Predatory Pricing and Section 36

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1. Preliminaries

In this paper I address three questions:

First, what are we to make of the Privy Council decision in *Carter Holt Harvey v Commerce Commission*, and how did NZ get to have the (lack of) competition law provisions around predatory pricing that the Privy Council tells us we have?

Second, would (indeed, could) the Privy Council have reached the same decision in *CHH* if the 3rd Circuit Court decision in *LePages v 3M*, and the US Supreme Court's denial of *certiorari* in that case, had been before them in the course of their deliberations?

Third (and assuming that you have allowed me to reach my anticipated conclusions on the first two), now that *Brooke* is dead, recoupment is recognized as amorphous at best, Areeda-Turner is gone, and clients want guidance in the light of *LePages* and *Michelin* about their bundled discounts and tying practices, what are you to tell them?

At the start, I'd better nail my own intellectual colours to the mast. On the topic of predatory pricing I stand with the dissenting minorities both of the Privy Council in *Carter Holt Harvey* and of the Australian High Court in *Boral*. On bundled discounting I stand with the European Court in *Michelin* and the US Third Circuit Court in *LePages*. I accept that in New Zealand the law is as the superior courts declare it to be, but upon close anatomical inspection it can nevertheless turn out to be an ass. Our Parliament has work to do.

2. *Carter Holt Harvey v The Commerce Commission*

Many in this room were, I hope, brought up short by the decision of the Privy Council in *Carter Holt Harvey v The Commerce Commission*[1].

Let me remind you of the salient facts[2]. A CHH subsidiary, INZCO, manufactured and sold throughout New Zealand a range of home insulation products including

[1] Decision delivered 14 July 2004, [2004] All ER (D) 235 (Jul); [2004] UKPC 37; [2006] 1 NZLR 145.

Thick Pink Batts. The firm was dominant, which means it definitely possessed a substantial degree of market power. INZCO found its product line confronted, in the Nelson region, by a locally-produced substitute for Pink Batts named Wool Bloc, which was differentiated by the fact that it was made of wool, and hence was able to advertise on the basis of being more environmentally friendly than synthetics such as fibreglass batts.

Not only was the Wool Bloc product distinguished by branding characteristics that gave it a marketing edge in the eyes of many buyers; it also turned out that the local manufacturer, New Wool Products (NWP) could produce the insulation considerably more cheaply than INZCO was able, even after extensive R&D, to produce and deliver a competing wool-polyester mix.

The distribution structure in the insulation market was significantly imperfect, relative to a competitive benchmark. Building-supply merchants in the Nelson area seem to have been in an arrangement or understanding of some sort with INZCO to carry that company's range of building products with some degree of exclusivity, whereas Wool Bloc was sold directly to users and was not stocked on the shelves of building supply merchants.

Place yourself briefly in the shoes of a building-products merchant in a putatively competitive environment. A highly competitive new product has entered the market, and is rapidly winning customer acceptance and eroding the market share of the products you currently stock. You might well suppose that your first reaction would be to ask NWP for supplies of Wool Bloc so that you can offer your retail customers a full range of cost-competitive products to meet their insulation needs. Even if NWP were unwilling to sell to merchants at wholesale[3], a sharp-eyed merchant in a fully-competitive market would surely look at joining the queue of retail buyers of Wool Bloc in order to put the product on its shelves, at a price including a margin to cover the selling costs, to attract custom from buyers interested in one-stop-shopping for a bundle of items and uninterested in seeking out the small local manufacturer to obtain Wool Bloc directly. A nationwide chain of hardware stores, receiving news of the new product, might even have seen a competitive opportunity and offered NWP a nationwide distribution arrangement in competition with Pink Batts.

Such was not, however, the actual course of events[4]. Instead of stocking the new low-cost Wool Bloc product, the Nelson merchants appealed to INZCO to supply a wool-based product that would "enable them to compete with Wool Bloc". Finding that INZCO could not supply such a product at a competitive price, the merchants

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2 For the detail, see the High Court judgment in (2000) 9 TCLR 535.

3 It is unclear how hard the merchants tried to secure supply from NWP. Paragraph 83 of the High Court judgment (per Williams J) describes negotiations between the merchants and NWP in intriguingly cloudy terms, which the Privy Council paragraph 20 translates into an unequivocal "NWP had been free to sell its product through merchants if it wanted, but it had made a commercial decision not to do so" – a statement which, with due respect, entirely begs the question of whether a commercial decision in the other direction would have been (a) possible, and (b) to the long-run benefit of consumers.

4 Notwithstanding the assertion, repeated by the Privy Council at paragraph 13, that INZCO's distribution agreements "were continually under threat of defection".

did not go back to again approach NWP for supply. Instead they continued to lobby INZCO to bring down the price of Wool Line.

[The story here is presumably a variant on the so-called "Chicago Three-Party Argument" discussed in a recent review by Farrell[5] and in detail by Bernheim and Whinston[6]. The game begins with an incumbent supplier, INZCO, and an incumbent (coalition of) buyers, the merchants, already mutually committed to a exclusive marketing arrangement. A new product (Wool Bloc), with costs lower than those of the incumbent supplier of Pink Batts for which Wool Bloc is a close substitute, presents the merchants with a choice between changing supplier or simply using the threat of NWP's entry to extract rents from their existing upstream partner, INZCO. INZCO then acts in conjunction with the merchants to try to force NWP out by marketing the new fighting brand of wool-polyester insulation, Wool Line, at a price 17-28% below INZCO's supply cost and below the full-cost price of Wool Bloc to final users. The fall in price resulting from this action expands market demand, thereby raising the total surplus available to INZCO and the distributors, but enabling the distributors to capture more than 100% of the increase, leaving INZCO worse off in relation to its Wool Line revenues, but secure in the affections of its distributors.]

The Commerce Commission rapidly ran an Areeda-Turner ruler over the cost and price information, and prosecuted INZCO for predatory pricing. At roughly the same time in Australia, in another building-products case, and on the basis of similar price/cost data, the ACCC embarked on prosecution of Boral for selling its concrete blocks below cost. Having succeeded in the High Court[7] and the Court of Appeal[8] the Commission's case was rejected by the Privy Council[9] on the basis that INZCO was doing no more than compete vigorously, in the process benefiting consumers, and so had not breached section 36. (The ACC met much the same fate in the Australian High Court[10].)

The majority in the Judicial Committee of the Privy Council found that INZCO was dominant and had undoubtedly had the purpose of driving Wool Bloc out of the market, but that it had not "used" its position of market dominance to do so[11]. The majority argued (para.40) that "the effect of preventing a monopolist from

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5 Farrell, J., "Deconstructing Chicago on Exclusive Dealing", *Antitrust Bulletin* 50(3): 465-480, Spring 2005, section III pp.463-478.

6 Bernheim, D. and Whinston, M., *Anticompetitive Exclusion and Foreclosure through Vertical Agreements*, CORE lecture, Centre for Operational Research and Economics, Université Catholique de Louvain, Belgium, 2000.

7 *Commerce Commission v Carter Holt HarveyBuilding Products Limited*, CL.27/95, reported in (2000) 9 TCLR 535.

8 *Carter Holt Harvey Building Products Group Ltd v Commerce Commission*, November 2001 decision, (2001) 10 TCLR 247.

9 *Carter Holt Harvey Building Products Group Ltd v Commerce Commission* decision delivered 14 July 2004, [2004] All ER (D) 235 (Jul); [2004] UKPC 37; [2006] 1 NZLR 145.

10 *Boral Besser Masonry Ltd v Australian Competition and Consumer Commission* (2003) 195 ALR 609.

11 The new s.36 wording of "substantial degree of market power" and "take advantage of" makes no perceptible difference to the logic (such as it is) of the judgment. The whole conceptual background to the test of "using" or "taking advantage of" market power is fraught with difficulty.

competing with its competitors like everyone else would be to protect inefficient competitors". Their Lordships did not provide any satisfactory explanation of how a "monopolist" could have "competitors" to "compete with like everyone else"[12]; nor did they address directly the possibility that allowing "monopolists to compete like everyone else" might destroy efficient competitors to the detriment of consumers. They concluded, however, that (para 53) "the margin between legitimate competition and anti-competitive conduct is not crossed by the lowering of prices. It is crossed when the dominant firm uses its ability to *raise* prices without losing its market share". The Judicial Committee majority thereby adopted the so-called "recoupment" rule for identifying "use of a dominant position" in the context of alleged predatory pricing, as the Australian High Court had done in *Boral*[13].

Having adopted this rule, the majority found against the Commerce Commission on the basis of the co-called "counterfactual test" from *Telecom v Clear*[14] , and New Zealand's only predatory-pricing prosecution to date had failed.

3. The Counterfactual Test

The Privy Council majority noted with apparent surprise that (para 50) "It is evident that the courts below showed a marked lack of enthusiasm for what has come to be known as the counterfactual test". A brief review of the application of that test by their Lordships in *CHH* rather quickly shows how difficult it is to sustain enthusiasm, or even suspension of disbelief.

Start with the crucial section in which the majority's decision was explained (paras 67-68):

> There must … be a causal connection between the dominant position and the conduct which is alleged to have breached section 36. That will not be so unless the conduct has given the dominant firm some advantage that it would not have had in the absence of its dominance. It is the ability to recoup losses because its price-cutting has removed competition and allows it to charge supra-competitive prices that harms consumers. Treating recoupment as a fundamental element in determining a claim of predatory pricing provides a simple means of applying the section without affecting the object of protecting consumer interests……
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> Their Lordships are not persuaded that the facts which were found proved in this case show that INZCO's conduct, in the face of strong competition

12 This is not a new problem. Following the *Telecom v Clear* judgment there was much talk in New Zealand of monopolists behaving "as otherwise-similar firms would do in a competitive market", a formulation which remained unintelligible to many observers including the present author, despite diligent attempts in the mid 1990s to extract a coherent translation from Commerce Commission and Ministry of Commerce officials.

13 *Boral Besser Masonry Ltd v Australian Competition and Consumer Commission* (2003) 195 ALR 609. The *Boral* precedent is explicitly cited as authority in the Privy Council judgment at para 60(c).

14 (1995) 1 NZLR 385.

> from NWP and in response to the demands of its distributors, was any different from that which a non-dominant firm of equivalent financial strength would have resorted to in the same circumstances. …… [T]here was no evidence that the '2-for-1' pricing of Wool Line was resorted to by INZCO with a view to charging supra-competitive prices at a later date on that or any other products. ….. The price level had been set by NWP, and no-one could sell a product comparable to Wool Bloc at a higher price and remain competitive. Without the offer of a comparable product to that of its distributors INZCO was at risk of losing its market share….
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> ….[F]rom start to finish it was the need to compete in the South Island regional market that was the driving force. This was not conduct in which INZCO was using, and thus abusing, its position of dominance.

Notice in particular two things the Privy Council says here:

- Recoupment, in the form of a causal connection between the price war and the charging of "supra-competitive prices at a later date on that or any other products….", is essential to prove a claim of predatory pricing and the necessary evidence was lacking in the *CHH* case. In writing this at paragraph 68, their Lordships seem to have forgotten their previous apparent acceptance at paragraph 48 of Ralph Lattimore's (and the Court of Appeal's) view that the price of Pink Batts had always included high margins amounting to "super-profits", which meant that the pricing being defended by the INZCO attack on NWP was indeed "supra-competitive". The most generous interpretation of the Judicial Committee's argument that I can offer is that, knowing that supra-competitive prices are not a breach of the Commerce Act 1986, and accepting that INZCO had started out with enough market power to charge such supra-competitive prices, the Board decided that protecting those not-illegal monopolistic margins - by destroying new entrants threatening to compete them down - provided some sort of legitimate business justification for deploying all the resources that any financially-strong firm in any market could have mustered in an attempt to crush a new entrant. How the clearly-intended maintenance of the existing supra-competitive pricing of INZCO's Pink Batts, post-predation, was to be distinguished from recoupment was not explained by their Lordships - let alone how consumers were in some way supposed to come out ahead.

- The actions taken by INZCO were in some sense an example of normal and legitimate business practice and in accordance in some way with economic notions of rationality and competitive behaviour. This is admittedly a loose translation of the passages above but, as will be seen shortly, it seems to be what the Board meant to say.

Let us turn to a crucial passage in the Privy Council judgment at paragraph 29, where the counterfactual test is directly and explicitly applied:

> It is by no means self-evident that INZCO would have behaved any differently if it had not been in a dominant position in the market when it was deciding what it should do to meet the competition which it was facing in the market from Wool Bloc. It would have been presented with the same complaint that the price which was originally set for Wool Line was uncompetitive. The obvious response, in a truly competitive market, was to cut the price of Wool Line to a level that was competitive.
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> [Emphasis added]

My third-year undergraduate students, when presented with this paragraph, took no more than a couple of minutes to spot the error in the economic reasoning. Suppose a truly competitive environment, assume single-product firms, and consider the new entrant INZCO with its Wool Line, trying to break into the submarket[15] for wool-based insulation products to attack the already-established Wool Bloc product. If the new entrant INZCO is unable to match the price of the incumbent NWP without pricing below cost, then the entrant

- is productively inefficient and shouldn't have entered to start with, since only tears lie ahead and society's resources are being wasted, and
- should exit quickly once the blood starts to flow, and if it doesn't do so of its own volition, should rapidly be driven into bankruptcy, to the applause of anyone with a genuine commitment to "productive economic efficiency".

There is nothing "self-evident" or "obvious" about their Lordship's suggestion that the correct way for an inefficient entrant to proceed is to cut price below cost and hang in there. The outcome of such a strategy, if successful, would be to destroy the efficient incumbent which is able to supply profitably at the low price, leaving an inefficient new entrant which cannot sustain its entry price without cross-subsidy from somewhere else. This may pass muster with lawyers, but it does not qualify as economic analysis.

It is of no avail for the Judicial Committee to appeal to resounding formulae such as "how the hypothetical seller would act in a competitive market (the 'counterfactual test')". The simple fact is that any economics textbook will tell you that a well-functioning, truly competitive market weeds out the productively inefficient in order to leave the efficient. The acid test is supply price, based on actual supply cost. INZCO's Wool Line failed that test comprehensively, and got into the market only by a pricing strategy that could never have even crossed the minds of the neoclassical rational single-product agent under "truly competitive" conditions.

It's therefore doubly ironic that a couple of pages further on the Judicial Committee majority talks (para 40) of "preventing a monopolist from competing with its

15 I do not propose to get into market-definition semantics at this point.

competitors like everyone else" as though this is in some way a fair and reasonable characterization of INZCO's behaviour, and says that the "effect" of protecting firms such as NWP from predation by a productively-inefficient but financially strong monopolist would be "to protect inefficient competitors".

What can possibly have been in their Lordships' minds? I think we find the answer by reading carefully their (hostile) analysis of Professor Lattimore's opinions, and especially paragraph 44 of the majority judgment.

> If it was rational for INZCO to do this [price below cost on Wool Line] in the face of competition from Wool Bloc, it would have been rational too for <u>anyone else</u> who was facing the same competition <u>and was seeking to meet the demands of its distributors</u>…
>
> [Emphasis added]

Ralph Lattimore may have let himself in for this by "accept[ing] that it was rational for INZCO to continue with Wool Line because it gave it the range of products that distributors required and helped to keep out other products" (ibid); but this is no excuse for the passages I have underlined in the Privy Council's passage above. "Anyone else" must presumably include non-dominant firms in competitive markets (after all, the behaviour is being defended as in some sense a generally acceptable and justifiable rule of good business practice); but such firms simply can't get away with INZCOs behaviour because they don't have the market power to use to do so, and it's not rational to take short-run losses for no long-run gain. INZCO acted in precisely the way that the Chicago theorists used to point to as irrational, and hence never likely to be observed - let alone recorded in ultimately-uncontested fact evidence before the New Zealand High Court.

There is, however, still something highly significant in the second underlined section above, relating to "the demands of its distributors" and thereby to a wider canvas on which INZCO was acting as a multi-product, not a single-product, firm.

Indeed, it could be "rational" for INZCO to protect its position as preferred supplier to those distributors – and rational for the distributors to seek to maintain their exclusive arrangement or understanding with INZCO, even if they might have been able to get one of their bundle of retail products more cheaply from NWP. Once the argument moves from single-product predator and single-product prey, onto the totally different arena of multi-product predator versus single-product prey, we enter a new world beyond the analytical boundaries of the Australian High Court majority in *Boral* and the Privy Council in *CHH*. The only way I can see to rationalise the Privy Council's paragraph 44 is to interpret it as arguing in effect that "bundled discounting" [to which I shall come shortly] is rational as a general pricing strategy, and therefore cannot be anticompetitive in the s.36 sense. I don't think the logic here is any more sustainable than the single-product version already discussed, but at least it engages with a central empirical feature of the two Australasian cases.

Why, to provide the curtain-raiser for the next two sections, did the Nelson merchants not do what the Staples superstore in the USA did with LePages sticky

tape, namely sell it at store-brand prices alongside the premium-branded 3M product, and let customers choose for themselves? Probably for precisely the same reason that generic sticky tape came into the US market only once superstores had appeared with enough countervailing power to tell the 3Ms and the INZCOs of the world to get lost when they insisted on exclusive rights to shelf space.

4. The Ground Shifts: *Le Pages v 3M*

In both *Boral* and *CHH*, the superior courts made reference to precedents set in the *Matsushita*[16] and *Brooke Group*[17] decisions of the US Supreme Court, which laid down bright-line tests for predatory pricing which required proof of later recoupment as well as below-cost pricing. A strong New Zealand precedent was set also by the Privy Council in *Telecom v Clear* where the conduct of the alleged monopoliser was to be judged against a competitive counterfactual – a test which led the Council to essentially the same bright-line criteria.

Notoriously, thus, in the decade up to 2003, predatory pricing was difficult to establish in the eyes of New Zealand, Australian, and US courts. Since 2000, however, there has emerged a strong current of legal thinking which is critical of the approach of the US Supreme Court in *Brooke*. This view was articulated initially by Brodley, Bolton and Riordan[18] and Edlin[19], and became manifest in the landmark decision of the US Supreme Court in June 2004[20] to refuse to reconsider the March 2003 decision of the US Court of Appeals (Third Circuit) in the case of *LePages v Minnesota Mining*[21] .

The exclusionary practice of which 3M was accused was its offer of a "bundled rebate" to retailers who stocked a full range of 3M products including "private brand"[22] lines. LePages was competing with 3M in the supply of private-brand adhesive tape, and had secured an 88% market share in that market, while 3M enjoyed a monopoly in the market for Scotch-brand tape. 3M brought in a bundled rebate scheme which provided a large price incentive for retailers to stock a full line of 3M products, including its private-brand lines (newly-introduced to fight the threat from LePages). A direct result of this was that several large retail chains ceased to stock the LePages product in order to benefit from the 3M bundled-rebate scheme.

The Third Circuit Appeal Court in 2003 ruled that 3M's conduct was exclusionary under s.2 of the Sherman Act, and $68 million damages was awarded to LePage's Inc. The US Supreme Court, before deciding whether to hear 3M's appeal, asked the US Government for guidance. The response was an *amicus curiae* brief from the

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16 *Matsushita Electric Industrial Co. Ltd. v. Zenith Radio Corp.*, [1986] 475 U.S. 574.

17 *Brooke Group Ltd. V. Brown & Williamson Tobacco Corp.* [1993] 509 U.S. 209.

18 Brodley, J.F., Bolton, P., and Riordan, M.H., "Predatory Pricing: Strategic Theory and Legal Policy", *Georgetown Law Journal* 88(8): 2241-2330, August 2000.

19 Edlin, A., "Stopping Above-Cost Predatory Pricing", *Yale Law Journal*, 111(4): 941-991, January 2002.

20 Certiorari denied by *3m Co. v. Lepage's Inc*., 2004 U.S. LEXIS 4768 (U.S., June 30, 2004)

21 *LePage's, Inc. v. 3M*, 324 F.3d 141 (3rd Cir. 2003).

22 That is, tape bearing the brand name of the retailer who sells the product, rather than of the manufacturer.

Solicitor General (Theodore Olsen) and six other government lawyers urging the Court to deny the petition for *certiorari*[23]. The Supreme Court accepted this advice two weeks before the Privy Council delivered its *CHH* judgment, and the Third Circuit *LePages* decision was allowed to stand.

LePages v 3M has opened a fairly devastating breach in what was previously regarded as the clear authority of the *Brooke Group* decision. A "bundled rebate" scheme of the sort operated by 3M bears more than a mere family resemblance to the cross-subsidisation of Wool Line out of profits secured from INZCO's other product lines. (The fact that the 3M rebate was credited across its full product range, and that the full range had to be purchased to qualify for the rebate, is a second-order matter of detail.)

As several observers have noted, if a single-product firm is attacked by means of a bundled discount, offered to distributors by a multi-product predator with a full monopoly in all but one of the bundle of products receiving the rebate, then the full amount of the rebate may reasonably be attached to the price of the one good supplied into a competitive market. If this approach is taken, the 3M price for its privately-labelled tape was not only below the price of the competing product supplied by LePages, but probably below the correctly-calculated 3M cost of supply also.[24]

The 3M pricing policy can be construed as a cross-subsidy from 3M's monopoly core business to a peripheral product facing competition. The Third Circuit full court clearly construed the issue in this way, as a means of excluding an equally-efficient rival[25]:

> "Depending on the number of products that are aggregated [in the bundle on which rebates are offered] and the customers' relative purchases of each, even an equally efficient rival may find it impossible to compensate for lost discounts on products that it does not produce."

The *amicus* brief from the US Government, which was accepted by the Supreme Court, echoed this theme (pp.12-13):

> "Unlike a low but above-cost price on a single product, a bundled rebate or discount can – under certain theoretical assumptions – exclude an equally efficient competitor, if the competitor competes with respect to but one component of the bundle and cannot profitably match the discount aggregated over the other products, even if the post-discount prices for both the bundle as a whole and each of its components are above cost"

The *amicus* brief rather coyly concluded that (p.15) "the applicability of the *Brooke Group* approach to this business practice would benefit from further judicial and scholarly analysis".

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[23] *3M v LePage: Brief for the United States as Amicus Curiae*

[24] This remains highly contentious in the commentary on the *LePages* case.

[25] *LePage's Inc v 3M*, 324 F.3d 141 (3rd Cir.2003).

The ground has therefore shifted significantly under the formerly-established *Brooke* precedents, insofar as those precedents were understood to say that a combination of below-cost pricing and subsequent high probability of recoupment constitute a necessary as well as sufficient bright-line test for price predation, and that absence of either of these essential components constitutes a sufficient defence against a predatory-pricing charge.

It is now clear in the USA that pricing behaviour which is (i) exclusionary in its effect in the relevant market (in the *CHH* case, exclusionary of NWP in the market for wool-based insulation products) and (ii) sustainable only by virtue of a cross-subsidy from some other line of business or activity undertaken by the predator but not the victim, and in which the predator enjoys market power, can be in breach of section 2 of the Sherman Act, the (imperfectly substitutable) New Zealand equivalent for which is s.36.

5. State of the Literature and of the US Law on Predatory Pricing and Bundled Discounts

Until very recently both the legal position in the USA on price predation, and the theoretical position in much of the economics and law literature both there and in New Zealand, rested upon three analytical pillars:

- the assumption that both predator and prey were single-product firms;
- the Areeda-Turner test; and
- the recoupment rule that predation could not be rational without subsequent recoupment, generally interpreted as an increase in price to a supra-competitive level once the predator had achieved its kill.

The past three years have radically changed this landscape.

- The focus of debate now is on situations where a multi-product predator attacks a single-product prey: Minnesota Mining's attack on Le Pages in the US sticky-tape market, where the 3rd Circuit Court in 2003 spotted the problem; and of course Carter Holt Harvey's attack on New Wool Products, where the Privy Council in mid-2004 missed the issue entirely. The new buzz-word for predatory pricing is "bundled discounting", aka loyalty rebates.[26]
- the Areeda-Turner test of price below marginal (or average variable) cost has turned out neither necessary nor sufficient to identify price

[26] For a wide range of recent commentary on "bundled discounting", "exclusionary bundling", "loyalty rebates" and the fallout from the *Le* Pages judgment, see the Fall 2005 issue of *Antitrust Bulletin* 50(3), which contains papers by Ray Hartwell, Barry Nalebuff, Joseph Farrell, Richard Posner, Patrick Greenlea and David Reitman, Alan Meese, and Roy T.Englert. On the economics of constructing legal tests for when rebates are exclusionary see especially Greenlea, P. and Reitman, D., "Distinguishing Competitive and Exclusionary Uses of Loyalty Rebates", *Antitrust Bulletin* 50(3): 441-463.

predation[27], largely because it assumed precisely the competitive conditions (constant industry-wide average variable cost and prevalence of a long-run market equilibrium) that are usually missing in interesting real-world predation events[28]. In particular, in situations where underlying average variable costs slope down for both players, the interests of consumers are not served by determining victory on the basis of financial strength, nor willingness and ability to cross-subsidise, nor the respective qualities of the law firms and QCs involved. The long-run interests of consumers (and of the economy as a whole) require that the market be dominated by whichever firm can achieve the lowest long-run cost - and there can be no presumption that this will be the incumbent.[29]

- the recoupment rule has died with the single-product predator and the dumping of *Brooke* by the *Le Pages* court. Unambiguous quantitative definition and measurement of "recoupment" have proved effectively impossible once the single-valued measure of post-predation single-product price had to be dropped. Qualitative evaluation remains vital – but inescapably forms part of a general analysis of the business conduct under analysis.

From Brooke to Le Pages

It seems clear from the recent US literature that defendants in antitrust cases, and lawyers advising clients on bundled discounting, had been too optimistic in appealing to the *Brooke* decision as a defence in law against all charges of anti-competitive behaviour. 3M took refuge behind *Brooke* and lost.

Ronald W. Davis[30] gives a helpful checklist of the core propositions in *Brooke*:

Brooke Group teaches that:

27 In the New Zealand context, see Paul Scott, "Is a Dominant Firm's Below Cost Pricing Always a Breach of Section 36 of the Commerce Act?" (2004) 21 NZULR 106, 129.

28 The initial attack on Areeda-Turner was led by Aaron S. Edlin, "Stopping Above-Cost Predatory Pricing", *Yale Law Journal* 111(94: 941-991, and Brodley, J.F., Bolton, P., and Riordan, M.H., "Predatory Pricing: Strategic Theory and Legal Policy", *Georgetown Law Journal* 88(8): 2241-2330, August 2000. The conventional riposte by Einar Elhauge, "Why Above-Cost Price Cuts to Drive Out Entrants are Not Predatory – and the Implications for Defining Costs and Market Power", *Yale Law Journal* 112, January 2003, was so full of qualifications and apparently minor concessions as to leave the main thrust of Edlin's critique unscathed – see, e.g., Edlin's contributions to the "Roundtable on Recent Developments in Section 2", *Antitrust* Fall 2003 pp.15-25.

29 An intriguing feature of the Commerce Commission's 2004 telecommunications-unbundling hearings was the presentation of expert testimony that rapid technical progress was in consumers' interests, this testimony being unaccompanied by any reason to presume that the incumbent would necessarily be the most technically innovative player. Since the witness appeared for Telecom NZ Ltd in opposition to unbundling, this implication was apparently supposed to be drawn by the commissioners without supporting evidence.

30 Davis, R.W., "Pricing With Strings Attached – At Sea in *Concord Boat* and *Lepage's*, *Antitrust,* Summer 2000, pp.69-73.

- Even a dominant firm may deliberately choose to forego short-term profits and instead price low in order to gain market share, so long as the price charged is above an appropriate level of cost, 509 U.S. 209, at 222-223…;
- Such strategic pricing is not, necessarily and always, pro-competitive (beneficial to consumers in the long run), but to distinguish between pro-competitive above-cost pricing and anticompetitive above-cost pricing would be "beyond the practical ability of a judicial tribunal … without courting intolerable risks of chilling legitimate price cutting", *id.* at 224;

and hence

- Injury in fact caused to a smaller player resulting from a dominant firm's strategic pricing is not actionable unless that pricing is below cost and unless there is an objective likelihood of recouping monopoly profits. *Id.* at 224-25.

Four particular points stand out here, and it is in these areas that the US position has shifted sharply, or at least come under renewed pressure, since *LePages*.

I. **False-Positive-Aversion: Above-cost price cuts were actually not held in *Brooke* to be not necessarily pro-competitive *per se*.** [Yes, that sentence is grammatically correct!] The US Supreme Court's view in *Brooke* was not that that judicial tribunals should presume that above-cost price cuts are never predatory. The *Brooke* position was that courts should avoid getting into the issue of considering allegations of above-cost price predation because of the risk of getting it wrong (of striking a "false positive"), and because of the allegedly chilling effect of this risk on legitimate competition. This is no more than a practical criticism of the efficiency and analytical capacity of judicial tribunals – not an affirmative statement of principle that strategic price cuts above cost are necessarily procompetitive. This fear of false convictions stands in stark contrast to the European approach to predation under Article 86 of the Treaty of Rome, which is more concerned with "false negatives" and correspondingly far more activist with respect to predatory pricing.[31]

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[31] More on the European approach below. The Privy Council in *CHH* acknowledged (para 37) that recoupment had been rejected by the European Court in *Tetrapak* as a test for predation; and in paragraphs 61 - 66 reviewed the European approach and identified crucial differences in the wording of Article 86 versus Section 36 of the Commerce Act 1986. The Treaty of Rome does not require proof that market power has been "used" [nor "taken advantage of"], and the European Court does not accept the Privy Council's counterfactual test which places monopolist and non-monopolist on an equal footing before the law. On the contrary, monopolists are considered to have a "special responsibility" not to behave in ways that might be acceptable for non-monopolists.

In October 2004 (after both *CHH* and *LePages*) the OECD Competition Committee held a Round Table on Predatory Foreclosure, the proceedings of which were published in March 2005 as: OECD Directorate for Financial and Enterprise Affairs Competition Committee, *Predatory Foreclosure*, DAF/COMP(2005)14, Paris, March 2005, http://www.oecd.org/dataoecd/26/53/34646189.pdf. This document includes an interesting New Zealand delegation paper on the *Carter Holt Harvey* decision, and several fairly biting (albeit

The *Brooke* judgment said (p.233) that "As a general rule, the exclusionary effect of prices above a relevant measure of cost either reflects the lower cost structure of the alleged predator, and so represents competition on the merits, or is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price cutting." The Court did not specify what exactly was meant by "a relevant measure of cost", and this opens a gap into which it is potentially possible to slide the cost/price implications of bundling and other tying arrangements. For example, so that cost could be measured as the aggregate incremental cost incurred by a predator to sell one more unit of the target good, including the revenue foregone across sales of all product lines due to the effect of the bundled rebate kicking in.

As Davis says[32], "in *Brooke Group* the Supreme Court recognized that above-cost pricing, with no strings attached, across the board, may sometimes be anticompetitive. The safe harbour that the Court established for above-cost pricing was not based on the perception that all such behaviour is procompetitive, but rather on the belief that giving the courts license to separate the competitive from the anticompetitive would chill, and hence discourage, too much procompetitive behaviour, and impose too great a burden on the courts."

[Edlin has remarked, in discussing the same safe-harbour approach in the case of *U.S. v AMR Corp*, that[33] "the safe harbour is very large when there is a lot of market or monopoly power, so that the firm's demand is very inelastic, and marginal revenue is far below price. In contrast, the safe harbour is very small when price is close to marginal revenue because the firm has very little market power. That's a peculiar kind of safe harbour. It is the opposite of what one would expect to avoid false positives. There may be a reason for a safe harbour, but it's strange to put it in by comparing a marginal concept like marginal cost with an average concept like price".]

So how should a court proceed in cases where Areeda-Turner does not apply? Davis in 2000 pointed out the implausibility of a court's being entirely unable to make progress on cases where above-cost predation was alleged in a bundled-discount context[34]:

> "If business people are rational, it follows that any complex program of package pricing or structured discounts must be based on some analysis, leading the relevant business people to conclude that adopting the plan is likely to be more profitable in the long run than not adopting it. Discovering or reconstructing that business analysis should be relatively easy, as litigation goes, particularly given that many people are likely to have been involved in developing and

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discreetly indirect) points about s.36 and the New Zealand case law from the Committee secretariat.

32 Davis, R.W., "Pricing With Strings Attached – At Sea in *Concord Boat* and *Lepage's*, *Antitrust,* Summer 2000, p.72.

33 "Roundtable: Recent Developments in Section 2", *Antitrust*, Fall 2003, p.18.

34 Davis, R.W., "Pricing With Strings Attached – At Sea in *Concord Boat* and *Lepage's*, *Antitrust,* Summer 2000, p.72.

> approving the program. In particular, it should not be beyond the ability of the plaintiff and the trier of fact to figure out whether defendant's plan either (a) is likely to be profitable even if the plaintiff does not exit the business, e.g. because the defendant is simply giving up margin on some sales in order to gain volume and market share, or, alternatively, (b) depends for its profitability on the assumption that the defendant's competitors will exit, permitting it to raise its prices. Deciding which of the assumptions underlies the plan in question ought not to be rocket science."

II. *Brooke* promised two bright-line tests: below-cost pricing (Areeda-Turner) and recoupment

Warren describes the *Brooke* bright-line tests, and their erosion in *LePage*, in the following terms[35]:

> "Prior to the *LePage's* decision, many practitioners and scholars read the case law to hold that, while there were few bright lines to follow, strategic pricing policies such as price-cutting and bundling would not be found to violate section 2 of the Sherman Act as long as prices did not drop below a certain measurement of cost. In particular, the most recent Supreme Court case on predatory pricing, *Brooke Group Ltd. V. Brown and Williamson Tobacco Corp.*, contained strong language indicating that 'above-cost prices that are below general market levels or the costs of a firm's competitors [do not] inflict injury to competition cognizable under the antitrust laws'. However, in *LePage's*, the Third Circuit allowed a finding of illegal monopoly maintenance in the absence of a showing of below-cost pricing."

The bright lines are no longer bright, for reasons set out elsewhere in this paper. There is nothing special about pricing above or below marginal cost, other than the convenience of judges trying to avoid judging hard cases. (The really important issue is not whether Firm 1's price is above or below its own marginal cost, but whether it is above or below the shut-down price for its rivals.) There is no need for recoupment unless the price prior to predation was already competitive, in which case predation has to be conceptually kick-started from nothing. There is no presumption that price-cutting by a dominant firm is good or bad for consumers in the long run. The world of anti-competitive predatory conduct has become more complex, more interesting, and more difficult to adjudicate.

III. The *Brooke Group* decision dealt only with single-product price predation.

Brooke arguably had no effect on earlier Supreme Court precedents regarding anti-competitive behaviour by multiproduct firms. Contemplating its

[35] Warren, Joanna, "Comment: *LePage's v. 3M*: An Antitrust Analysis of Loyalty Rates", *New York University Law Review* 79: 1605-1632, October 2004, p.1606.

relationship with the then-in-progress *LePages* case, Davis commented[36] that "[t]he *Brooke* Court considered only the question when strategically low pricing, as such, might violate the antitrust laws: it was not asked to think about the consequences, if any, of a 'string' attached to a low price."

Where a strategic price has strings attached - for example, where a dominant multiproduct firm uses bundled discounts across a range of products (in some of which it has a monopoly) to squeeze a smaller competitor in a single-product market (as was the case in *LePage's v 3M* and in *CHH*) – the result can be anticompetitive[37], and it is no defence for the defendant to claim that its single-product price was above cost, as 3M did in *LePage's*. Davis again, p.70:

> "LePage's problem was not predatory pricing, it was that if a customer bought any substantial amount of its private label tape, the customer would lose the rebate not only on the buyer's purchases of Scotch™ and other 3M tape, but also on the PostIt™ notes purchases as well. To meet such a deal, LePage's would have had to cut its price substantially…." The issue was "not the low price but rather the string attached to the low price".

This does point to a test that might be used: assuming a hypothetical equally-efficient competitor in the private-label market, what price cut would such a competitor have to make in order to match the bundled discount incentive on buyers to switch?[38] If the required price is clearly below cost, then the bundled discount is anti-competitive.

Several authors have made a clear distinction between the narrow concept of "predatory pricing" (the single-product case) and "exclusionary conduct" (the bundled-discount case). The latter can be defined as[39] "conduct that intentionally, significantly and without business justification excludes a potential competitor from outlets (even though not in the relevant market), where access to those outlets is a necessary though not sufficient condition to waging a challenge to a monopolist and fear of the challenge prompts the conduct."

As the Supreme Court had noted in *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*,[40] "[t]he question … whether conduct may properly be

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36 Davis, R.W., "Pricing With Strings Attached – At Sea in *Concord Boat* and *Lepage's*, *Antitrust,* Summer 2000, p.69

37 For an in-depth review of the recent literature on bundled discounts see Lambert, T. A., "Evaluating Bundled Discounts" , *Minnesota Law Review*, Forthcoming.; available at SSRN: http://ssrn.com/abstract=650326. See also Kobayashi, B., *Not Ready for Prime Time? A Survey of the Economic Literature on Bundling*, Law and Economics Working Paper Series 05-35, George Mason School of Law, at SSRN http://ssrn.com/abstract_id=836724.

38 Warren (2004) p.1631 has proposed a test along these lines to apply to above-cost loyalty rebates: "The plaintiff should be allowed to show that an equally efficient producer of the competitive product would find it unprofitable to continue producing. This requirement addresses the fundamental exclusionary aspect of loyalty rebates: foreclosure of equally efficient single-product rivals due to discounts aggregated across multiple products."

39 Eleanor M. Fox, "What is Harm to Competition? Exclusionary Practices and Anticompetitive Effect", *Antitrust Law Journal* 371,390 (2002), commenting on *Microsoft*.

40 472 U.S. 585, 605 (1985).

characterized as exclusionary cannot be answered by simply considering its effect on [the plaintiff-competitor. In addition, it is relevant to consider its impact on consumers and whether it has impaired competition in an unnecessarily restrictive way. If a firm has been 'attempting to exclude rivals on some basis other than efficiency', it is fair to characterize its behavior as predatory".

An example of the new writing in this field is Nalebuff's model of "exclusionary bundling", defined as follows:[41]

> "Under exclusionary bundling, a firm with market power in good *A* and facing actual (or potential) competition in good *B* prices an *A-B* bundle in a way that makes it impossible for equally-efficient one-good rivals selling *B* to compete. Exclusionary bundling has a foreclosure effect similar to that of [single-product] predatory pricing, but the two practices have important differences. Unlike traditional predatory pricing, the exclusionary behaviour need not be costly to the firm. The intuition is that under predation, the firm actually has to charge a price below cost and thus loses money that it later has to recoup. Under exclusionary bundling, the firm has only to threaten to raise its unbundled prices if the bundle is not bought. All customers are led to buy the bundle and so the threat need never be carried out."

Nalebuff goes on to argue that the courts have always implicitly accepted this line of argument, and that numerous cases before *LePages* rested on such reasoning. He concludes that[42]

> "The theory of exclusionary bundling brings together tying and predation. Exclusionary bundling is akin to predation in that when prices and costs are calculated correctly, the implied price of *B* to the customer is below cost. But, unlike predation, an implied price below cost need not imply any actual or even potential profit sacrifice. This is because the implied price is based on the alternative a la carte price of *A*, a price that might never be charged to a customer….. The primary difference between exclusionary bundling and predation pricing is that there is no need to establish recoupment."

IV. The *Brooke* requirement for recoupment implicitly starts from a competitive price.

The district court judge in *LePage's* (Judge Padova) found that[43] "there is no separate recoupment requirement when the defendant is *already* a monopolist … In other words, if the theory of the case is that the defendant is trying to protect its ability to price monopolistically, not gain the ability to charge a monopoly price, it seems to make no sense to require the plaintiff to prove that the defendant would recoup its predatory investment by charging even higher prices in the future".[44]

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41 Nalebuff, B., "Exclusionary Bundling", *Antitrust Bulletin* 50(3): 321-320, Fall 2005, p.321.
42 Ibid. p.365.
43 Cited by Davis (2000) p.71.
44 This obviously goes immediately to the heart of the *Carter Holt Harvey* case.

Similarly, the Third Circuit decision said (at 151-152)

> "Assuming *arguendo* that *Brooke Group* should be read for the proposition that a company's pricing action is legal if its prices are not below its costs, nothing in the decision suggests that its discussion of the issue is applicable to a monopolist with its unconstrained market power … 3M is a monopolist; a monopolist is not free to take certain actions that a company in a competitive (or even oligopolistic) market may take, because there is no market constraint on a monopolist's behaviour".

On this particular issue, the Third Circuit Court ran into a direct rebuttal from the US Government *amicus* brief, footnote 11:

> But this Court's language [in *Brooke*] plainly applies to a monopolist. The Court stated, without qualification, that in a "claim alleg[ing] predatory pricing under § 2 of the Sherman Act . . . 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." 509 U.S. at 222. Whether to extend *Brooke Group* to bundled pricing properly depends on considerations other than whether the defendant is a monopolist.

Nevertheless, it is clear that the Third Circuit position contains a very significant acknowledgment of the validity of the European view that monopolists are not to be treated analytically as on a par with non-monopolists – an inescapable corrollory of which is that the Privy Council's "counterfactual test" in *Telecom v Clear* and *Carter Holt Harvey* is basically unsound, even when read within the US jurisprudence.

6. A Few Concluding Remarks

The recent literature has rediscovered a number of long-familiar reasons why the predatory-price claims of the Chicago school (that the phenomenon makes no neoclassical sense) lose validity once simplistic neoclassical perfectly-competitive assumptions are dropped[45].

The first problem with Chicago is the static cross-section nature of the story, when in practice strategic behaviour must rest upon expectations of the discounted present value of future cashflows. It seems to me that the prevailing neoclassical comparative-static treatment of predatory pricing in the legal discussions is far too often divorced from the dynamic considerations that drive strategic behaviour. Suppose we accept that the relevant issue is "damage to competition", then the appropriate way to think about it is the long-run quality-adjusted price that consumers will have to pay for the product. This will depend not only on the degree of monopoly power that will be available post-predation, but also on the impact of

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45 For an entertaining critique from an Austrian point of view, not further discussed in the present paper, see Anderson,W., "Pounding Square Pegs into Round Holes: Another Look at the Neoclassical Theory of Predatory Pricing*", Quarterly Austrian Journal of Economics* 6(1): 23-40, Spring 2003.

the short-run exclusionary contest on technical progress. Thus we should worry more about a dominant firm which kills a highly innovative new start-up competitor, than about one which merely puts a slow-moving laggard to sleep. Yet there seems to be little in-depth analysis before the courts of the effect of strategic behaviour in defence of market shares on the pace of technical progress

The second problem is the Chicago assumption of a single-product predator in a world where virtually all actual cases have involved both multi-product predators and some degree of bundling. *Carter Holt Harvey* was not about a single-product firm. Had the Privy Council judges read *Le Pages* before pronouncing, they might have decided quite differently – because *CHH* was actually an example of a "bundled discount", of the sort the 3rd Circuit Court punished in *Le Pages*, and the European Court of First Instance in *Michelin II*.[46]

A third problem is the rhetorical imagery. Predation brings a vertical dimension to the horizontal competitive processes determining market shares. Antelopes compete horizontally for space in their environmental niche (market) while their predators coexist in the same niche, but vertically – surviving by feeding off those below them on the food chain. What the predator exercises is not superior ability at the activities of horizontal competition (eating faster, running faster, breeding better, digesting better……) but superior power in any head-to-head combat. Power is intrinsic to the predator's success, by definition. But while predation is inherently vertical, the complaints most often heard in so-called "predatory pricing" cases have to do with horizontal brutality rather than vertical culling – "Raw" wrestling rather than pheasant-shooting. The word "predation" itself may have got us off to the wrong start in competition-law thinking.

.A fourth problem is the false-positives-aversion arising from a misapplication of the doctrine of innocent-until-proven-guilty. Adam Smith long ago pointed out that rights of the individual such as presumption of innocence should be radically reversed as soon as the individual changes role to become a "businessman" or a "merchant". Smith's reasoning was that the ever-present incentive for any business is to eliminate competition, and consolidate market power, by whatever means are available. This translates to a presumption of guilt whenever one sees businesspeople congregating together or behaving in ways that seem directed to the acquisition and maintenance of power to exploit consumers. The Europeans have this right, it seems to me: they have correctly understood the two sides of the Enlightenment, namely liberty of the individual and restraint on corporatist power[47]. It is ironic that New Zealand, a tiny economy in which market power hangs like low fruit from the trees in many markets, should have adopted the false-positive-aversion

46 Alas, pressure of time has foreclosed discussion of *Michelin II* in this paper. An aspect of *Michelin II* that illustrates well the philosophical difference of approach between Europe and the USA is the refusal of the Court of First Instance to insist on a showing of anti-competitive effect even from an ostensibly non-discriminatory discount programme. See Sher, B. and Ojala, A., "Abuse of Dominance: Effects and Inherent Effects Under Article 82: Michelin 2 and Van den Bergh Foods", *Competition Law Insight* December 2003/January 2004, pp.7-9.

47 For recent discussion of the Europe-US contrast in competition law, see the colloquium in *Antitrust Bulletin* Spring-Summer 2004; e.g. Kolasky, W., "What is Competition? A Comparison of U.S. and European Perspectives", *Antitrust Bulletin* 49(1/2): 29-53,; and Niels, G. and Ten Kaate, A., "Introduction: Antitrust in the U.S. and the EU – Converging or Diverging Paths?", *Bulletin* 49(1/2): 1-27.

of the USA whose market of 400 million people virtually guarantees space for new species to get a fair crack of the evolutionary whip.

To demonstrate the problem of false-positive-paranoia in New Zealand and Australia, the appropriate thought experiment is to construct in your imagination the most unequivocally outrageous example of price predation you can think of, and then try (still in your imagination) prosecuting it under s.36. Only one group in this audience will find this an easy exercise, I suspect, namely those who start from the prior belief that predation can never happen as a matter of economic principle.

While the new overseas developments since 2000 should have greatly improved the prospects of success with a claim of predatory pricing of the INZCO sort, it cannot be said that New Zealand's lawmakers have covered themselves with glory. Section s.36 of the Commerce Act has been amended to replace "dominance" with "a substantial degree of market power", and "use" with "take advantage of". Neither these changes has, on the face of it, made it any easier to prove exclusionary or predatory behaviour, and neither has brought New Zealand any closer to the philosophy and wording of the Treaty of Rome's Article 86.

Because the Privy Council decision in *CHH* was under the old wording of "dominance" and "use", and because of the blessedly vigorous dissent by two of the five Law Lords, the way is nevertheless open to test the waters under the amended wording to see how far the change in wording has had a material effect on the scope of s.36.

Section 36 of the Commerce Act 1986 has failed the test of the sole New Zealand predatory-pricing case to date. It is unfortunate that after taking ten weary years to wind its way slowly through the courts, the *Carter Holt Harvey* case reached the Privy Council at the same time as *3M v Le Pages* was being decided by the US Third Circuit, and the Privy Council judges were writing their opinions before the US Supreme Court denied *certiorari*. The absence of any reference to *Le Pages* in the Privy Council judgment (in particular, by the dissenting two) leaves me wondering how different the outcome in *Carter Holt Harvey* might have been had it been decided six months later by the same bank of judges, or alternatively if the Commerce Commission's legal team had run the *LePages* case in argument.

Are there simple policy prescriptions on how to deal with a predator once identified? There is certainly one, which has quite a long history in the literature. Williamson[48] argued that an incumbent which responds to entry by driving down price should be prohibited from expanding into the market space created by the demise of the prey. Baumol[49] and Edlin[50] argue along similar lines that a firm which lowers its prices to drive out competitors ought to be prohibited from raising price again after predation ends. All of these are variants on the familiar case for price-capped incentive regulation.

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48 Williamson, O., "Predatory Pricing: A Strategic and Welfare Analysis", *Yale Law Journal* 89:284-340, 1977.

49 Baumol, W.J., "Quasi-Permanence of Price Reductions: A Policy for Prevention of Predatory Pricing", *Yale Law Journal* 89: 1-26, 1979.

50 Edlin, A.S., "Stopping Above-Cost Predatory Pricing", *Yale Law Journal* 111: 941-991, 2001.

In fact, once one starts thinking creatively about what regulators can do right (rather than simply running a blanket condemnation of all regulation *per se*) there are plenty of interesting options for forestalling anti-competitive predation, provided only that Parliament is not stampeded into legislating the constructive possibilities to death by passing vaguely-worded provisions wide open to semantic manipulation by the rent-seekers of the world.