipline attempted predation might be dissuaded by informational asymmetries possessed by an incumbent due to its greater experience in the market. Such asymmetries can create uncertainty in the minds of potential entrants, helping to deter entry. Indeed, something like this is the basis for the famous Milgrum-Roberts limit-pricing model. As the basis for enforcement, however, we are skeptical. Why couldn't the entrant reduce the informational asymmetry by hiring employees away from the incumbent? Why couldn't it commission studies of the market and technology? Isn't there usually more than one incumbent to make this even easier?

5. Conclusion.

21. Predatory foreclosure covers a variety of practices designed to make a market less competitive by handicapping rivals. Historically, predatory pricing has been the practice most studied under this heading. Although predatory pricing is certainly significant, it is also of interest to study "cheaper" forms of foreclosure. These strategies involve conduct that may cost the predator less, or nothing at all, while at the same time reducing the amount of competition faced by the firm engaging in these practices. None of this is to say that such practices are being widely used to reduce competition, or that there are no risks of incurring costs from falsely concluding in a particular case that a problem exists when the conduct in question is actually benign. It does, however, argue in favour of competition authorities devoting attention to such practices and intervening when the evidence clearly warrants doing so.