

INDUSTRIE CANADA / INDUSTRY CANADA

Comments

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Order Varying Telecom Decision CRTC 2006-15

**Quebec Internet Service Provider Coalition**  
**1/15/2007**

For public inspection

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## Introduction

1. The Quebec Coalition of Internet Service Providers (QCISP) is pleased to provide comments on the proposed Order Varying Telecom Decision CRTC 2006-15.
2. The QCISP wishes to thank Industry Canada for the opportunity to provide these comments.
3. Our purpose is to encourage Industry Canada to clarify its proposed order Varying Telecom Decision 2006-15.
4. The clarification sought by the QCISP is for Industry Canada to identify more precisely the relief afforded by premature forbearance if prices indeed not fall as anticipated in the proposed Order.
5. For this purpose, the QCISP is providing Industry Canada with an up-to-date view of the status of forbearance in markets where the CRTC has chosen to forbear in the past, and where the involvement of the Competition Bureau is urgently required. One such area is the failure to implement series 4 and 5 of the Telecom Policy Review recommendations.

## Presentation of the QCISP

6. The Quebec Coalition of Internet Service Providers (QCISP) is the premier alliance of competitors in the telecommunications industry in the province of Quebec. None of the members of the QCISP is an incumbent telephone or cable carrier, nor is any affiliated with independent telephone or cable carriers. Furthermore, none of the members is owned or affiliated with incumbent power utilities.
7. The QCISP was created by the 11 largest independent Internet Service Providers of the province of Quebec, which are: AEI Internet, B2B2C, Colbanet, CiteNet Telecom, Le 9<sup>e</sup> Bit Inc, Megaquebec, Oricom Internet, Rocler Technologies, Uniserve Communications, VIF Internet & Xittel Telecommunications.
8. Collectively, the QCISP members employ more than 400 people and provide service to over one hundred thousand customers in Quebec.

## About the Internet Access industry

9. Statistics Canada released a report<sup>1</sup> on December 18<sup>th</sup> 2006, stating that the Internet Access industry in Canada is highly concentrated, with the largest 20 firms accounting for nearly 90% of the industry's total operating revenues. Statistics Canada also stated that in 2005, three-quarters (76%) of Internet access revenues were generated from the provision of broadband access, and that the industry profit margin increased 2% to a new level of 19%. The result is that this highly concentrated industry is significantly more profitable than the rest of the telecommunications industry.
10. For instance, the CRTC 2006 Monitoring Report identifies in table 4.4.4<sup>2</sup> that Bell Canada, TCC, RWI and Shaw are the four largest Internet access service providers and that these carriers have increased their share of the retail Internet access market from 44% in 2001 to 63% in 2005.
11. The CRTC also correctly points out that independent Internet Service Providers have to this date survived because of the high 2.5 ratio of profitable dial-up subscribers to every unprofitable high-speed subscriber. However, with the growth of so-called Lite service which QCISP members cannot purchase from the incumbents at appropriate wholesale levels, QCISP members, which are losing dial-up subscribers at the rate of 23% per year, will soon be forced to exit the residential Internet access market unless profitability can be achieved in selling high-speed services.
12. The Statistics Canada survey shows that for 2005, the operating revenues for the industry amounted to \$1.9 billion. On the other hand, the CRTC 2006 Telecommunications Monitoring Report shows<sup>3</sup> that for 2005, the industry operating revenues in Internet Access were of \$3.6B while total Internet Revenues were of \$4.5B.
13. According to the QCISP, this discrepancy between the Statistics Canada data and the CRTC data, only serves to amplify the fact that the ISP industry is even more concentrated than that which the 2005 Statistics Canada survey reveals.
14. The Government of Canada has claimed in announcements made during the second half of 2006 that it is pushing for more competition, purportedly in the consumers' interest. Curiously this has been met with strong & open dissent from the consumer groups<sup>4</sup> themselves.

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<sup>1</sup> <http://www.statcan.ca/Daily/English/061218/d061218c.htm>

<sup>2</sup> <http://www.crtc.gc.ca/eng/publications/reports/PolicyMonitoring/2006/tmr2006.htm#n72b>

<sup>3</sup> <http://www.crtc.gc.ca/eng/publications/reports/PolicyMonitoring/2006/tmr2006.htm#n59b>

<sup>4</sup> <http://www.consommateur.qc.ca/union/instructionsCRTC.pdf>

15. QCISP members are deeply affected by these new government policies which will structure markets well in advance of anyone's ability to monitoring consumer behaviour. For instance, should consumers decide to move back to plain old telephone services (POTS) as a result of the poor performance of battery-operated competitive local telephone infrastructure<sup>5</sup>, they would likely be doing so in an environment where the market has already been forborne de facto.
16. Then going back to POTS may be doing so at terms and conditions that may not be in the public interest, as not regulated by the CRTC anymore.
17. It is our view that the fair application of the Competition Act does not allow such prejudgment of industry outcomes.

#### **More Competition in the Internet Access industry is desirable**

18. The QCISP finds no merit in stalling the application of competition law in the telecommunications industry on the premise that the current concentration of the ISP industry should be considered normal. More than network effects and scale economies for telecommunications infrastructure created the current concentration of market power.
19. We hold that the current level of concentration in the ISP industry is a historical artefact of previous policy: the result of 1) infrastructure deployed by monopolies before the CRTC allowed non-dominant carriers to become deregulated in 1995 and 2) the deliberate commercialization by telcos and cablecos of higher-speed internet access as a loss leader until most recently.
20. The QCISP rejects the premise that a Telco+Cableco duopoly represents sufficient competition and that any further competition should be quite literally considered a *pipe dream* from the perspective of antitrust enforcement.
21. In fact, consumer groups have conducted their own survey<sup>6</sup>, which has identified that only 35% of the respondents believed that competition between the local telephone company and the

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<sup>5</sup> No cable carrier aside from Eastlink offers local exchange services with network-side power of the equipment in the home. Teaching young kids to use cell phones when the babysitter is at home is not necessarily an option either. No process on the Canadian public record has yet to take place where the merits of forbearance in advance of witnessing consumer behaviour in light of the goals of national emergency preparedness have been analyzed. It would not be prudent to wait until a few people are dead as a result of it being too onerous for certain consumers to go back to POTS to consider whether forbearance of POTS was premature or whether minimum standards for lifeline uptime in light of prolonged power outages would have been warranted in advance of forbearance.

<sup>6</sup>

[http://www.piac.ca/telecom/piac\\_pollara\\_survey\\_shows\\_phone\\_company\\_deregulation\\_plans\\_unpopular\\_with\\_canadians/](http://www.piac.ca/telecom/piac_pollara_survey_shows_phone_company_deregulation_plans_unpopular_with_canadians/)

cable company will be sufficient to protect the interest of consumers without the need for the CRTC to ensure reasonable rates or quality of service.

22. The government clearly believes it is pushing towards effective competition. However, the only form of competition its decisions, if implemented, will nurture is the formation of duopolies in all Canadian geographic markets: the ILEC and the cable company that had been granted a monopoly in a given area.
23. Rather than promoting a mature competitive market, the Government of Canada, in answering to the ILECs' pleas for the freedom to defend themselves from the cable carriers, is entrenching in regulation the ILECs' privileges. Such a view of competition is in the eyes of the independent Internet Service Providers, at best, partial, and should be unacceptable to the Competition Bureau.

#### **Further facilities-based entry**

24. As a result of the Villages Branchés program, the Province of Quebec has experienced the deployment of thousands of kilometres wireline competitive fibre optic infrastructure over the last few years. However, currently, this infrastructure is mostly only still at the stage of a backbone and does not extend into towns anywhere near as pervasively as the infrastructure of the incumbent telephone and cable carriers.
25. The QCISP believes that this deployment has set the stage for wireline competition beyond that of the Telco+Cableco duopoly and that such potential is now truly achievable in most of Quebec's economic regions<sup>7</sup>.
26. The deployment of competitive infrastructure in Quebec has parallels elsewhere in Canada with the Alberta Supernet and various BRAND projects deployed by non-incumbents, such as CMON<sup>8</sup> in British Columbia. In our view, further facilities-based entry should be encouraged by efficient, effective and timely regulation. It should not be dissuaded. Recent government policy aimed at protecting telephone and cable incumbents from further competition is having this dissuasive effect, with the result that three of the four largest cable carriers in Canada did not oppose the new policy<sup>9</sup>.

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<sup>7</sup> The following Quebec Economic Regions (not exhaustive) have gained a third competitive wireline infrastructure as a result of the Villages Branchés program: Brois-Francis, Centre-du-Québec, Érable, Hauts-Cantons, Lanaudière, Mauricie, Pontiac, Vaudreuil-Soulanges & Vallée-de-la-Gatineau.

<sup>8</sup> [www.cmon.ca](http://www.cmon.ca) (with some pretty good pictures of competitive fibre deployment)

<sup>9</sup> Cogeco Cable said Bernier's announcement is "contrary to sound public interest policy and practice for deregulating the telecommunications sector, and it ignores the relevant recommendations of the

27. The QCISP believes that the **prospect of further facilities-based competition**, in the form of a third wireline infrastructure providing competition incremental to the Cableco+Telco duopoly, should be treated as the attainable national benchmark by which the Competition Bureau assesses the presence of abuse of dominance.
28. The QCISP therefore requests that the Industry Canada recognizes that any deliberate behaviour on the part of telephone and cable incumbents, which can be reasonably inferred as an attempt to prevent the sustainable provision of telephony by a third wireline carrier, as being cases of abuse of dominance.
29. The principle of allowing further facilities-based competition is deeply entrenched into the CRTC sector-specific service-oriented forbearance framework. The CRTC forbearance framework requires making determination that, a particular class of services in a particular geographic market is ripe for forbearance. The CRTC has yet to every forbear on an infrastructure-wide basis (such as to say that all FTTH services would be *de facto* is forborne were them by an ILEC) and does recognize first mover advantages this way.
30. As it stands, the proposed Order would not allow for re-regulation based on complaints of abuses of dominance in the form of first mover advantages, such as preferential access to monopoly-acquired rights of ways or refusal to advance the dismantling of old inefficient plants in order to make room for competitor infrastructure. The notion of dominance based on a first mover advantage is recognized in American anti-trust legislation. If an ILEC accepts to remove a 600 pair copper cable clogging a conduit, because it wants to build a FTTH system, how will a competitor, who has been asking for this conduit, be notified of the opportunity to finally get into the conduit?
31. The removal of the sunset clause removed the obligation to overbuild within the first five years of Decision 97-8 and the CRTC allowed for more realistic view of the time it takes to deploy competitive infrastructure. The proposed two-year window in the TAB, in which a competitor would need to have overbuilt in order for its infrastructure to be recognized as a benchmark point for the presence of abuse of dominance, is unrealistic and represents in appropriately short term view of the time it takes for competition to take place at the infrastructure level. It usually takes sometimes much longer than two years to complete an infrastructure build-out in the entire territory of the smallest forbearance region, the ILEC local exchange, especially when ILECs take 3 months to respond to even the most smallest permitting applications.

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Telecommunications Policy Review Panel issued earlier this year." Source:  
<http://www.angustel.ca/update/up559.html>

### Jurisdiction of the Competition Bureau despite partial CRTC forbearance

32. The QCISP stresses that Industry Canada must outline in its proposed Order that the Competition Bureau is now prepared to deal with complaints of refusal to provide service in existing forborne markets. Industry Canada should state that it will be prepared to do so because the CRTC will be unable to resolve complaints dealing with margin squeeze in the interim period until PN 2006-14 concludes (which is Mid-2008).
33. The QCISP notes that the Competition Bureau took the following position in paragraph 238 of its intervention<sup>10</sup> of June 22<sup>nd</sup> 2005 in CRTC Public Notice 2005-2 on the forbearance of local exchange services:

328 As alluded to earlier in this evidence, forbearance **orders may blur the lines between the Commission’s responsibilities under the *Telecommunications Act* and the Bureau’s responsibilities under the *Competition Act*.** When the Commission forbears from regulation on an unconditional basis, it is clear that the laws of general application apply to telecommunications carriers’ unregulated conduct, including the *Competition Act*. In cases of conditional or partial forbearance, the situation is less clear (i.e., it may be unclear as to whether the CRTC’s application of the *Telecommunications Act* and the Bureau’s application of the *Competition Act* are in conflict.) Ambiguity or lack of clarity in the scope of forbearance may even result in situations where parties are deprived of both *Telecommunications Act* and *Competition Act* remedies, because of the reservation of residual power by the Commission and its failure to take the step of re-regulating.

34. The QCISP has prepared the following Table 1 which identifies the telecommunication services markets subject to partial forbearance. Table 1 describes the nature of the forbearance implemented by the CRTC and the type of complaints that QCISP members should be able to address to the Competition Bureau when the CRTC is currently ineffective:

Services markets	Year	CRTC description	Nature of forbearance	Justification for the direct involvement of the Competition Bureau
Terminal equipment	1994	Sales and rental of terminal equipment.	In Decision <a href="#">2005-12</a> the Commission directed an ILEC to file a tariff for the equipment sold to a school board unless the ILEC could demonstrate that the equipment was forborne terminal equipment within the meaning of Decision <a href="#">96-5</a> .	<b>Cases where dominant carriers provide or even offer non-terminal equipment at preferred conditions to preferred customers on the pretence that such equipment are terminal equipment</b>
Satellite services	1994	Telesat's digital video	84. The Commission further notes that it will shortly be initiating a	<b>Cases where SRDU refuse outright or with exclusionary rates to provide services to</b>

<sup>10</sup> [http://www.crtc.gc.ca/public/partvii/2005/8640/comm\\_comp/050622.zip](http://www.crtc.gc.ca/public/partvii/2005/8640/comm_comp/050622.zip)

Services markets	Year	CRTC description	Nature of forbearance	Justification for the direct involvement of the Competition Bureau
		compression services initially; further services offered by Telesat, such as sale/lease of earth stations and RF channels, in subsequent years.	proceeding to finalize the regulatory framework for the distribution of HD services by DTH undertakings. The regulatory framework that results from that proceeding may have some impact on SRDUs and on their regulatory obligations. <a href="http://www.crtc.gc.ca/archive/ENG/Decisions/2006/db2006-564.htm">http://www.crtc.gc.ca/archive/ENG/Decisions/2006/db2006-564.htm</a>	<p><b>competitors.</b></p> <p><b>With the impending deployment by the ILECs of their IPTV services over ADSL2+/VDSL2 and the lack of access to this infrastructure and to HDTV content, QCISP members will be deprived from their ability to compete for customers wishing to obtain triple play services.</b></p> <p><b>Each bundle will form its own relevant market.</b></p>
Services provided by non-dominant carriers	1995	Services, such as long distance, data, Internet and private line, provided by non-dominant competitive carriers.	The Commission will continue to exercise powers and perform duties under subsections 27(2) and (4), with regard to issues related to access to the networks of competing carriers and the resale and sharing of their services. <a href="http://www.crtc.gc.ca/archive/ENG/Decisions/1995/DT95-19.HTM">http://www.crtc.gc.ca/archive/ENG/Decisions/1995/DT95-19.HTM</a>	<b>Cases where Non-dominant carriers refuse outright or with exclusionary rates to provide services to competitors</b>
Internet services	1997	Incumbent telephone companies' retail Internet services in 1997 and those of cable service providers in 1998.	40. In light of the foregoing and consistent with its previous IS forbearance rulings, the Commission will, - retain part of its powers under section 24 of the Act in order to ensure that existing conditions regarding confidential information continue to apply and to retain the power to impose conditions on the offering and provision of retail IS as may be necessary in the future; - retain its powers under subsections 27(2), 27(3) (except to the extent that that provision refers to powers that are forborne), and 27(4) of the Act to provide an additional safeguard against carriers granting any undue preference. <a href="http://www.crtc.gc.ca/archive/ENG">http://www.crtc.gc.ca/archive/ENG</a>	<p><b>Cases where incumbent telephone and cable carriers refuse outright or with exclusionary rates to provide access to underlying infrastructure to competitors</b></p> <p><b>Currently, ILECs refuse to unbundled subloops, refuse to provide access to quality of service functionality and refuse to consider that all of the bandwidth of higher-speed DSL and FTTH services (ADSL2+/VDSL2 and FTTH) can be the subject of unbundling such as to allow triple play competition.</b></p> <p><b>In a similar manner, cable carrier refuse to unbundled RF channels, refuse to provide access to quality of service functionality and refuse to consider that all of the bandwidth of higher-speed HFC can be the subject of unbundling such as to allow triple play competition. This issue is further</b></p>

Services markets	Year	CRTC description	Nature of forbearance	Justification for the direct involvement of the Competition Bureau
			<a href="#">/Orders/1999/O99-592.HTM</a>	<b>compounded by the lack of centralized POIs and the fact that the NNI is not layer 2 and thus acts as a deterrent to competition.</b>
Long distance	1998	Toll and toll-free services.	96. Consistent with its approach in the Non-dominant Carriers Decision, the Commission will retain its subsection 27(2) powers in respect of issues related to access to the Stentor companies' networks and resale and sharing of their toll and toll free services. However, because of the absence of competition in non-equal access areas, the Commission considers it appropriate to retain all of its subsection 27(2) powers in those areas. Similarly, the Commission will continue to exercise all its subsection 27(2) powers in respect of basic toll services. Subject to the Commission's concerns regarding bundling, described below, in all other respects, the Commission will forbear from the exercise of its powers under subsection 27(2). <a href="http://www.crtc.gc.ca/archive/ENG/Decisions/1997/DT97-19.HTM">http://www.crtc.gc.ca/archive/ENG/Decisions/1997/DT97-19.HTM</a>	<b>Cases where Stentor Companies (circa 1997) refuse outright or with exclusionary rates to provide services to competitors</b>
International services	1998	Initially excluded Teleglobe; however, certain international services provided by Teleglobe were later forborne as well.	<a href="http://www.crtc.gc.ca/archive/ENG/Circulars/2005/ct2005-8.htm">http://www.crtc.gc.ca/archive/ENG/Circulars/2005/ct2005-8.htm</a> 1. The licensee shall not engage in anti-competitive conduct in relation to the provision of an international telecommunications service or services. For the purposes of this condition, anti-competitive conduct includes entering into or continuing to participate in an agreement or an arrangement that has or is likely to have the effect of preventing or lessening competition unduly in Canada, or otherwise providing telecommunications services in a manner that has or is likely to have the effect of preventing or lessening competition unduly in Canada. The licensee shall file with the	<b>Cases where Class A and Class B Basic International Telecommunications Service Licences refuse outright or with exclusionary rates to provide services to competitors</b>

Services markets	Year	CRTC description	Nature of forbearance	Justification for the direct involvement of the Competition Bureau
			Commission, should it become necessary to investigate whether or not the licensee is engaging in practices having an anti-competitive effect in Canada, any information that the Commission may deem necessary.	
Wide Area Network	2000	CRTC omitted to list to Order 2000-553 in the Appendix 3 to the monitoring report <a href="http://www.crtc.gc.ca/eng/publications/reports/PolicyMonitoring/2006/tmr2006.htm#a3">http://www.crtc.gc.ca/eng/publications/reports/PolicyMonitoring/2006/tmr2006.htm#a3</a>	<a href="http://www.crtc.gc.ca/archive/eng/Orders/2000/O2000-553.htm">http://www.crtc.gc.ca/archive/eng/Orders/2000/O2000-553.htm</a> 23. Further, in view of the pervasive position of the applicants in markets for access and transport, the Commission also will retain its powers under Subsections 27(2), 27(3) and 27(4) of the Act in order to ensure that the applicants do not unjustly discriminate against other service providers or customers, or confer an undue or unreasonable preference with respect to the provision of WAN services.	<b>Cases where incumbent telephone and cable carriers refuse outright or with exclusionary rates to provide access to underlying wide area networking infrastructure to competitors on intra-exchange and non-forborne IXPL routes</b>
Data and private line	1997 & 2004	With some conditions, additional high capacity digital data interexchange private line services forborne from regulation on routes for which competitors of several incumbent local exchange carriers now offer, or provide, services at DS-3 or greater bandwidth.	<a href="http://www.crtc.gc.ca/ENG/Proc_re/TELECOM/1998/8638/s1-01.html">http://www.crtc.gc.ca/ENG/Proc_re/TELECOM/1998/8638/s1-01.html</a> <a href="http://www.crtc.gc.ca/archive/ENG/Letters/2004/lt041129.htm">http://www.crtc.gc.ca/archive/ENG/Letters/2004/lt041129.htm</a> November 29 <sup>th</sup> 2004: Commission staff notes that recent developments imply that, on some IXPL routes where the Commission has forborne from the regulation of the provision of IXPL services, there may be routes where offers or the provision of IXPL services can only use capacity obtained from the ILEC or an in-territory affiliate of the ILEC. For example, Québecor Média Inc., on behalf of its subsidiary, Vidéotron Télécom Ltée (VTL), informed the Commission, in the course of its 2004 semi-annual filings, that it had ceased to provide, or offer to provide, IXPL services on many of the IXPL routes in respect	<b>Cases where carriers refuse outright or with exclusionary rates to provide IXPL services to competitors</b>  The definition of IXPL services opposes that of Wide Area Networking services and extends to all facilities which provide dedicated transport for the needs of one customer. This issue is before the CRTC, see: <a href="http://www.crtc.gc.ca/public/partvii/2006/8640/t66_200606931/641883.doc">http://www.crtc.gc.ca/public/partvii/2006/8640/t66_200606931/641883.doc</a>  The CRTC has announced that it would address the issue of re-regulation of IXPL routes no longer meeting the forbearance criteria. However, after 25 months, the CRTC has yet to issue its decision.  Also see: <a href="http://www.crtc.gc.ca/public/partvii/1998/8638/xit/050112.doc">http://www.crtc.gc.ca/public/partvii/1998/8638/xit/050112.doc</a>

Services markets	Year	CRTC description	Nature of forbearance	Justification for the direct involvement of the Competition Bureau
			<p>to which forbearance had been granted in the past, namely in <i>The Commission forbears from regulating interexchange private line services on additional routes of Bell Canada</i>, Telecom Order CRTC 2001-2, 10 January 2001 and <i>Forbearance from regulating additional interexchange private line services</i>, Telecom Decision CRTC 2004-2, 16 January 2004.</p> <p>Further, recently MTS Communications Inc. acquired Allstream Inc., and Bell Canada acquired 360 Networks, after 360 Networks had acquired GT Group Telecom.</p> <p>Therefore, in addition to dealing with matters normally arising out of the October 2004 IXPL filings pursuant to Order 99-434, the Commission will address the issue of re-regulation of IXPL routes no longer meeting the forbearance criteria.</p>	
VoIP access independent Local exchange service	2005	The Commission determined that local voice over Internet protocol (VoIP) services are part of the same relevant market as circuit-switched local exchange services.	<p><a href="http://www.crtc.gc.ca/archive/ENG/Circulars/2006/ct2006-10.htm">http://www.crtc.gc.ca/archive/ENG/Circulars/2006/ct2006-10.htm</a></p> <p><i>On 9 November 2006, the Governor in Council issued Order in Council P.C. 2006-1314 (the Order in Council), a copy of which is appended to this circular. The Governor in Council, pursuant to subsection 12(7) of the Telecommunications Act (the Act), varied Regulatory framework for voice communication services using Internet Protocol, Telecom Decision CRTC 2005-28, 12 May 2005, as amended by Telecom Decision CRTC 2005-28-1 dated 30 June 2005, and as confirmed in Reconsideration of Regulatory framework for voice communication services using Internet Protocol, Telecom Decision CRTC 2006-53, 1 September 2006, so that, in relation to retail local</i></p>	<p><b>Cases where Incumbent Local Exchange Carriers refuse outright or with exclusionary rates to interconnect using VoIP technology with competitors</b></p> <p>The QCISP called for a VoIP interconnection framework as a pre-condition for VoIP forbearance:  <a href="http://www.crtc.gc.ca/public/partvii/2006/8663/c12_200605587/632285.doc">http://www.crtc.gc.ca/public/partvii/2006/8663/c12_200605587/632285.doc</a></p> <p>The QCISP assessed that these matters were too far into the Commission 3 year work plan with implementation only scheduled for 2008-2009:  <a href="http://www.crtc.gc.ca/eng/BACKGRND/plan2006.htm">http://www.crtc.gc.ca/eng/BACKGRND/plan2006.htm</a></p> <p>The Commission decided in 2006-53 that these issues continue to be referred to CISC without any policy guidelines because VoIP was remaining regulated.  <a href="http://www.crtc.gc.ca/archive/ENG/Decisions">http://www.crtc.gc.ca/archive/ENG/Decisions</a></p>

Services markets	Year	CRTC description	Nature of forbearance	Justification for the direct involvement of the Competition Bureau
			<p><i>access-independent voice over Internet Protocol (VoIP) services provided by incumbent local exchange carriers (ILECs) within their incumbent territories, the Commission refrains from exercising its powers and performing its duties under section 25, subsections 27(1), (5), and (6), and sections 29 and 31 of the Act to the same extent that it does in relation to retail local telecommunications services provided to end-users by competitive local exchange carriers as set out in Local competition, Telecom Decision CRTC 97-8, 1 May 1997 and subsequent determinations.</i></p>	<p><a href="/2006/dt2006-53.htm">/2006/dt2006-53.htm</a></p> <p><b>QCISP-proposed technical framework</b></p> <p>135. The QCISP proposed a framework, involving 11 technical components, to provide greater flexibility for the provision of local services over retail Internet services or wide area networking services.</p> <p>136. In Decision <a href="#">2005-28</a> the Commission ruled that the CRTC Interconnection Steering Committee (CISC) was the appropriate venue to resolve technical issues pertaining to the provision of VoIP services. Subsequent to that Decision, CISC working groups analyzed various VoIP-related technical issues and have provided reports to the Commission. The Commission notes that QCISP has been an active participant in these working groups.</p> <p>137. In <i>IP-to-IP interconnection – Follow-up to Decision <a href="#">2005-28</a></i>, Telecom Decision CRTC <a href="#">2006-13</a>, 16 March 2006, the Commission approved a CISC consensus report on IP-to-IP interconnection interface guidelines. The report also indicated that CISC planned further consideration of technical documentation on IP-to-IP interconnection guidelines produced by various standards-writing bodies and other organizations, in order to provide additional guidelines for IP-to-IP interconnection.</p> <p>138. Accordingly, the Commission concludes that the technical issues raised by QCISP in this proceeding should continue to be resolved in CISC working groups.</p> <p>Access independent VoIP is no longer regulated since 9 November 2006. This is a significant problem since QCISP members are still being denied IP-IP interconnection in a VoIP-deregulated environment.</p> <p>The lack of consensus on an IP-IP interconnection framework is currently before the CRTC in the form of a dispute elevated by the CISC steering committee to the attention of the Commission.</p>

Services markets	Year	CRTC description	Nature of forbearance	Justification for the direct involvement of the Competition Bureau
Local exchange service	2006	A framework for forbearance from the regulation of local exchange services was established. The framework set out criteria that incumbents must meet for forbearance from regulation of residential or business local exchange service within a defined geographic area.	<p>Proposed Order in Council to vary part of Decision 2006-15  <a href="http://www.crtc.gc.ca/archive/ENG/Circulars/2006/ct2006-12.htm">http://www.crtc.gc.ca/archive/ENG/Circulars/2006/ct2006-12.htm</a></p> <p>5. On 16 December 2006, the Governor in Council published, in the Canada Gazette, Part I, a proposed Order to vary part of Decision 2006-15 (the proposed Order) pursuant to subsection 12(1) of the Act.  <a href="http://canadagazette.gc.ca/part1/2006/20061216/html/regle6-e.html">http://canadagazette.gc.ca/part1/2006/20061216/html/regle6-e.html</a></p> <p>The proposed Order sets out a revised framework to determine when local forbearance would be granted to the ILECs. The revised framework would, among other things, eliminate the Commission's 25 percent market share loss test and modify the application of the competitor quality of service indicators. Upon coming into force, the proposed Order would also eliminate the winback rule.</p> <p>6. Interested parties were given 30 days to provide comments on the proposed Order until January 16<sup>th</sup> 2007.  <a href="http://www.ic.gc.ca/cmb/welcome1.c.nsf/261ce500dfcd7259852564820068dc6d/85256a5d006b972085257245005c3b13!OpenDocument">http://www.ic.gc.ca/cmb/welcome1.c.nsf/261ce500dfcd7259852564820068dc6d/85256a5d006b972085257245005c3b13!OpenDocument</a></p> <p>Canada's New Government Issues Policy Direction to CRTC that Calls for Greater Reliance on Market Forces</p>	<p><b>Cases where Incumbent Local Exchange Carriers refuse outright or with exclusionary rates to interconnect using VoIP technology with competitors</b></p>

**Table 1 – Intervention before Competition Bureau in areas of partial forbearance**

35. For instance, the Competition Bureau was recently asked by a QCISP member to intervene in the case where an ILEC, despite several months of negotiations, still refuses to provide high-capacity dedicated transport services over a non-forborne IXPL route financed with tax payer money, while at the same time the ILEC considers itself entitled to provide WAN services at unregulated rates, terms and conditions, over that same route.
36. This issue was brought forward to CRTC staff who questioned why it is not the Bureau of Competition which must deal with the Open Access<sup>11</sup> Requirements<sup>12</sup> embodied under the BRAND program of Industry Canada<sup>13</sup>.
37. The QCISP wishes Industry Canada to be very clear in its proposed Order about which cases the Competition Bureau will be assigned to take in the context of CRTC forbearance of local exchange services and which role will the Competition Bureau will need to take in order to **quickly** provide the CRTC with the legitimacy to intervene whereby the Bureau would decide that a specific complaint does not fall under its jurisdiction.
38. Industry Canada is requested by the QCISP to accompany its proposed Order with a description of the specific nature of means that, when used in a manner which would result in a refusal to provide service (such as with exclusionary or prohibitively high rates), would result in the Competition Bureau being requested to consider as being a violation of Competition Act.
39. Industry Canada is further requested by the QCISP to accompany its proposed Order with a description of the circumstances where the Competition Bureau must be prepared, whereby it would be willing to refer matters to the Competition Tribunal, to assert treatment of a complaint (in both cases of partial and complete forbearance by the CRTC) when the CRTC would be deemed by the Bureau as likely to grant lesser of a relief (too little or too late) then resulting from prosecution under the Competition Act.

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<sup>11</sup> [http://broadband.ic.gc.ca/pub/appcentre/open\\_access.html](http://broadband.ic.gc.ca/pub/appcentre/open_access.html)

<sup>12</sup> Where no tariff applies, the existing service provider must offer its services and/or facilities to any qualified competitive service provider at **a rate equal to the existing service provider's lowest retail price minus 25%**.

<sup>13</sup> <http://broadband.ic.gc.ca/pub/program/bbindex.html>

## Definitions of anti-competitive acts and of relevant product and geographic markets

41. The QCISP agrees with the Competition Bureau in the proposed wording of Section 28 of its draft Telecommunications Abuse Bulletin, and the interpretation of this wording as developed upon in the TAB's introduction by referring to a Federal Court of Appeal's 2006 Decision (Commissioner of Competition v. Canada Pipe Company Ltd.). Practices intended to have a negative effect on a competitor fall under the definition of anti-competitive acts.
42. Among international jurisprudence helpful in understanding why the definition needs to encompass a wide array of practices is an Australian case that has been much discussed in recent economic literature. In a case concerning businesses in the masonry sector, the full Federal Court (the Australian Court of Appeals) has found that neither the ability to recoup the costs incurred in margin-squeezing nor violation of a cost-based standard is required to establish predatory pricing and "that the ability of a firm to exclude a competitor is evidence that it possesses a substantial degree of market power"<sup>14</sup>. The High Court did not look into the question of intent for it could limit its analysis of the situation to the fact that there was a sufficient number of competitors in the market. Hence it left aside the issue as to whether the accused had "misused market power and therefore whether its pricing behaviour had been predatory or competitive"<sup>15</sup>. The use of market power can be an important factor making it possible and rational, for near-monopoly businesses to use anti-competitive behaviour.
43. As to other matters of definition in the draft TAB, the Competition Bureau recognizes that wireline infrastructure serving one customer premise can be relevant geographic market for which abuse of dominance can be exerted.
44. The QCISP agrees with the Competition Bureau that at the time of defining product and geographic markets, a particular service bundle in a small geographic area can be specifically designed to deter facilities-based entry from a specific competitor acting as reseller. Consequently, it will be important to define as many geographic and product markets as there will be bundles designed to deter competitive entry.
45. The QCISP submits that the Ministerial directives to the CRTC, including the overriding the conditions for achieving local telephone service forbearance, take the issue of forbearance far beyond the principle of service-oriented forbearance policy which the CRTC has, albeit painstakingly and way too unresponsively, been applying up to now.

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<sup>14</sup> Fallon, John and Flavio M. Menezes (2005), "Exclusionary Conduct: Theory, Tests and Some Relevant Australian Cases" in The Australian National University Papers in Regulatory Economics, no. 3/2005, p 40.

<http://www.acore.org.au/research/WorkingPaper03-2005.pdf>

<sup>15</sup> Ibid. p. 41.

## Remedies that do more harm than good

46. The remedies that the Competition Bureau describes in the Bulletin are those that the Competition Act assigns to the Bureau and are, in most cases, adequate for a mature competitive market.
47. Even in such markets, the timeliness for the Bureau's complaint's process have been questioned. Prof. Andrew Eckert has described the two-stage process through which a complaint against anti-competitive acts goes through: the data collection and analysis stage, and the legal proceedings, both of which are time-consuming<sup>16</sup>. He comes to the conclusion that speeding the economic analysis is the most likely solution if the whole process can be made timelier. At the moment, the delay between a complaint and the first steps in the legal procedures, the exchange of expert reports, is often more than a year-long. The QCISP is submitting as evidence in Appendix 1 to the present intervention, the article by Prof. Eckert, entitled *Predatory Pricing and the Speed of Antitrust Enforcement*.
48. The perspective of delays of 12 to 15 months before a complaint might even result in a legal procedure is a poor omen for the future of the telecommunications industry. The fact that the Minister of Industry has recently presented Bill C-41<sup>17</sup> that would bestow the Competition Bureau the responsibility to supervise the state of competition in the telecommunications industry is in direct contradiction with a recommendation made by the recent *Telecommunications Policy Review Panel Final Report 2006*<sup>18</sup> ("TPRP Report") to the effect that a specific telecommunications competition monitoring bureau be set up. It is noteworthy that the Telecom Review Panel's recommendation concurs with Prof. Eckert, who finds that speeding up antitrust enforcement could be attained by having industry-specific agencies investigate cases of predation. Neither the TAB, nor Bill C-41 seem to understand that the import of such recommendations.
49. In a more recent article, Prof. Eckert describes the difficulty for agencies to develop tests that can properly identify predatory acts in the case of multiproduct retailers, which is exactly what the telecommunications industry has become. He concludes his literature review by stating that he "did not uncover any discussion of applied procedures for analyzing the multiproduct firm predation problem in a retail context when products are complements or substitutes.

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<sup>16</sup> Eckert, Andrew, "Predatory Pricing and the Speed of Antitrust Enforcement" in Review of Industrial Organization, Vol. 20, no 4, June 2003, p. 375-383.

<sup>17</sup> <http://www2.parl.gc.ca/HousePublications/Publication.aspx?Docid=2578106&file=4>

<sup>18</sup> [http://www.telecomreview.ca/epic/internet/intprp-gecrt.nsf/en/h\\_rx00054e.html](http://www.telecomreview.ca/epic/internet/intprp-gecrt.nsf/en/h_rx00054e.html)

Competition authorities would clearly benefit from the development of such procedures”<sup>19</sup>. Without such procedures, it might take a few years for the new entity, even with its specialists' staff, to offer an enforcement process that is timelier yet than the one currently offered by the Competition Bureau.

50. However, even if post-facto regulation could be made swifter through such a development, the analysis of a complaint against predatory pricing would still be a lengthy process, during which the complainant might be eliminated as a competitor. The legislator has toyed with the idea of granting the Commissioner of Competition the power to issue cease and desist orders or perhaps, in a softer version of this, the power to apply to the Competition Tribunal for interim injunctions when it is believed that injury to competition might ensue as an effect of the situation existing at the time an enquiry has been set in motion.<sup>20</sup> Neither of these powers has been awarded to the Commissioner of Competition. In the situation of frailty of the telecommunications competitive market that we have described previously, post-facto regulation might prove to be the end for newly-founded firms competing in an industry in which the ILECs and the cablecos have developed networks and a customer-base through years of monopoly markets.

51. There are also questions as to whether or not there might be an incentive for the Bureau to act. The VanDuser Report commissioned by the Bureau of Competition makes this particularly clear:

“With respect to taking cases under the abuse provision, there are a variety of questions which would arise with respect to how the Competition Tribunal would deal with a price discrimination case. It is not obvious that pursuing cases to resolve these questions would be a responsible use of the Bureau’s constrained resources, except perhaps where price discrimination is one of a number of alleged anticompetitive acts or the anticompetitive effect is substantial.”<sup>21</sup>

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<sup>19</sup> Eckert, Andrew and West, Douglas S. “Testing for predation by a multiproduct retailer”, Conference at the “Pros and Cons of Low Prices” Seminar, Konkurrensverket (Swedish Competition Authority), November 2003, p. 39-69. [http://www.kkv.se/t/Page\\_790.aspx](http://www.kkv.se/t/Page_790.aspx)

<sup>20</sup> The House's Standing Committee on Industry has studied the possibility of modifying Section 100 of the Competition Act in order to make such an application by the Commissioner of Competition possible.

Standing Committee on Industry, Chapter 7 “Interim Cease and Desist Powers” in Interim Report on the Competition Act, June 2000.

<http://cmte.parl.gc.ca/Content/HOC/committee/362/indu/reports/rp1031742/indu01/07-toc-e.html>

<sup>21</sup> VanDuser, J. Anthony and Paquet, Gilles, *Anticompetitive Pricing Practices and the Competition Act. Theory, Law and Practice*, Part IV “Conclusions Regarding Specific Types of Anticompetitive Pricing Practices”

<http://www.competitionbureau.gc.ca/internet/index.cfm?itemID=1256&lg=e#ToC>

52. The TAB needs to be much clearer in defining areas in which it is felt that price discrimination might produce anticompetitive effects that will warrant the Bureau's action.
53. The QCISP further submits that regulatory grey zones which act as compounding sources of delays are also recognized by the Competition Bureau. In its intervention<sup>22</sup> to the CRTC on June 22<sup>nd</sup> 2005, the Bureau also urged the CRTC, in paragraph 329, to make clear, in its forbearance orders, the precise matters (i.e., activities) it intends to continue to regulate if it decides on partial forbearance.
54. The QCISP fears that until such time as the CRTC provides further direction as an outcome of PN 2006-14 sometime in Mid-2008, the CRTC will provide no meaningful relief to the issue of margin squeeze and it is for this reason that the QCISP submits that the TAB must be made much clearer with regards to the cases which the Competition Bureau will be willing to take between now and such time as the CRTC provides its decision in PN 2006-14.

### **Margin-squeeze and price eviction under premature local forbearance**

55. The TAB prudently reminds its readers that “at the theoretical level, establishing an appropriate test to determine below-cost pricing is difficult.” It then goes on to present the sequential approach that it would take in examining predatory pricing complaints. The QCISP argues that the sequence presented in the TAB, even if it is firmly based in the time-proven framework of Joskow and Klevorick (1979)<sup>23</sup>, needs to be much more precise, especially in the description of the third step.
56. We mentioned earlier in our submission a second article by Prof. Andrew Eckert. This article, written in collaboration with Prof. Douglas West, addresses the proper processes that should be developed by competition authorities when dealing with multiproduct retailers. We present it as evidence in Appendix 2 to the present intervention. The QCISP submits that the dominant telecommunications service providers, now that most of them have entered the quadruple-play market, correspond to the definition of multiproduct retailers. Not only do they offer wireline phone service, cellular phone service, distribute television channels and make available diverse types of access to the Internet, but each of these services comes with its own palette of optional services.

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<sup>22</sup> [http://www.crtc.gc.ca/public/partvii/2005/8640/comm\\_comp/050622.zip](http://www.crtc.gc.ca/public/partvii/2005/8640/comm_comp/050622.zip)

<sup>23</sup> Joskow, Paul, and Alvin Klevorick (1979), ‘A Framework for Analyzing Predatory Pricing Policy’, in *Yale Law Journal*, vol. 89, p. 213-270.

57. Before they present the processes that are most adequate to prevent predatory pricing in the case of multiproduct retailers, Profs. Eckert and West refer to the established analysis by Cabral and Riordan (1997)<sup>24</sup> of pricing issues for such retailers. When under review by a competition authority;

“it is not enough for a firm to argue that below cost pricing on a subset of items is justified by the net revenue gain on complementary goods sold by the firm. Rather, if such pricing causes a rival firm to incur losses, the question would be whether the firm could have realized net revenue gains on complementary goods without engaging in pricing that forces losses on the rival.” (p. 53)

58. Profs. Eckert and West move from Cabral and Riordan's definition into issues of implementation. The QCISP submits that the Eckert and West proposal should serve as a model for the Competition Bureau both in analyses of recoupment and of avoidable costs. Eckert and West's proposal focuses on issues of best practices for competition authorities in finding data for economic analysis following a complaint against predatory pricing and in doing so in a timely fashion.

59. Eckert and West state that:

“While the conceptual approach seems clear, the difficulty arises in having a competition authority implement the approach. Part of the difficulty is that in the initial stage of an investigation into a predation complaint, the competition authority may not have access to the alleged predator's revenue and cost data. It will have to assess the depth of the alleged predator's discounting using information provided by the complainant. [...] The next step would be to determine what “normal” loss leading prices would be for the products. The complainant could provide information in this regard. [...]

Having followed the steps outlined above, one should be able to establish that (1) Firm 1 is pricing a set of items [...] lower than one would expect with normal loss leading, and likely below its acquisition cost as well, (2) Firm 2 is suffering a loss of net revenues by charging the same prices as Firm 1, and could have higher net revenues if normal loss leading prices were charged.” (p. 61-62)

60. If the practices presented by Profs. Eckert and West (as summarized above and in their complete form in an appendix to this intervention) were used by the Competition Bureau, the

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<sup>24</sup> Cabral, L. and M. Riordan (1997), “The Learning Curve, Predation, Antitrust and Welfare,” in *The Journal of Industrial Economics*, vol. 45, no 2, p. 155-169.

QCISP submits that such a process, in finding whether there are foundations to a complaint, provides enough information to set, when appropriate, legal procedures in motion.

61. The QCISP submits that such reverse onus of proof must behold on industries which do not divulge costs but which exhibit dominant market power, especially given the relative size of the ISPs compared to the incumbent telephone and cable carriers.
62. The QCISP contends that dominant carriers, if they are not behaving in a manner that is anticompetitive, should be able to defend their wholesale rate structure by proving that an efficient independent ISP would be able to compete in the downstream retail local telephony market with the products that are provided to it by in the form of the wholesale products supplied by the dominant carrier to the independent ISP (including all elements necessary for user traceability for E-9-1-1 across the network-to-network elements of the wholesale DSL and DOCSIS infrastructures, IP-based Bill & keep interconnection, interconnection to local number portability system and IP-based interconnection to the E-9-1-1 infrastructure). Forbearance should not be granted until such time these new wholesale products are in place.
63. The QCISP submit that the test for margin squeeze and price eviction in the TAB must not be so complex as to nullify all desire of competitors to remain in the market. If this is so, market forces will remain artificially held back by poor enforcement of deficient pro-competitive regulation with the telco and cable incumbents unfairly winning the fight.

## Conclusion

64. The QCISP is concerned that the proposed Order, as it stands, does not provide means for QCISP members to intervene to the Bureau of Competition, in view of the fact that the CRTC has not unconditionally forbore most services upon which the QCISP depends to offer telephone services in competition with much dominant ILECs and dominant cable carriers. It is for these reasons that the proposed Order must be made explicit as to which kinds of complaint Industry Canada will expect the Competition Bureau to be willing to take.
65. The QCISP fears that the proposed Order, as it stands, will not be of any use to patch the current *cracks-through-the-system* which permit the incumbent telephone and cable carriers go about their Internet access business units generating 19% profit margins despite such profit margins being significantly above that of other industries considered as competitive. This alone, should be considered by Industry Canada that the telecommunications industry is not nearly as competitive as the ILECs and the incumbent cable carriers would consider it to be.
66. It is the view of the QCISP that the powers to fine for up to \$15M provided to the Competition Bureau also grant the Competition Bureau the right to receive complaints under the umbrella of implementation of recommendations 4.1 to 4.17<sup>25</sup> of the TPR which calls for a Telecommunications Competition Tribunal. In view of the QCISP, telecom complaints should be dealt with by that the Competition Tribunal until such time as the TCT is formally enacted in law.
67. Consequently, it is the view of the QCISP that the proposed Order must outline how the Competition Bureau will be dealing with complaint that relate to the implementation of recommendations 5.1 to 5.13<sup>26</sup> of the Telecom Policy Review until such time as the CRTC updates its regulatory framework to be able to deal with such complaints.
68. The QCISP further submits that regulatory grey zones that act as unnecessary compounding source of delays are also recognized by the Competition Bureau, which in its intervention<sup>27</sup> to the CRTC on June 22<sup>nd</sup> 2005, also urged the CRTC, in paragraph 329, to make clear, in its forbearance orders, the precise matters (i.e., activities) it intends to continue to regulate if it decides on partial forbearance.

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<sup>25</sup> <http://www.telecomreview.ca/epic/internet/intprp-gecrt.nsf/en/rx00066e.html#T3>

<sup>26</sup> <http://www.telecomreview.ca/epic/internet/intprp-gecrt.nsf/en/rx00066e.html#T4>

<sup>27</sup> [http://www.crtc.gc.ca/public/partvii/2005/8640/comm\\_comp/050622.zip](http://www.crtc.gc.ca/public/partvii/2005/8640/comm_comp/050622.zip)

69. The QCISP fears that, until the CRTC provides further direction as an outcome of the proceeding in PN 2006-14, which is expected sometime in Mid-2008, the CRTC will provide no meaningful relief to the issue of margin squeeze. In voice, margin squeeze arise out of the current cost structure of interconnection as a status quo. Delays in the implementation of ENUM as a replacement for the SS7 system and lack of expedient migration to IP-based intercarrier bill & keep interconnection as a replacement for the current ISDN infrastructure, will act as the principal deterrent to real competition. Forbearance should not be granted until these matters are resolved.

70. It is for this reason that the QCISP submits that the proposed Order must be made much clearer with regard to the cases which the Competition Bureau will be assigned to take between now and such time as the CRTC provides its decision.

\*\*\* END OF SUBMISSION \*\*\*

## Appendix 1



## Predatory Pricing and the Speed of Antitrust Enforcement

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**Abstract.** A common complaint is that in certain industries antitrust action against predation is too slow to ensure that a true victim can survive until the antitrust process has been concluded. This paper discusses, in the context of two recent antitrust cases, the sources of delay in the antitrust process, and different policy reforms aimed at speeding up the process or otherwise protecting a true victim.

**Key words:** Competition policy, predatory pricing.

### I. Introduction

Policy makers and antitrust enforcement agencies often assert that in certain industries, antitrust action against predation must be swift to ensure that the prey is not eliminated before the antitrust action is concluded. As U.S. Congressman Charles E. Schumer argued in his comments before the house judiciary committee regarding policies proposed by the Department of Transportation (DOT), “Currently, the Department takes far too long to respond to a complaint of predatory practices. It is little solace for executives at a small airline for DOT to declare their complaint valid if they have already been driven out of business by unfair competition”.<sup>1</sup> Similar concerns have been expressed in Canada regarding the airline industry. The Commissioner of Competition, who conducts investigations under the Canadian *Competition Act*, has stated that “it takes considerable time for the Bureau to investigate the merits of complaints and prepare a case for litigation before the Tribunal. Given the extraordinary circumstances in the airline industry, the current provisions of the Act are inadequate to secure timely and effective relief”.<sup>2</sup>

In response to these concerns, several policies have been proposed to reduce the time required for the antitrust process in predation cases, or otherwise protect a true victim. The purpose of this paper is to consider the causes for antitrust enforcement

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\* I thank Douglas West and Heather Eckert for detailed comments. Remaining errors are my own.

<sup>1</sup> Testimony of congressman Charles E. Schumer before the House Judiciary Committee, May 19, 1998 (available online at [http://commdocs.house.gov/committees/judiciary/hju57743.000/hju57743\\_0.f.htm](http://commdocs.house.gov/committees/judiciary/hju57743.000/hju57743_0.f.htm)).

<sup>2</sup> Letter from Konrad von Finckenstein to The Honourable David M. Collenette, Minister of Transport, October 22, 1999 (Available on the Competition Bureau’s website at [competition.ic.gc.ca](http://competition.ic.gc.ca))

delay and to evaluate the ability of various policy proposals to reduce the time required to enforce antitrust law against predatory behavior or to protect a true victim through the process. Throughout the paper, I will refer to two recent cases, the U.S. Department of Justice's case against American Airlines, and the Canadian Competition Bureau's case against Air Canada. This focus is motivated by the fact that possible predation in the airline industry has been the subject of much concern regarding the timeliness of enforcement. As well, to maintain the focus on the speed of antitrust enforcement, it is taken as given that predation in a market has been alleged.<sup>3</sup>

## II. The Traditional Antitrust Approach to Predatory Pricing

The traditional antitrust enforcement approach to complaints of predation, adopted for example in the United States and Canada, can take years from the time of a complaint to a decision by a court or other decision making body. Table I presents a timeline for the U.S. Department of Justice's (DOJ's) case against American Airlines, which began with a complaint by the DOJ in May 1999 concerning alleged predation occurring as early as 1995, and was not resolved until summary judgment was granted in April 2001. Table II presents a timeline for the Canadian Competition Bureau's case against Air Canada, regarding complaints by the airlines WestJet and CanJet. The Competition Bureau received its first complaint of predation in April 2000, and began presenting its case to the Competition Tribunal on August 29, 2001.

Table I. Pretrial schedule in American Airlines Case

Event	Date
Complaint filed by DOJ	May 13, 1999
Completion of all fact discovery	August 31, 2000
Completion of expert discovery	December 22, 2000
Deadline for dispositive motions (such as motions for summary judgment)	January 8, 2001
Deadline for other pre-trial motions	April 30, 2001
First date of trial	May 22, 2001

Sources: *United States v. AMR Corporation, et al.*, Civil Action No. 99-1180-JTM, District Court for Kansas, complaint filed May 13, 1999; *United States v. AMR Corporation, et al.* (13 April 2000), revised scheduling order, Case No. 99-1180-JTM, Kan. (Dist. Ct), online: Department of Justice, <<http://www.usdoj.gov/atr/cases/f7000/7032.pdf>> (accessed 31 August 2001).

<sup>3</sup> As a consequence, I will also not discuss policies that would reduce the time of enforcement by inducing the alleged predator to voluntarily cease questionable practices. Such policies would include a practice of issuing warnings, which would indicate that the firm in violation will be monitored more closely in the future and face stiffer penalties if found in repeat violation. For a discussion of the economic theory involved (in an environmental setting) see Harrington (1988).

Table II. Timeline for Air Canada Case

Event	Date
Complaint by WestJet to the Competition Bureau	April 20, 2000
Inquiry into WestJet's complaint initiated	May 8, 2000
Complaint by CanJet to the Competition Bureau	September 7, 2000
Inquiry into CanJet's complaint initiated	September 28, 2000
First order for relevant records from Air Canada	June 12, 2000 (response received on July 31, 2000)
Depositions conducted	January–February 2001
Competition Bureau applies to Competition Tribunal seeking an order against Air Canada	March 5, 2001
Documentary and oral discovery to be completed	June 2001
Completion of all expert reports, including replies	August 20, 2001
Hearing begins	August 29, 2001

Sources: Derived from information from the Competition Bureau Website (<http://competition.ic.gc.ca>); *Commissioner of Competition v. Air Canada*, (29 May 2001), scheduling order, File no.: CT2001002 (Comp. Trib.), online: Competition Tribunal <http://www.ct-tc.gc.ca/english/cases/ct-2001-002/0021.pdf> (accessed August 31, 2001).

The length of time required for the analysis of an allegation of predation and the enforcement of the antitrust laws depends both on the legal framework and on the detailed economic analysis required. In the American Airlines case, the expert reports (not including responses and rebuttals) had to be completed by September 18, 2000 for the plaintiff and by October 11, 2000 for the defendants, more than fifteen months after the U.S. DOJ's complaint was filed. Similarly, in the Air Canada case, the period between the initiation of the inquiry by the Competition Bureau and the date scheduled for the exchange of expert reports was over fourteen months.<sup>4</sup> This delay results in part from the time required for the collection and analysis of data and information relevant to the complaints, as well as the completion of the discovery process.

After the exchange of initial expert reports, additional time is required for the legal proceedings themselves. This includes responses to expert reports and expert depositions, pretrial motions, and the trial or hearing itself. In the American Airlines case, two to three months were allowed for responses and rebuttals, and, after discovery, over four months were allowed for the submission of motions (for example, a motion for summary judgment was required seventeen days after the completion of discovery). In the Canadian case, the time allowed for responses to expert reports was only seventeen days; hearings were scheduled to begin seven days after responses were submitted. Because American Airlines was granted sum-

<sup>4</sup> The investigation of Air Canada's conduct was modified in September 2000 to incorporate additional complaints by CanJet, another rival airline. The time between the initiation of the CanJet inquiry and the exchange of expert reports was 10 months.

mary judgment, it is difficult to comment on the length of time that would have been required for the trial, but a period of months is likely.<sup>5</sup> In the *Air Canada* case, the planned hearing schedule spans the period from August 29, 2001 to November 26, 2001.

In summary, the antitrust process in a case of predation can be broken down into two broad stages: the data collection and analysis stage, and the legal proceedings. Two recent cases regarding airlines seem to suggest that the time required for data collection and analysis is at least as important as the time for legal proceedings, although this would likely depend on the nature of the industry. The remainder of this section focuses on the time costs of the economic analysis.

The traditional analysis by antitrust agencies in the U.S. and Canada of an allegation of predatory pricing follows a two stage approach similar to the one recommended by Joskow and Klevorick (1979). Two distinct questions are addressed in a two-stage analysis: the probability of recoupment and whether the alleged predator set prices that fell below some measure of its costs.<sup>6</sup> In the United States, this procedure is the result of jurisprudence, while in Canada, enforcement guidelines have indicated that the antitrust agency follows such an approach.

In satisfying the recoupment element of a case, an antitrust agency attempts to demonstrate that the predatory pricing allowed or would have allowed the predator to subsequently increase prices to recoup the losses from the predatory campaign, or maintain high prices in other markets that would otherwise have faced entry from competitors. To prove actual or probable recoupment requires demonstrating (a) that increasing prices or maintaining prices in other markets would not attract further entry, and (b) that the alleged predator possessed or would possess, in the event of successful predation, sufficient market power to ensure that such a price increase would be possible and profitable.

The second stage of a traditional antitrust analysis of a predation case involves a comparison of the alleged predator's price to some measure of its costs, typically average variable or average avoidable cost. Although the precise test varies, prices above the specified cost are usually taken not to be predatory, whereas prices below the cost measure are held to be predatory, provided the recoupment element is met.<sup>7</sup>

Both the recoupment analysis and the cost-based test are potentially time consuming when applied to certain industries, as they require the economic analysis of data that must be collected from the alleged predator. In analyzing the potential for recoupment, economic analysis is likely required on the issue of entry barriers, and in determining whether post-predation prices in a market were higher or will likely

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<sup>5</sup> For example, the trial in *Brooke Group Ltd v. Brown and Williamson Tobacco Corp.* (113 S.Ct. 2578(1993)), a landmark case in predation litigation, took 115 days.

<sup>6</sup> In some jurisdictions, the recoupment element is replaced by a similar requirement to demonstrate that competition has been or is likely to be prevented or lessened. Such a requirement appears, for example, in a civil case of predation under the abuse of dominance provisions of the *Competition Act*. For a discussion of the elements of an abuse of dominance case, see Church and Ware (1998).

<sup>7</sup> Alternatively, the test may specify a "grey range" in which prices may be deemed either lawful or unlawful depending on circumstances.

be higher than they would be in the absence of predation. In the DOJ case against American Airlines, the summary judgment indicates that the DOJ, in attempting to prove recoupment, relied on economic analysis of changes in revenues and costs before and after the alleged predation, and comparisons of profitability measures on the routes on which predation was alleged to benchmark routes and time periods.<sup>8</sup>

Depending on the nature of the industry, carrying out the cost test can be even more time-intensive than the analysis of recoupment. Assume that the costs standard is avoidable costs, and that the firm whose conduct is being investigated faces a large number of different cost items. The price-cost test would require that each cost item be classified as either avoidable or not. As well, in certain industries including airlines, firms set a complex array of prices instead of a single price. An analysis of alleged predation would then include a determination of the appropriate measure of revenues for the price-cost test. Carrying out the cost-based test for predation thus will entail a time-consuming determination of both the costs and revenues of operation of the alleged predator, including an analysis of which of the alleged predator's costs are avoidable.

### III. Policy Options

Policy proposals that would speed up the antitrust process or provide other mechanisms to ensure the survival of the victim can be targeted at the time requirements of the legal process, the complexity of the economic analysis, or at protecting the alleged victim throughout the traditional antitrust process. While there are several causes of delay in both the legal process and the economic analysis, the more practical and likely more effective reforms target the speed with which the cost based test and recoupment analysis can proceed and be argued in a trial or hearing, as opposed to changing the test itself. Such reforms could involve enhancing the information readily available to antitrust agencies, or specifying precisely in antitrust laws or regulations the test of predation to be used.

#### 1. THE LEGAL PROCESS

Few proposals for reform of the legal process have been suggested. One promising approach would target the time spent litigating the legal definition of predation, and the precise legal standard that must be applied. By making the legal definition of predation and elements that must be met more specific, the "rules of the game" would be clarified, narrowing the range of issues that need to be decided, and shortening the time spent arguing the appropriate test of predation. For example, the Canadian House of Commons amended the *Competition Act* recently to allow the Governor in Council to specify, through regulation, anticompetitive acts specific to

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<sup>8</sup> In the AMR summary judgment, the court rejected the recoupment calculations provided by the DOJ, in part because they were based on revenue-less-costs figures used by American Airlines for internal comparisons, which the court held to be inappropriate for an analysis of predation.

the airline industry, for the purposes of the abuse of dominance provisions of the *Competition Act*. This amendment allowed the creation of regulations that define predatory acts by a dominant airline, and which were in place when the government's application to the Competition Tribunal regarding Air Canada's conduct was made. The regulations entrench the comparison of revenues with avoidable costs into the law, possibly eliminating time spent in hearings arguing about the appropriate test for predation.

These regulations do not state which costs should be considered avoidable in a particular setting, or address other questions regarding the application of the test. However, Competition Tribunal documents indicate that phase one of the hearing regarding Air Canada's conduct will be devoted to establishing the appropriate application of the avoidable cost standard: which costs are avoidable, whether the test pertains to a flight or a route, and the time period that should be considered.<sup>9</sup> Once the Tribunal has made these decisions, the time required in future cases should be substantially reduced.

## 2. THE ECONOMIC ANALYSIS

Possibly because of the large amount of time required for data collection and analysis, as well as the difficulty in reducing the time required for the legal process, several proposals attempt to reduce the time required for the economic analysis. One suggestion has been that the enforcement of laws or regulations dealing with predation in certain industries be handled by industry-specific agencies. For example, the U.S. Department of Transportation in 1998 indicated in draft policy guidelines its intention to investigate certain complaints of predation by an airline. Certainly, reforms of this sort might reduce the time required for the traditional analysis by providing an agency with specialized knowledge of the cost and pricing practices in certain industries, thus speeding up the application of the cost-based test. As well, specialized bodies may engage in regular monitoring of market characteristics, resulting in the faster determination of the recoupment element. To the extent that delays in the economic analysis are due to a lack of understanding of the industry in which the behavior is alleged, specialized bodies could be able to facilitate the investigation of competitive complaints in specific industries.

Alternatively, a related possibility for specific industries would be requirements of data availability. By requiring, through law or regulation, that firms in particular industries keep certain records of their costs and price structures, one could potentially reduce the time required for data collection. However, before such a regulation could be brought into effect, a careful study would need to determine the level of aggregation and the frequency with which the data should be reported, which would vary across industries.

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<sup>9</sup> *Commissioner of Competition v. Air Canada*, (15 May 2001), order regarding issues to be determined at the hearing, File no.: CT2001002 (Comp. Trib.), online: Competition Tribunal <<http://www.ct-tc.gc.ca/english/cases/ct-2001-002/0018.pdf>> (accessed August 31, 2001).

Some proposals for reform have focused not on the speed of the existing economic analysis, but on abandoning the two stage economic analysis in favor of a different economic test. For example, in its 1998 proposal, the U.S. DOT advocated an analysis of the degree to which the alleged predator's actions caused it to earn substantially lower profits than a reasonable alternative response, as opposed to analysis of recoupment and the application of a cost-based test. While the DOT's proposed approach has been argued to be consistent with an economic definition of predation (Bolton et al., 2000), this approach would seem if anything to extend the time required for analysis, as it would appear to require more information and a more complicated analysis than would the recoupment and cost test procedure. Certainly, the DOT's proposal included simplified bright-line tests that would be used to initiate an inquiry, such as when the alleged predator's passenger count at the new entrant's fares exceeds the new entrant's total capacity (and resulted in lower revenues than would an alternative response). However, the proposal did not indicate whether such a finding could form the basis for prosecution.<sup>10</sup>

In Australia, a recent decision by the Full Federal Court has indicated that neither recoupment nor violation of a cost-based standard is required to establish predatory pricing under Section 46 of the Trade Practices Act, and that the key element that needs to be satisfied is that of intent.<sup>11</sup> Regarding recoupment, the court found that what must be established is only that the firm misused a substantial degree of market power. It is unclear what effect this decision will have on the speed with which predation can be dealt in Australia, as there is little jurisprudence concerning intent. As well, any gains in terms of speed would need to be offset against the ability of methods other than the cost-based test to effectively detect true predation.

### 3. CEASE AND DESIST POWERS

Beyond shortening the enforcement period, reforms can focus on protecting a true victim. In Canada, attention has been paid to the scope for cease and desist orders, which would require alleged predators to stop setting particular prices until an analysis can be concluded. Bill C-23, which received first reading on April 4, 2001, would extend the scope under which the Competition Tribunal could issue temporary orders. Regarding airlines, recent legislation grants the Commissioner the power to issue temporary cease and desist orders when the Commissioner considers that in the absence of such an order (i) injury to competition that cannot adequately be remedied by the Competition Tribunal is likely to occur, or (ii) a person is likely to be eliminated as a competitor, suffer a significant loss of market share or revenue, or suffer other harm that cannot be adequately remedied by the

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<sup>10</sup> For a detailed discussion of the DOT proposal, see Eckert and West (2001).

<sup>11</sup> In its 2001 decision regarding an appeal by Boral Limited, the Full Federal Court indicated that while persistent pricing below cost may be taken as evidence of intent, it is not required.

Tribunal. Such an order has effect for 20 days, and may be renewed for two 30-day periods.

While the use of temporary orders to prevent the exit of an alleged victim is appealing, certain criticisms have been made against the approach.<sup>12</sup> Clearly, care must be taken to ensure that the cease and desist power is not used to temporarily maintain prices above competitive levels, a task that becomes more difficult given that by definition the temporary orders are used before there has been sufficient time to conduct an analysis of the observed pricing. As well, the question has been raised whether the antitrust agency should have the power to issue an order, or whether this power belongs with a court or tribunal.<sup>13</sup>

The Competition Bureau's recent experience with such cease and desist powers has been mixed. On October 12, 2000 the Commissioner issued a temporary order requiring Air Canada to stop offering L14EASTS fares, or any similar fares on five routes in eastern Canada, in response to allegations of predation made by CanJet, a new airline. The Competition Tribunal ruled on November 24 that the phrase "any similar fares" must be removed from the order, but otherwise confirmed the order until December 31, 2000. In 2001, CanJet was acquired by Canada 3000, another small Canadian airline. Whether the acquisition came about because CanJet could not survive against Air Canada despite the temporary orders is at this point unclear.

#### IV. Concluding Remarks

The length of time required for the antitrust process in a case of alleged predation has been publicly criticized because of the possibility that a true victim may be driven out of a market before the process can be completed. An examination of recent cases and the analysis involved suggests that both the legal process and the complexity of the economic analysis required by jurisprudence contribute to the time required. There have been many proposals to speed up the enforcement process or otherwise ensure the survival of a true victim. However, it is argued that those proposals most likely to be successful involve maintaining the recoupment analysis and cost based test and reducing the time required for that analysis to be conducted and argued. This could be achieved by creating industry-specific knowledge and ready access to appropriate data, and defining through law and regulation the precise behaviors that will be considered predatory in particular industries.

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<sup>12</sup> For a discussion of these concerns in the Canadian context, see for example the Interim Report on the *Competition Act* (2000) of the Standing Committee on Industry, available online at <http://www.parl.gc.ca/InfoComDoc/36/2/INDU/Studies/Reports/indu01-e.html>

<sup>13</sup> Air Canada recently lost a constitutional challenge regarding the Commissioner of Competition's new cease and desist powers; see *Air Canada v. Canada (Procureur Général)*, [2000]JQ. No.4771 (C. S. Q) online: QL (JQ).

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## Appendix 2

# The Pros and Cons of Low Prices

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## **Preface**

"The Pros and Cons of Low Prices" is the second in the Swedish Competition Authority's Pros and Cons series following last year's "The Pros and Cons of Merger Control." The book will be officially released on December 5, at a seminar in Stockholm where the authors will present their work and high-ranking officials from competition authorities around the world will act as discussants.

I would like to express my gratitude to the all the authors who have contributed; without you we would not have a book at all. The editor, Professor Einar Hope also deserves a lot of credit for taking care of the scientific review. Finally, I would like to thank Arvid Nilsson at the Swedish Competition Authority for managing the entire project.

Stockholm, October 2003

*Claes Norgren*

*Director-General*

### **3. Testing for predation by a multiproduct retailer**

*Andrew Eckert and Douglas S. West*

#### **3.1 Introduction**

Few sectors of the economy receive as much attention regarding potentially predatory behavior as retailing. In Canada, the United States, and many European countries, allegations of predatory pricing in gasoline retailing or grocery retailing have resulted in numerous antitrust cases and government and industry studies. In addition, many jurisdictions have responded to popular concern regarding predation by retailers by adopting new laws, or proposing amendments to existing laws, that target certain pricing behavior by firms in specific industries.

An important characteristic of retailing is that retailers frequently sell multiple products. In many cases, predation is alleged with respect to a small subset of products that the retailer sells. For example, a grocery chain may be accused of predatory pricing over a small subset of a large number of grocery items, or through the pricing of gasoline sold at outlets located on store property. In general, however, the demand a multiproduct retailer faces for one product will depend upon the prices set on other items. A retailer may therefore have an incentive to set a “low” price on certain high profile products, thus increasing demand over a wider set of items. Such loss-leading behavior can lead to prices on individual products that are much lower than what the retailer would charge if the effect on the demand for other products was ignored. To the extent that this loss-leading is non-predatory, it may therefore represent an

explanation for low prices that does not depend on anti-competitive conduct.

Unfortunately, while modern predatory pricing tests provide some guidance on the treatment of costs for multiproduct firms in a cost-based predation test, the tests currently used by competition authorities say little about how to deal with the demand linkages across products. Practically, this means that governments do not have clearly articulated tests of predatory pricing that can be applied in the retailing sector.

The purpose of this paper is to consider how a predatory pricing test would be affected by the assumption that the alleged predator is a multiproduct retailer. It is argued that although the theoretical economics literature has considered this problem and proposed solutions, this discussion seems to have been forgotten or ignored in formulating current policy. Under the approach presented in this paper, in addition to a consideration of other elements as required by the relevant jurisdiction, a price-cost comparison will be conducted as an initial screen for an individual product or reasonable group of products, based on circumstances, ignoring demand complementarities across products. If the firm passes this initial screen then the test ends. If the firm fails this price-cost test, one would then proceed to analyze whether the magnitude of pricing below cost was necessary for the firm to fully exploit the demand complementarity, or whether higher prices would have sufficed. This analysis would likely be complicated, possibly involving detailed statistical analysis of the retailer's behavior in other markets.

The remainder of this paper is organized as follows. In Section II, we begin by reviewing any guidance in this matter provided by government guidelines, industry studies, and case law. In Section III, the theoretical and predation policy economics literature on the subject is reviewed. Section IV provides a detailed discussion of how an allegation of predatory pricing would be analyzed under several specific scenarios. Section V concludes.

### 3.2 Government predation policies and case law

While most countries have laws equipped to deal with predatory pricing by a multiproduct retailer, few governments have articulated how such a case would be analyzed. This section surveys the existing laws and any government documents that shed light on the application of these laws in the context of a multiproduct retailer, and discusses the relevant case law.<sup>1</sup>

#### ***Government policy and guidance***

##### *Canada*

Under the Canadian *Competition Act*, complaints of predatory pricing can be addressed with reference to two different sections of the *Act*. Under Section 50(1)(c), engaging in “a policy of selling products at prices unreasonably low, having the effect or tendency of substantially lessening competition or eliminating a competitor, or designed to have that effect” is prohibited as a criminal offense. Alternatively, Sections 78 and 79 of the *Competition Act* are civil provisions designed to prevent an abuse of a dominant position. Section 78 sets out a non-exhaustive list of anti-competitive acts, including “selling articles at a price lower than the acquisition cost for the purpose of disciplining or eliminating a competitor”. Other forms of predation can also be addressed under the abuse provisions.

The Competition Bureau has provided guidelines on Section 50(1)(c), which were recently revised and released in draft form (see Director of Investigation and Research, 1992, and Competition Bureau, 2002, respectively). The Bureau has also released guidelines on Sections 78 and 79 (Competition Bureau, 2001(a)). These sets of

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<sup>1</sup> A comprehensive comparison of general predatory pricing standards in various countries is provided in Niels and Ten Kate (2000).

guidelines describe the general approaches taken by the Bureau in assessing allegations of predatory pricing. While the guidelines differ on the approach to some issues (e.g., the need to show that the alleged predator is dominant, the need to demonstrate the possibility of recoupment, the assessment of legitimate business justifications, and the anticompetitive effects of the alleged predation), this is due in part to differences in the wording of Sections 50(1)(c) and 78/79. Both of the more recent guidelines rely on a comparison of the prices of the products or services in question to their avoidable costs. Little guidance is provided regarding how such a comparison would be carried out in the case of a multiproduct retailer.

The Competition Bureau has released guidelines regarding the application of the abuse of dominance provisions to the retail grocery industry (Competition Bureau, 2001b), which include a brief discussion of predatory pricing. The Bureau indicates that below cost pricing on fifty or fewer products would not be considered sufficient to lessen competition substantially, but provides no justification for that particular threshold other than reference to experience in previous unnamed cases. The Bureau also indicates that if below cost pricing is the result of competition between large supermarkets, and that competition leads to the exit of higher cost competitors, such conduct would not be an abuse of dominance. Finally, the Bureau indicates that a new entrant may be capable of predatory pricing, and thus analysis is not restricted to predatory pricing by established incumbents in the market in which predation is alleged.

### *United States*

Predatory pricing cases in the U.S. can be taken forward under Section 2 of the *Sherman Act*, which deals with monopolization and attempted monopolization, and the *Robinson-Patman Act*, which addresses price discrimination. The standard approach to a predatory pricing case, as developed through jurisprudence, combines a price-cost comparison with an examination of whether the costs of the predation to the predator will be recouped through

the exercise of future market power. Many courts have adopted the Areeda and Turner (1975) price-cost test for predation: a price below average variable cost is regarded as predatory. In addition, many U.S. states have their own below cost pricing laws that can be used to address predatory pricing. These laws are either of general application or they apply to specific products such as gasoline.<sup>2</sup> While in some states the elements that must be established are similar to those from federal jurisprudence, in other states the requirements differ.<sup>3</sup>

To our knowledge, there are no guidelines or policy documents of the Department of Justice regarding the analysis of predatory pricing cases in general or regarding predation by multiproduct retailers specifically. Some guidance in the case of a multiproduct retailer is provided by jurisprudence, as discussed below.

### *The U.K.*

Section 18(1) of the *Competition Act* (the Chapter II provision) of the United Kingdom prohibits the abuse of a dominant position. Guidelines issued by the Office of Fair Trading indicate that after establishing that an alleged predator is dominant in a market, the analysis would focus on a price-cost comparison.<sup>4</sup> This would be followed by a consideration of evidence of intent if prices fall between average variable and average total costs. The guidelines indicate that since Chapter II applies to firms that can be shown to be dominant in a market, recoupment would be expected if the firm is dominant in the market in which predation is alleged and need not be proven separately. In addition, the guidelines state that under European Court jurisprudence, establishing recoupment and the

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<sup>2</sup> In some states, below cost pricing laws also deal with pricing for purposes other than predation. For example, in California, pricing below cost is prohibited when such pricing represents loss-leading for the purpose of promoting the sales of other merchandise.

<sup>3</sup> The effect of state below cost sales statutes on price levels is discussed in Calvani (1999).

<sup>4</sup> See Office of Fair Trading (1999).

feasibility of predation would not necessarily be required in making a case.

The guidelines make little mention of the specific case of multiproduct retailing, except for noting that “a policy of loss leading might be objectively justified and would not therefore normally be predatory.”<sup>5</sup> However, studies by the Office of Fair Trading (1997) and the Competition Commission (2000) on retailing and supermarket behavior consider the possibility of predatory pricing by multiproduct retailers. In the Competition Commission’s study of supermarkets, the Commission concludes that supermarkets do engage in below cost selling of certain frequently purchased items, but does not conclude that this pricing is predatory. The Commission does not indicate that a recognized legal test of predatory pricing was carried out, but refers to evidence that supermarkets compete on the prices of certain products (which are advertised and whose prices are closely watched by consumers) below marginal cost, recovering these losses through above-cost prices on other items in the store. The Commission concludes that although this below cost pricing was not predatory, it was still harmful to competition by harming smaller grocery stores and convenience stores.

The Office of Fair Trading (1997) discusses how an allegation of predation should be analyzed in a retailing setting. The OFT argues that in retailing, a price-cost comparison will be of little use. The reasons given are that (1) larger retailers may obtain volume discounts from manufacturers, possibly allowing them to drive smaller retailers out of the market without pricing below cost, and (2) due to possible loss-leading behavior, pricing below cost on individual items may be profitable without being predatory.<sup>6</sup> The OFT argues that instead of a price-cost comparison, in the retailing sector an analysis of an allegation of predation should examine two elements: (1) whether the alleged predator deviated from its short

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<sup>5</sup> *Id.* at 12.

<sup>6</sup> However, the OFT claims that loss-leading may yield its own negative results.

run profit maximizing behavior in any way, and (2) whether predatory pricing would be rational. Unfortunately, the OFT does not provide any guidance for how the first element would be examined, and it does not explain how short-run profit-maximizing behavior can be tested without a comparison of prices to costs.

Finally, the OFT does consider, in a context other than retailing, the problem of an alleged predator who sells multiple products with demand complementarities. In the OFT's guidelines on the application of the *Competition Act* to the telecommunications sector (Office of Fair Trading, 2000, p.30), the OFT acknowledges that "where there is strong complementarity, in applying the relevant tests it may be more appropriate to take into account the costs and revenues of all the complementary services rather than require each individual service to cover its costs." There is no indication that such an approach would be taken in other sectors, or how complementary revenues can be measured.

### *European Commission*

Article 82 of the Amsterdam Treaty (previously Article 86 of the Rome Treaty) addresses the abuse of a dominant position, including pricing abuses. While guidelines regarding the application of Article 82 to predatory pricing cases by the Commission do not appear to exist, the structure of the analysis that emerges from jurisprudence seems to be similar to that outlined by the Office of Fair Trading: a cost comparison, plus evidence of intent if prices are between average variable and average total costs.<sup>7</sup>

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<sup>7</sup> Indeed, the OFT guidelines cite the European Court jurisprudence as the source of the test presented in its guidelines.

### *European below-cost pricing laws*

In addition to laws regarding the abuse of a dominant position, several European countries address predatory pricing by a multiproduct retailer through below cost pricing laws. These laws apply to the pricing of individual items, and may or may not have additional requirements, such as evidence of dominance of a market. For example, the Irish *Restrictive Practices (Groceries) Order* of 1987 prohibits selling grocery goods at prices below the net invoice prices of the goods, and considers no market structure conditions or legitimate business justifications (with the exception of goods whose minimum durability date has expired).<sup>8</sup> Alternatively, the German *Act Against Restraints of Competition* prohibits an undertaking with superior market power from offering “goods or services not merely occasionally below its cost price, unless there is an objective justification for this.”<sup>9</sup> Such a provision would appear to resemble at least superficially certain predatory pricing tests, in that in addition to a price-cost comparison, a consideration of market power and legitimate business justification is required. Guidelines regarding the application of this provision were not available at time of writing.

### **Case law**

In most countries there is little jurisprudence regarding predatory pricing in general, and predatory pricing by a multiproduct retailer in particular. The notable exception is the U.S., where private litigation has resulted in a large number of cases, both under federal antitrust law and state below cost pricing law.

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<sup>8</sup> This order has recently survived an attempt to have it repealed. In arguing for the repeal of the grocery order, the Irish Competition Authority (2000) contends that the order prohibits legitimate loss-leading behavior. This argument is also made in Walsh and Whelan (1999).

<sup>9</sup> See page 17 of the *Act Against Restraints of Competition*. The first application of this prohibition was against Wal-Mart, regarding the pricing of staples such as milk and butter.

For the most part, jurisprudence provides little guidance regarding the application of price-cost tests in predatory pricing allegations involving retailing, since many such cases are decided on the basis of the possibility of recoupment, market definition, or evidence of a likely anticompetitive effect.<sup>10</sup> With respect to multiproduct firms, U.S. courts have indicated that in the analysis under the *Sherman Act*, below cost pricing on individual items is likely to be insufficient to eliminate a multiproduct rival. (See Denger and Herfort (1994) for a discussion of the jurisprudence on this point and a list of relevant cases.) Rather, below cost pricing should be shown for the product line or for a relevant product market, to establish that such pricing would prove a threat to a rival.

The possibility that below cost pricing may be loss-leading instead of predatory has received little attention by the courts in *Sherman Act* cases. However, in one such case, *Lormar, Inc. v. Kroger Co.*, the court ruled that since using loss-leaders for promotional reasons is common in the grocery industry, pricing below cost is insufficient evidence of predatory intent.<sup>11</sup> The court did not suggest how a test for predatory pricing could take loss-leading into account.

Loss-leading as an explanation for below cost pricing has received some recent attention under state below cost pricing laws. In *American Drugs, Inc. v. Wal-Mart Stores, Inc.*,<sup>12</sup> Wal-Mart was sued under Arkansas' *Unfair Practices Act* for below cost pricing on certain pharmaceuticals. Wal-Mart lost the initial trial, but won on appeal. The trial court's conclusion is based on the finding that Wal-Mart

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<sup>10</sup> See for example *Speedway/SuperAmerica, L.L. C. v. Phillips Truck Stop, Inc.*, 782 So. 2d 255 (Ala. 2000); *Ghem, Inc. v. Mapco Petroleum, Inc.*, 767 F. Supp. 1418 (N.D. Tenn. 1990); *McGuire Oil Co. v. Mapco Petroleum, Inc.*, 763 F. Supp. 1103 (S.D. Ala. 1991); *Star Fuel Marts, L.L.C. v. Murphy Oil USA, Inc.*, No. CIV-02-202-F (W.D. Okla. 2003) (order granting preliminary injunction); *Bathke v. Casey's General Stores, Inc.*, 64 F. 3d 340 (8<sup>th</sup> Cir. 1995); *Indiana Grocery, Inc. v. Super Valu Stores, Inc.*, 864 F. 2d 1409 (7<sup>th</sup> Cir. 1989); *Rebel Oil Co., Inc. v. Atlantic Richfield Co.*, 51 F. 3d 1421 (9<sup>th</sup> cir. App. 1995); *Tennessean Truckstop Inc. v. Mapco Petroleum, Inc.*, 728 F. Supp 489 (M.D. Tenn. 1990).

<sup>11</sup> *Lormar, Inc., et al. v. The Kroger Co.*, 1979-1 Trade Cas. (CCH) ¶ 62, 498 (S.D. Ohio 1979).

<sup>12</sup> *American Drugs, Inc. v. Wal-Mart Stores, Inc.*, E-92-1158 (Oct. 1993). A detailed discussion of this case is provided in Boudreaux (1996).

priced certain individual items below cost. The Court also found that intent to injure competitors and destroy competition could be inferred from circumstances such as the number and extent of below cost sales, Wal-Mart's stated pricing policy and its stated purpose for the policy, Wal-Mart's use of in-store price comparisons with other retailers, and how Wal-Mart's prices varied across markets according to competition.

Wal-Mart's appeal was based on three points: (1) the court erred in finding that Wal-Mart sold products below cost *for the purpose of injuring competitors and destroying competition*; (2) the court should have considered whether consumer baskets of products were priced below cost, as opposed to individual items; and (3) the Court's interpretation of Arkansas' *Unfair Trade Practices Act* violated the Arkansas and U.S. Constitutions. The Supreme Court of Arkansas agreed with Wal-Mart on the first point, and reversed the decision. The Supreme Court stated that "In the case before us, the loss-leader strategy employed by Conway Wal-Mart is readily justifiable as a tool to foster competition and to gain a competitive edge as opposed to simply being viewed as a strategem to eliminate rivals all together." The Supreme Court did not comment on the last two points of the appeal. Therefore, we do not know whether the Supreme Court would have supported the lower court's finding that pricing below cost need only be shown for individual items.

In another recent case, however, a court has been less receptive to business justifications for pricing below cost given the state below cost pricing prohibitions. In *Star Fuel Marts v. Murphy Oil USA, Inc.*,<sup>13</sup> a preliminary injunction was granted under Oklahoma's *Unfair Sales Act*, prohibiting below cost sales of gasoline by Sam's East, a Wal-Mart subsidiary which sells groceries in a wholesale club format. The court held that pricing below cost is prima facie evidence of intent to injure competitors and to lessen competition substantially, and also of a tendency to destroy or substantially lessen competition. In

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<sup>13</sup> *Star Fuel Marts, LLC. v. Murphy Oil, Inc.*, No. CIV-02-202-F (W.D. Okla. 2003) (order granting preliminary injunction).

addition, Oklahoma's *Unfair Sales Act* prohibits pricing below cost that tends to deceive consumers into believing prices on other products will be low. The court held that "inherent in the below cost sale of one commodity among hundreds or thousands sold at the same establishment is the implication that the pricing of the item which is sold below cost is indicative of pricing generally at the same establishment."

Therefore, loss-leading cannot be considered a defense, and is in fact an offence (if it misleads consumers) under Oklahoma law.

### ***Summary***

In general, neither competition agencies nor jurisprudence have articulated how a test of predation would be carried out in the case of a multiproduct retailer, although some suggestions and observations have been made in several jurisdictions. According to government statements and jurisprudence, price-cost comparisons should not be carried out for individual items, since below cost pricing on a single item or a small number of items would be insufficient to eliminate a rival. This appears to conflict with below cost sales laws in many jurisdictions, which focus on individual items. As well, loss-leading is recognized in some countries as a possible justification for below cost prices, although some jurisdictions prohibit or express concern over loss-leading pricing that misleads consumers regarding general price levels on other products. Countries that consider loss-leading to be a business justification for below cost pricing have not specified how predation tests can differentiate between predatory pricing and legitimate loss-leading.

### 3.3 Predation and the multiproduct firm

The preceding review of government predation policies and relevant case law shows that the possibility of predation by multiproduct firms is a very real concern. However, there seems to be a lack of precision in the guidance that has been given with respect to the test for predation in the multiproduct firm context. Economists are at least partly responsible for this lack of precision given that much of the theory and policy analysis dealing with predation has been carried out in the context of single product firms. However, there have been a few notable exceptions.

Areeda and Turner (1975) seem to have had some awareness of the multiproduct problem, but they address it under the heading of “predatory investment in new product lines”. They note that a monopolist investing in a competitive product line might contribute more to profits than is shown by the estimated revenue-cost relationship on that line alone. They recognize (at page 722) that “the ability to offer a fuller line of complementary products may increase the sales of each, either because consumers prefer to deal with a single seller or because the fuller line enhances the seller’s image”. They conclude that even if a new investment in a competitive line would appear to be less profitable than additional investment in the monopoly line (after taking risks into account), it should not be deemed predatory so long as the expected return equals or exceeds the “normal” return for the product line concerned. While acknowledging that the predation case for a monopolist’s investment that is expected to generate below cost returns is stronger, Areeda and Turner reject a predatory investment rule because of their belief that the possibility of such an investment is too remote. Areeda and Turner have likely erred in rejecting such a rule given the concerns among various competition authorities regarding predatory expansions of aircraft capacity by various airlines against low cost competitors. The possibility that an incumbent firm undertakes an

aggressive store expansion in a market in order to drive a rival out also exists.<sup>14</sup>

Posner (1976) was also aware of the multiproduct firm predation problem, but did not offer a solution to it. According to Posner, under his definition of predatory pricing (“pricing at a level calculated to exclude from the market an equally or more efficient competitor”), selling below “long-run marginal cost” with the intent to exclude would be predatory.<sup>15</sup> Long-run marginal costs are defined by Posner as those that must be recovered to stay in business for the more or less indefinite future, and are similar to (if not the same as) avoidable costs.<sup>16</sup> So Posner can be interpreted as suggesting an avoidable cost test for predatory pricing, subject to an intent requirement or no legitimate business justification for the pricing. He goes on to state that it will sometimes be difficult or even impossible to make a nonarbitrary allocation of marginal costs to an individual product or market. He apparently did not recognize that an avoidable cost test does not require arbitrary allocations of costs.

Baumol (1979, p. 9, fn. 26), in a comment on Williamson (1977), also touches on the multiproduct problem, but does not discuss how demand externalities should be dealt with in the context of a predation test. Baumol states that when Williamson requires that the price of a good in the long run exceeds its average total cost, he assumes that Williamson meant the good’s average incremental cost, including any fixed cost outlays required to provide the good.<sup>17</sup> This assumption is based on the fact that most firms are multiproduct

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<sup>14</sup> See Von Hohenbalken and West (1984).

<sup>15</sup> See Posner (1976) at pp. 188-189.

<sup>16</sup> Williamson (1977, p. 322, fn. 88) discusses some “terminological confusion” that he finds in Posner (1976). In particular, Williamson suggests that average variable cost should be substituted for short-run marginal cost in Posner’s discussion on p. 192, and average total cost should replace long-run marginal cost.

<sup>17</sup> Baumol (1979, p. 9) states: “That is, the average incremental cost of product X is defined as total company cost minus what the total cost of the company would be in the absence of production of X, all divided by the quantity of X being produced. Total costs refer to those that would prevail in the long-run with the output combinations specified.”

firms and average total cost is not well-defined for a multiproduct firm. The same point is made by Joskow and Klevorick (1979, p. 252.).

Ordoover and Willig (1981) are perhaps the first economists to suggest a predation test for multiproduct firms when there are demand externalities. Ordoover and Willig (p. 9) first define predatory objectives as being present if a practice would be unprofitable without the exit it causes, but profitable with the exit. They then (at page 16) propose an avoidable cost test for predation: for the value of an output cutback that corresponds to elimination of the incumbent's entire output, "the test for predatory sacrifice is whether the incumbent's price is below the average avoidable cost of the product line in question." Under their test, the cost savings from the output contraction (including avoidable advertising costs and capital costs) are compared with the associated revenue reduction.

With respect to multiproduct firms, Ordoover and Willig consider the case of a dominant firm responding to the entry of a new rival. The incumbent is a multiproduct firm, and the predatory output is assumed to be cross-elastic with another of the incumbent's products. The test for predatory sacrifice is stated to be the same as in the single product firm case. Predation, then, is said to exist if the conservative estimate of the loss of direct revenues from an output contraction is less than the sum of the direct cost saving from the contraction and the estimate of the net effect on profit from the sales of the cross-elastic product.<sup>18</sup> Where the cross-elastic good is a complement for the predatory good, the adjustment for the demand complementarity lowers the price that the incumbent can charge on the predatory good without violating the cost-based test. Ordoover and Willig note that the size of the adjustment to the price floor is greater the larger is the mark-up of price over cost for the cross-elastic good and the more sensitive are the sales of the cross-elastic good to the price and output of the good in question. However, "if

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<sup>18</sup> The "conservative estimate" of the loss of direct revenues is obtained by multiplying the output reduction by the existing price prior to the output reduction.

there is no significant cross-elastic effect, or if there is no significant mark-up over average incremental costs on the cross-elastic good, the adjustment for cross-elastic effects may be ignored.”<sup>19</sup>

Baumol (1996) provides an extensive discussion of the avoidable cost test for predation, emphasizing the applicability of the test in the multiproduct firm case. Baumol’s Rule 4 (on page 61) states that for a multiproduct firm, the price of each product by itself must equal or exceed that item’s average avoidable cost. In addition, “any combination of the firm’s products must be priced so as to yield an incremental revenue that exceeds the avoidable cost incurred by that combination of products.” Baumol, however, does not deal with the case of demand complementarity for the products of a multiproduct firm.<sup>20</sup>

Cabral and Riordan (1997) modify the Ordover and Willig (1981) definition of predation in a way that suggests a practical test for predatory behavior in the multiproduct firm case where demand complementarities might exist. Cabral and Riordan (at p. 160) “call an action predatory if (1) a different action would increase the likelihood that rivals remain viable, and (2) the different action would be more profitable under the counterfactual hypothesis that the rival’s viability were unaffected. In other words, a predatory action is unprofitable but for its effect on a rival’s exit decision.” Cabral and Riordan’s test suggests that it is not enough for a firm to argue that below cost pricing on a subset of items is justified by the net revenue gain on complementary goods sold by the firm. Rather, if such pricing causes a rival firm to incur losses, the question would be whether the firm could have realized net revenue gains on complementary goods without engaging in pricing that forces losses on the rival.

A similar approach is advanced by Bolton, Brodley and Riordan (2000, p. 2277). In their discussion of market-expanding price cutting,

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<sup>19</sup> See Ordover and Willig (1981, p. 21).

<sup>20</sup> Testing for predatory pricing by a multiproduct firm when demands are related is touched on in Baumol (1986), in the context of a response to a suggestion by Professor Areeda.

they note that such price cutting can be either pro-competitive and output expanding, or anti-competitive by excluding or disciplining rivals without compensating efficiency gains. They go on to write that a market-expanding business justification defense would have three threshold requirements: (1) plausible efficiency gains: synergies or scale economies are examples; (2) no less restrictive alternative: efficiencies cannot be achieved without selling below cost or by shortening the period of below cost pricing; and (3) efficiency-enhancing recoupment: recoupment of the investment in below cost pricing arises from efficiency gains rather than through eliminating or disciplining a rival. Bolton, Brodley and Riordan would have the defendant bear the burden of proving elements (1) and (3), while the plaintiff and defendant would share the burden of establishing or rejecting the feasibility of element (2).

The tests proposed by Cabral and Riordan (1997) and Bolton, Brodley and Riordan (2000) can be interpreted in a way that will provide some guidance in the construction of an algorithm for determining whether supermarkets are engaging in predation against rivals. Craswell and Fratrick (1985-86), who identify the problems in predation analysis that arise from loss-leading and demand complementarities, are skeptical that a test for predation can be constructed for supermarkets that would distinguish predatory conduct without deterring competitive price cuts. They recommend that price wars in the retail grocery industry not give rise to antitrust concerns, regardless of how low prices fall. As will be discussed in the next section, a test for predation can be constructed for supermarkets that is more revealing than Craswell and Fratrick's paper would suggest.

Finally, Areeda and Hovenkamp (2002) also discuss predation in the multiproduct firm case in their *Antitrust Law* treatise (in section 742). They consider the case where two goods are complementary in the sense that a lower price for A increases the sales of product B. (This would seem to cover the case of loss leading by a supermarket.) They acknowledge that it is theoretically correct to say that some revenues from selling B are properly attributable to A or that part of

the costs of producing A are properly attributable to B. However, they reject such a claim by a monopolist seeking to justify a product's apparently predatory price. They offer three reasons for this: (1) reallocating revenues or costs presents administrative difficulties; (2) if A is complementary with B, B is also complementary with A, so that reallocation of revenues and costs will lead to a "wash"; (3) to some extent, the monopolist could achieve the desired increase in revenues by reducing the price of B rather than A.

Areeda and Hovenkamp also consider the case where a firm with a monopoly in product A faces competition on product B. They argue that a below cost price on B cannot be justified by increased revenues on the monopolized product, "for it is the prospect of monopolizing product B that generates our concern over predation there." However, if the rival also produces both A and B, they argue that a firm's selling B below cost cannot harm the rival as long as the combination of A and B remain profitable for both firms.

In the case of multiple products with common costs, Areeda and Hovenkamp recommend that a test for predation in this case requires showing that the firm is pricing below average variable cost across its entire product line. The reasons for this recommendation are that (1) the cost allocation problem in such cases is "well nigh insurmountable", and (2) "when multiple products are produced in the same plant and share this many common variable costs, the chances of creating a monopoly in one of the products are quite small." It is not clear why Areeda and Hovenkamp believe that any allocations of common costs in the multiproduct case are required for the predation test. Their second reason for their recommendation seems to lack a theoretical justification.

Areeda and Hovenkamp also have a brief discussion of loss leading. They do not regard true loss leading as predatory, assuming the reasonably anticipated incremental revenue impact of such pricing is positive. From their discussion, it seems that they would carry out the test for predation at the store level, and not by examining whether the revenue from the sale of the loss leading products covers their costs. While a test for predation can be carried

out at the store level, it can also be carried out for a subset of products, as will be argued in the next section.

### **3.4 Multiproduct firm predation proposals**

There are two types of possible multiproduct firm predation in a retail context that have given rise to complaints to competition authorities. The first type of complaint involves a multiproduct firm, like a supermarket chain, operating a supermarket and a second business, like a gas station, nearby. The second business sets low prices, perhaps to attract customers to the supermarket as well as the gas station, but the low prices produce predatory pricing complaints. The second type of complaint involves loss leading, where a multiproduct firm like a supermarket sells a subset of products at prices below some measure of cost, usually acquisition costs. Both types of possible multiproduct firm predation involve demand complementarities, and thus require some method for handling them. Our earlier review of the policy and case literature suggests that competition authorities are still trying to determine workable rules for handling complaints involving multiproduct firm predation where there are demand complementarities.

There are a number of competitive scenarios to consider in the case of multiproduct retail firm predation when there are demand complementarities. To discuss them, suppose that two stores, A and B, are owned by a supermarket chain, called Firm 1. Store A is a member of a supermarket chain that has a number of dispersed store locations in a city. Call Store A the primary store. Store B can be regarded as a single product store in that it mainly sells one type of product (e.g., gasoline or beverage alcohol). Call Store B the secondary store.

Suppose further that Store B has been located next to Store A because of presumed demand complementarities between Stores A and B. For Scenarios 1 and 2 below, assume that Firm 1 has decided

to have Store B charge a price that is below the acquisition cost of the product sold by B.

*Scenario 1:* In this scenario, another firm, called Firm 2, has a supermarket, C, located across the street from Firm 1's stores. Firm 2 does not own or operate secondary stores that compete directly with B. In this case, below cost pricing by Store B can have two effects: first, some of C's usual customers might be attracted to make a purchase at B and shop at A on the same trip. The loss of business by C could cause it to earn negative profits. Second, below cost pricing by Store B could cause losses for B's direct competitors, depending on where they are located in relation to B. How does one assess a predation complaint in these circumstances?

Assuming no constraints on data availability, one could first compare each of A and B's revenues with their respective avoidable costs, assuming no demand complementarity. One could then compare the combined revenues of A and B with the combined avoidable costs of both stores. If combined revenues are less than combined avoidable costs, then one could conclude that the firm has failed the avoidable cost test, and proceed to examine the other elements that need to be proved in a predation case. If Store A has passed the avoidable cost test, while Store B has failed it, then the question is whether Store B would pass the test if the incremental net revenues to A that are produced by below cost pricing at B are added to Store B's revenues. If the answer is no, then one could conclude that Store B has failed the avoidable cost test. If the answer is yes, then one must consider, based on the Cabral/Riordan test, whether there is a different action by Firm 1 that would leave Store C viable, and whether the different action would be more profitable under the assumption that the rival's viability is unaffected. In other words, the increase in net revenues at A due to B's pricing might be large enough to have B cover its avoidable costs only because B's pricing leads C to fail. There could be an alternative action, such as higher prices at B, that could still produce positive demand externalities for Firm 1 without leading to C's demise.

The assessment of A and B's revenues and costs depends on having access to Firm 1's data. In some jurisdictions, such data will only be made available under a court order once it has been established that there is reason to believe that a competition law has been violated. Prior to this time, one is more likely to have access to the cost and revenue data of the complainant. The competition authority will have to use market structure information in conjunction with the complainant's cost and revenue data and price comparison information in order to determine whether (1) market structure conditions are conducive to predatory conduct, (2) the alleged predator is behaving differently against the complainant than elsewhere that it has stores, (3) the alleged predator has an incentive to engage in predatory conduct, and (4) the complainant and/or competition are potentially being harmed by the alleged predator's conduct. It is an awkward fact, however, that the possibility that a firm's conduct is predatory is extremely difficult to assess in the absence of the alleged predator's cost and revenue data.

*Scenario 2:* In this scenario, Firm 1 still operates Stores A and B, but the store across the street owned by Firm 2 sells the same product as Store B instead of Store A. Store B sells its product below acquisition cost, forcing Firm 2's store, called Store D, to do the same. Is Firm 1's pricing behavior predatory?

The approach to take in assessing predation in Scenario 2 is essentially the same as the approach applied in Scenario 1, although the cases appear different. In Scenario 1, Firm 1's below cost pricing on a good that Firm 2 does not sell is capable of forcing losses on Firm 2. In Scenario 2, Firm 2 does sell the good that is being sold below cost by Firm 1, but it does not also operate a second store that could benefit from below cost pricing. It cannot rely on a demand externality to generate net profits that offset the effects of Firm 1's below cost pricing. Nor might it have sufficient space available at its store location to build a second store.

In this case one can first compare each of A and B's revenues with their respective avoidable costs, assuming no demand complementarity. If there indeed is no demand complementarity,

then each of Store A and Store B should have revenues in excess of avoidable cost in order to comply with the predatory pricing rule. One can also compare the combined revenues of A and B with the combined avoidable costs. If combined revenues are less than combined avoidable costs, then one could conclude that the firm has failed the avoidable cost test. The other elements that need to be proved for a finding of predation could then be examined.

If Store A has passed the avoidable cost test while Store B has failed it, then the net incremental revenue effects of B's pricing would again be assessed, as would the question regarding a more profitable alternative action on the assumption that Firm 2's store remains viable.

From a fairness perspective, one might be concerned that Firm 2's store can be driven from the market, in part because it is site-constrained from taking steps to defend itself. On the other hand, consumers receive a benefit from the lower prices at Stores B and D (as long as D remains in business). There may also be a concern that Firm 1 will raise its price at Store B once Firm 2's store goes out of business. If, however, Store B's low price does generate higher net revenues for Store A, then Store B will not necessarily raise price once Firm 2's store shuts down. It would raise price, however, with the demise of Store D if its price at Store B is lower than the one necessary to generate the demand externality at Store A.

*Scenario 3:* In Scenario 3, Firm 1 operates multiproduct Store A and single product Store B, while Firm 2 operates both multiproduct Store C and single product Store D in competition (in the same product market) with Firm 1's stores. Firm 1 sets prices below acquisition costs for a subset of products sold by Store A. (If it did not, then one would evaluate the alleged predatory conduct by A by examining the store's performance as a whole as set out in Scenarios 1 and 2.) Firm 2 complains that Firm 1's prices are predatory. How does one proceed to evaluate the complaint in this case?

First, it should be noted that Store A's below cost prices could attract customers away from both Stores C and D, depending on the nature of Firm 2's response. Customers of Store C would be attracted

by A's low prices, while some of C's customers that would have also patronized Store D will now patronize Store B instead. Depending on the extent of Firm 1's discounting and Firm 2's response, Firm 2 could incur losses as a result of Firm 1's pricing strategy. But is the pricing strategy predatory?

Firm 1's pricing could be analyzed using the same approach as outlined in Scenarios 1 and 2. That is, one could evaluate whether Stores A and B have revenues above avoidable cost separately and/or jointly, and one could ask whether some alternative pricing strategy for Firm 1 would be more profitable, assuming Firm 2 remains in the market. The latter question takes on added significance for Scenario 3 because of the likelihood that Firm 1's pricing of a subset of products below acquisition cost will not in fact lead it to have revenues below avoidable cost on a store basis.

It is here that a consideration of loss leading by Firm 1 becomes relevant. Loss leading pricing strategies are widely used among multiproduct retailers in certain industries like the supermarket industry. The strategy typically involves a retailer selecting a small subset of products to advertise with prices that are below avoidable cost. The products are not chosen randomly. Rather, some of the products are selected because they are frequently purchased items for which many consumers are price sensitive. Low prices for these products might then be capable of inducing consumers to abandon the store that they would normally patronize in favor of the store with the lower prices. To the extent that happens, the retailer expects consumers to purchase the products with negative margins, but also other products for which the retailer receives positive margins. Net revenues from the latter can exceed the losses from the former, and then the loss leading strategy would be profitable.

It is not difficult to imagine a case where loss leading by both Firms 1 and 2 results in higher sales and profits for both firms. This could happen if consumers that are attracted to Firms 1 and 2 by their low pricing, both their usual customers as well as customers that normally patronize other stores, actually increase their total expenditures on the goods sold by Firms 1 and 2.

Still, what appears to be loss leading can pass a certain threshold where it is no longer part of an innocent profit-maximizing strategy. Rather, it could be predatory by design. The set of products chosen for below cost pricing by Firm 1 may or may not result in Firm 1 incurring losses at the store level, even as they force losses on Firm 2. While Firm 2 might match Firm 1's below cost prices, it might not offer the same set of other goods as Firm 1 that are priced with positive margins. In this case, testing for predation by simply looking at Firm 1's revenues and avoidable costs at the store level would permit Firm 1 to engage in predation while at the same time passing the predation test. What is required, then, is a test that would distinguish sales increasing loss leading behavior from predation.

Once again, Cabral and Riordan provide the conceptual approach. One would ask whether the set of products being priced below acquisition cost could be priced higher in a way that results in higher profits for Firm 1, while at the same time allowing Firm 2 to cover its costs. While the conceptual approach seems clear, the difficulty arises in having a competition authority implement the approach.

Part of the difficulty is that in the initial stage of an investigation into a predation complaint, the competition authority may not have access to the alleged predator's revenue and cost data. It will have to assess the depth of the alleged predator's discounting using information provided by the complainant. In the case where Firms 1 and 2 are operating supermarkets as Stores A and C, the complainant Firm 2 likely has price surveys taken from Store A. The complainant should also be able to provide data on its own acquisition costs for the products on the price survey. These costs could be similar to Firm 1's costs if both firms are members of large buying groups having access to the best supplier prices.

The next step would be to determine what "normal" loss leading prices would be for the products. The complainant could provide information in this regard. Alternatively, one could calculate the average percentage by which price is below cost for loss leading items in a supermarket where predation is not alleged. This could be

compared to the percentage price reduction at the alleged predatory store.

Having established the relative magnitude of Firm 1's price reduction relative to costs, one would then want to estimate the possible net revenue gain to Firm 2 if prices were raised to their "normal" loss leading levels. One could get an estimate of the possible net revenue gain by examining store sales before and after the start of the alleged predation period (assuming that the store was not confronted by predatory prices from the day it opened).

Finally, one would wish to compare Firm 1's prices for loss leading products at Store A with the prices that it charges at other of its stores in the same market where predation is not alleged. Alternatively, one could compare the percentage reductions below cost of loss leading items at Firm 1's predatory store and a non-predatory store (assuming that the sets of loss leading items could differ), to assess the extent of the differential reduction.

Having followed the steps outlined above, one should be able to establish that (1) Firm 1 is pricing a set of items at Store A lower than at other of its stores in the same market, lower than one would expect with normal loss leading, and likely below its acquisition cost as well, (2) Firm 2 is suffering a loss of net revenues by charging the same prices as Firm 1, and could have higher net revenues if normal loss leading prices were charged. Showing (1) and (2) should be sufficient to permit the competition authority to meet the requirements for obtaining a court order to retrieve Firm 1's cost and revenue data. One could then examine whether Firm 1 is operating with revenues below cost on a store basis. One could also attempt to estimate the net revenue increase that Firm 1 could achieve by raising prices on its deeply discounted loss leading items.

With respect to the implementation of the predation test for Scenarios 1 and 2, the difficulty is in estimating the value of the demand externality that A experiences from the below cost pricing by Store B. One would also wish to estimate the value of this externality at higher prices charged by Store B. To help obtain these estimates, one might be able to examine sales of Store A before and

after below cost pricing by Store B. Assuming that Store A is a member of a chain, one might be able to examine the sales and profits of other stores in the chain, particularly those that do not have another store like B generating demand externalities for them. In doing this, one would have to control for other factors that could affect the sales of these stores, such as trade area populations, local competition, store size and product mix. One might also be able to undertake some demand analysis in order to estimate cross price elasticities between Stores A and B.

It is not known to what extent the type of analysis discussed here has been undertaken in investigations of predation complaints involving multiproduct firms. While most firms are multiproduct, our literature and case review did not uncover any discussion of applied procedures for analyzing the multiproduct firm predation problem in a retail context when products are complements or substitutes. Competition authorities would clearly benefit from the development of such procedures, as they would expedite the evaluation of predation complaints. The development of such procedures in real market settings would also permit economists to assess the sensitivity of the outcomes of the price/cost test to alternative treatments of costs and revenues by the test.

### **3.5 Conclusion**

Statements of predatory pricing policy for most countries that have one ignore many of the problems that arise from attempting to determine whether a multiproduct retailer has engaged in predation. They therefore provide little guidance regarding how such a case would be handled. In particular, government policy and case law leave the question of how to deal with demand complementarities in retailing largely unanswered.

In this paper, we have argued that although government policy has not addressed this issue, economic literature does suggest an overall approach that can be applied. The approach entails

determining whether an alleged predator can earn higher profits by raising price on the goods being priced below cost, on the assumption that the rival firm remains viable. If so, then one of the required elements of a predation case is met. This approach is then illustrated in several scenarios involving two types of possible multiproduct firm predation. In the first two scenarios, the alleged predator operates two adjacent stores (at least one of which is multiproduct), and lowers the price below cost at one, which can affect the sales and profits of the other. In the third, the alleged predator lowers a subset of prices at its multiproduct store, which can also affect the sales and profits of both stores. Some general applied approaches to carrying out this type of analysis are also briefly discussed.

This article does not set out a complete applied algorithm for assessing the possibility of multiproduct firm predation since the appropriate algorithm would likely depend upon the particular case. We do suggest that if a multiproduct retailer is found to be pricing below avoidable costs on a product or certain combination of products, further analysis may be required to determine whether such below cost pricing was necessary to take full advantage of demand complementarities. Since this likely cannot be determined from an analysis of a single store's costs and revenues, consideration may have to be given to the prices and sales of other stores operated by the alleged predator in the same and different markets (depending on whether predatory pricing is confined to one part of the market), or estimation of cross elasticities. Since these are costly and time consuming tasks, a competition agency may be best served by reserving such analysis for cases involving large national chains operating in many markets.

This paper has focused on testing for predation when multiproduct retailers face demand complementarities. However, testing for predatory pricing in retailing may be complicated for other reasons as well. One important factor is the location of the retailers in geographic space. If the alleged predator, prey, and other retailers in the market are spread out across an urban area, several

elements of a case may be affected. The distribution of retailers over space will determine how low a firm must price in order to achieve predatory aims and which outlets must lower price the most. As well, the spatial distribution of outlets will affect the ability of the alleged predator to harm the prey and the possibility that subsequent price increases will be constrained by competitors. The literature on tests for predatory pricing has tended to examine firms competing in a spaceless world.<sup>21</sup> The appropriate test for predation in a spatial market is a subject of future research.

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<sup>21</sup> One exception is the recent article by Lindsey and West (2003).

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