

**Charles University Prague**

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***Abuse of dominant position in EU & US Law***

*Ph.D. Dissertation*

*Department of European Law*

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**V Prahe/In Prague, 2011**

.....  
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Abstract

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## Abstract

*“Price competition is the essence of free and open competition. It favours more efficient firms and it is for the benefit of consumers both in the short and the long run. Dominant firms not only have the right but should be encouraged to compete on price”<sup>1</sup>*

The past and recent decisions of the EU and US Courts refreshed the debate on the different approaches to antitrust policies on both continents. While in contrast to the US where it will be highlighted that Americans protect competition in the EU Europeans protect competitors.<sup>2</sup> Nevertheless, protecting the consumer welfare and securing that entrepreneurs have a real opportunity to compete in the market economy are overall important objectives. This has been the main objective of the European Community since the former Article 3 (1) (g) of the EC Treaty provided that *“a system ensuring that competition in the internal market is not distorted.”*<sup>3</sup> To achieve an effective competition, the creation of a system of undistorted competition is necessary.<sup>4</sup> But an effective competition is unthinkable without competitive freedom of the market participants.<sup>5</sup>

By an investigation if an undertaking has substantial market power giving it a dominant position we have to consider a variety of factors, among others, market position of the allegedly dominant undertaking, market position of the competitors, or the buyer’s strength. It is often difficult to distinguish between an undertaking that is monopolist and other

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<sup>1</sup> Opinion of Advocate General Fennelley in the *Compagnie Maritime Belge* Case (for further discussion please see under 4.1.7.)

<sup>2</sup> Fox, E. M. (2003): *We Protect Competition, You Protect Competitors*, European University Institute, pp. 149-165

<sup>3</sup> This wording has not disappeared but has been annexed in the Protocol No. 27 to the Treaty according to which the Internal market “includes a system ensuring that competition is not distorted.” The Lisbon Treaty (2009) thus removed the establishment/wording of former Article 3 (1) (g) of the EC Treaty (now Protocol No. 27) as an objective of the Union.

<sup>4</sup> Frenz, W. (2006): *Europarecht, Band 2, Europäisches Kartellrecht*, Springer, Heidelberg, p. 4

<sup>5</sup> Chalmers, D., Davies, G., Monti, G. (2010): *European Union Law: Cases and Materials*, Cambridge University Press, p. 1023

one that is a competitor as well as between predatory pricing and legitimate price competition. Although a dominant undertaking has the right to protect its own commercial interests, this does not mean to undertake actions to strengthen its dominant position.

Abuse of dominance as a legal concept has been defined by the European Court of Justice (ECJ) in *United Brands* and *Hoffmann La Roche* as: “*a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, customers and ultimately of its consumers.*”<sup>6</sup> For the term corresponding to “*dominant position*” in the EU law, in the USA will be used the term “*monopoly*”. In America, the U.S. Supreme Court held that, “*a party has monopoly power if it has, over any part of the trade or commerce among the several States a power of controlling prices or unreasonably restricting competition.*”<sup>7</sup> The fundamental difference between the EU (Article 102 TFEU) and US (Section 2 of the Sherman Act) law may be explained with the words that while Section 2 aims at preventing monopolization, Article 102 TFEU is primarily focus on constraining monopolies. To the subparts which are often considered as abuse of a dominant position belongs unfair prices, refusal to supply, price discrimination, predatory pricing, etc. In the next parts we will analyze and clarify the phenomenon of predatory pricing using three-sided approach (economic, legal and business strategy). Predatory pricing is described as illegitimate anti-competitive strategy in both the EU and the USA. The principle of free price formation is the essence of competition and price cuttings are necessary and desirable expression of intense competition, however, they can be used specifically with the intention to force the competitors from the market. Whether the entrepreneurial behaviour is commercially and economically correct or not is the central task of the

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<sup>6</sup> Case: 85/76, *Hoffmann-La Roche & Co AG v. Commission*, 1979 ECR 461, 3 CMLR 211, para. 38

<sup>7</sup> Case: *U.S. v. E.I. du Pont de Nemours and Co.* 351 U.S. 377, 76 S. Ct. 994, (1956)

competition, which in case of an abuse has to punish such behavior. Predatory pricing realized by a dominant undertaking, i.e. setting predatory prices, which are designed to force competitors out of the market or deter the market access is a violation of Article 102 TFEU. According to the decision practice of the EU Commission and the ECJ the current practice is characterized by use of economic methods, which play a crucial role in identifying predatory pricing. However, there is a criticism that the economic context is not sufficiently considered.

From the perspective of consumers, predatory prices are generally positive evaluated because consumers are neither interested about the undertakings strategic motives nor about the problems associated with predatory pricing by competing companies. Predatory prices may, however, as well as discount schemes lead to force competitors off the market or deter them the market access, which in the medium to long term period is not in the consumer interest. Competition is thus a "*process of creative destruction*."<sup>8</sup> The resulting injury to competitors is immanent to competition and can not therefore be the measure of the competitive nature of entrepreneurial behavior. Predatory pricing strategies are thus consequently very difficult to distinguish from normal competitive behavior. The assessment of targeted predatory pricing strategies is therefore one of the most controversial question of the theory of competition and competition (antitrust) law. The extensive collection of literature goes from the denial of such behavior as a rational business strategy to the appraisal that it has to be vigorously tackled. The more recent - especially game theory - models come to the conclusion that for predatory pricing strategies particularly imperfect information is a necessary prerequisite. Therefore, it is difficult to undertake the proof in practice.

Also in the U.S., the American studies are limited on the one side on the analysis of historical cases and on the other hand on statistics over the period of the last century, which covers all the most important competition

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<sup>8</sup> Schumpeter, J. A. (1980): Kapitalismus, Sozialismus und Demokratie, 5. Auflage, München, p. 134



cases in this area. This statistics is showing us that claims concerning the predatory pricing strategies were numerically small and on decline.<sup>9</sup> The frequency of predatory pricing strategies depends not only on the importance of price as a marketing tool. In the earlier neo-classical price theory, the price formation was in the focus of scientific interest. Therefore, Schumpeter wrote in 1942: *"The economists finally outgrown to the stage where they saw only price competition and nothing else. As soon as quality competition and customer service will be accepted in the sacred realm of the theory, the price variable is displaced from its dominant position."*<sup>10</sup> Also in business administration the interest is focused on the pricing policy. This one-sided focus on prices will be in the practice not reflected: undertakings take their decisions because of various alternatives, of which pricing is one of many. What strategy is finally used depends largely on where the best cost-benefit ratio is achieved.

The European competition rules have a special position, as they have to watch not only about the maintenance of effective competition, but also about the achievement of the objectives of the Treaty. They contain no specific finding that prohibits systematic price cuttings. Thus, the EU Commission and the European courts have to develop criteria for the assessment of such behavior. The European Commission has, regarding the evaluation of the concentrations between undertakings raised a question whether predatory pricing can be subsumed under Article 82 (now Article 102 TFEU). If an undertaking use its dominant position, e.g. during long-time practice of selling below cost, to force a competitor to the merger, it is contrary to Article 82 (now Article 102 TFEU). The discussion of the competitive assessment of this question gained additional relevance in the ECJ AKZO case.

After the statement of influential Professor McGee who believes that predatory prices are so irrational that they can be hardly used in practice, the

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<sup>9</sup> Salop, S. C., White, L. J. (1985): Economic Analysis of Private Antitrust Litigation, 74 Georgetown Law Journal, p. 1001

<sup>10</sup> see under footnote 8: Schumpeter, J. A. (1980): p. 139

U.S. antitrust law began to examine this question in broad details in order to recognize this behavior from the competitive behavior. The answer to this question was provided by Areeda and Turner, through their economic test based on a comparison of prices and costs. But this does not satisfy the scholar audience and the critics began their discussion regarding next element by the examination of predatory pricing. The difference in the doctrine on both continents has been fully reflected in Brooke and AKZO cases. In the first case, the U.S. Supreme Court stated as a precondition by a proof of the predation the so called recoupment, while the ECJ held in the AKZO case the intent of the dominant undertaking as a relevant factor. Since the landmark ruling in the Brooke case, the American antitrust law requires recoupment as one of two conditions proving predation. On the European continent, the ECJ rejected this condition as a prerequisite of a predation, but scholars are often looking to the opposite conclusion. This conviction is based on the ground that if the undertaking will not raise its prices and then begin to recoup its losses suffered in the previous period, consumers can not be harmed and there is no need to punish the dominant (thus without any evidence of a recoupment). Opposite to this is the argument, that the recoupment, it is not the same as the harm of consumers, because, in the case when the dominant behavior has not been successful there will be no recoupment, it may result in weakening competition and thus adversely affect consumers. While in the U.S. it will be required the proof of recoupment during the examination of predatory pricing, on the European continent in the first place we have the predatory intent of the dominant undertaking. In the case AKZO the Court held that if prices are between average variable and average total cost the predation occur only if a dominant undertaking will try to force the concurrence from the market.

In the United States, predatory pricing has been examined in the Standard Oil Company Case. In the EU the ECJ and the European Commission had the chance to deal with predatory pricing cases nearly 100

years after the Standard Oil Company Case, namely in the above mentioned case AKZO case followed by the Tetra Pak or Irish Sugar.

I will divide my analysis as follows: we begin in Part I with the Introduction to the Review of Predatory pricing (pp. 19 and follows) → The second part represents the theoretical competitive approaches and competition policy solutions to predatory pricing (pp. 32 and follows) → The third part presents the classification and subsumption of targeted predatory pricing strategies under Article 102 TFEU (pp. 80 and follows) → The fourth part investigates the EU/US Judicial Approach to Predatory Pricing (pp. 107 and follows) → The last part presents proposals for the treatment of predatory strategies under Article 102 TFEU (pp. 149 and follows).

The present dissertation is conceived to illustrate legal and economic developments of predatory pricing and shed light on the analyse of different approaches having a look from both sides of the Atlantic, because predatory pricing phenomenon is a great area of study both from EU as well as US perspective (using three sided approach economic, legal and business strategy). The method chosen for this dissertation is qualitative in its nature because it does not rely on numbers or other quantitative measures but mainly on verbal wordings. I decided for this method because it represents the best approach to the submitted work. Also the case study does not focus only to one case. Comparative analysis between the legal views from both sides of the Atlantic has been considered as well. I have relied on EU Treaty provisions, EU/U.S. case law and literature dealing with the predatory pricing theories.

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**Keywords:** Predatory pricing, Abuse, Antitrust law

## Abstrakt

"Cenová konkurencia je podstatou slobodnej a otvorenej hospodárskej súťaže. Zvýhodňuje efektívnejšie spoločnosti a je v prospech spotrebiteľov jak z krátkodobého tak z dlhodobého hľadiska. Dominantné spoločnosti majú mať nielen právo ale aj motiváciu k cenovej konkurencii"

Minulé a súčasné rozhodnutia Európskych a Amerických súdov znovu nastolili otázku o rôznych prístupoch k protimonopolnej politike na oboch kontinentoch. Kým na rozdiel od USA, kde sa zdôrazňuje že Amerika ochraňuje hospodársku súťaž v EÚ sa chránia súťažitelia. Ochrana záujmov spotrebiteľov a vytvorenie prostredia kde majú podnikatelia skutočnú príležitosť súťažiť v trhovej ekonomike sú celkovo dôležitými cieľmi. To bolo hlavným cieľom Európskeho spoločenstva už v zmysle bývalého článku 3 (1) (g) Zmluvy o ES hovoriacom o *"systéme ktorým sa zabezpečí, aby sa na vnútornom trhu nenarušila hospodárska súťaž."* Na dosiahnutie účinnej hospodárskej súťaže je nevyhnutné vytvorenie systému hospodárskej súťaže bez jej narúšania. Avšak účinná hospodárska súťaž je nemysliteľná bez slobody účastníkov pôsobiacich na trhu.

Pri skúmaní či má spoločnosť významnú trhovú silu ktorá mu umožňuje dominantné postavenie musíme zväžiť viacero faktorov, okrem iného, postavenie údajne dominantnej spoločnosti na trhu, postavenie konkurencie na trhu, ako aj postavenie kupujúceho. Je často ťažké rozlíšiť medzi spoločnosťou ktorá je monopolistom a inou spoločnosťou ktorá je konkurentom ako aj medzi predátorskými cenami a legitímnou cenovou súťažou. Aj keď má dominantná spoločnosť právo chrániť svoje vlastné obchodné záujmy, neznamená to prijatie opatrení za účelom posilnenia svojho dominantného postavenia.

Zneužitie dominantného postavenia je podľa ustálenej judikatúry pojmom, *"ktorý sleduje také konanie podniku v dominantnom postavení, ktoré môže ovplyvniť štruktúru trhu, kde práve z dôvodu prítomnosti takéhoto podniku je úroveň hospodárskej súťaže už oslabená, a ktoré má vo*

svojom dôsledku zabrániť zachovaniu existujúcej úrovne hospodárskej súťaže na trhu alebo rozvoju tejto hospodárskej súťaže, a to s použitím iných prostriedkov, než ktoré ovládajú obvyklú súťaž výrobkov alebo služieb na základe plnení hospodárskych subjektov." Pre výraz zodpovedajúci "dominantnému postaveniu" v právnych predpisoch EÚ, sa v USA používa termín "monopol". V Amerike, Najvyšší súd uviedol, že "strana má monopolné postavenie za predpokladom že môže voči ktorejkoľvek strane v rámci obchodovania medzi jednotlivými štátmi ovplyvňovať ceny alebo obmedzovať súťaž." Základný rozdiel medzi EÚ (článok 102 Zmluvy o fungovaní EÚ) a USA (§ 2 Shermanovho zákona) môže byť objasnený slovami, že zatiaľ čo § 2 Shermanovho zákona sa zameriava na prevenciu monopolizácie, článok 102 Zmluvy o fungovaní EÚ sa zameriava predovšetkým na zamedzovanie monopolov. Medzi skutkové podstaty ktoré sú často považované za zneužitie dominantného postavenia patria napr. neprimerané ceny, odmietnutie dodávok, cenová diskriminácia, predátorské ceny, atď. V ďalšej časti budeme analyzovať a vysvetľovať fenomén predátorských cien pomocou trojstranného porovnávania (ekonomickej, právnej a obchodnej stratégie). Predátorské ceny sú označované ako nelegitímna stratégia narušujúca hospodársku súťaž jak v EU tak v USA. Zásada voľnej tvorby cien je základom súťaže a znižovanie cien je výrazom intenzívnej konkurencie, avšak takéto konania môžu byť použité najmä so zámerom vylúčenia konkurentov z trhu. To, či podnikateľské správanie je správne jak z obchodného tak z ekonomického pohľadu je ústrednou úlohou súťaže, ktorá v prípade zneužitia má sankcionovať takéto správanie. Predátorské ceny realizované spoločnosťou v dominantnom postavení, napr. stanovovaním predátorských cien, ktoré sú navrhnuté tak, aby vytlačili konkurentov z trhu, alebo im zabránili v prístupe na trh sú v rozpore s článkom 102 Zmluvy o fungovaní EÚ. Podľa rozhodovacej praxe Európskej Komisie a Európskeho súdneho dvora je súčasná prax charakterizovaná aplikáciou ekonomických metód, ktoré hrajú kľúčovú úlohu pri určovaní predátorských cien. Avšak panuje kritika, že ekonomický kontext nie je dostatočne zohľadňovaný.

Z pohľadu spotrebiteľa sú predátorské ceny všeobecne pozitívne hodnotené, pretože spotrebiteľov nezujímajú ani strategické motívy spoločnosti, ani problémy spojené s predátorskými cenami. Predátorské ceny však môžu, rovnako ako rabatové programy, viesť k vylúčeniu konkurencie z trhu, alebo k zabráneniu prístupu na trh, čo v strednodobom až dlhodobom horizonte nie je v záujme spotrebiteľa. Konkurencia je teda *"proces kreatívnej deštrukcie"*. Výsledné straty konkurentov sú imanentné voči hospodárskej súťaži, a preto nemôžu byť meradlom konkurenčného spôsobu podnikateľského správania. Predátorské cenové stratégie sa tak v dôsledku toho dajú veľmi ťažko odlišiť od bežných konkurenčných praktík. Posúdenie cielených predátorských stratégií je preto jedným z najkontroverznejších otázok teórie hospodárskej súťaže a súťažného (antitrustového) práva. Rozsiahla zbierka literatúry sa pohybuje od popierania tohto správania vychádzajúc s racionálnej obchodnej stratégie k posúdeniu, ktoré musí byť predmetom detailnejšieho rozboru. Novšie – predovšetkým modely teórie hier - dospeli k záveru, že pre predátorské stratégie je najmä existencia nedokonalých informácií nevyhnutným predpokladom. Preto je ťažké ich celkové zistenie v praxi.

Aj v USA, sa americké štúdie obmedzujú na jednej strane na analýzu historických prípadov, a na druhej strane na štatistiky s obdobia minulého storočia, ktoré zahŕňajú všetky najdôležitejšie prípady hospodárskej súťaže v tejto oblasti. Táto štatistika nám ukazuje, že žaloby týkajúce sa stratégie predátorských cien boli v podstate málo početné a celkovo na úpadku. Frekvencia predátorských stratégií závisí nielen na význame ceny ako marketingovom nástroji. V skorších neo-klasických teóriách cien, bola otázka tvorby cien v centre vedeckého záujmu. Preto Schumpeter napísal v roku 1942: *"Ekonomia sa nakoniec dostala do štádia, kedy videla len cenovú konkurenciu a nič iné. Akonáhle budú kvalita súťaže a zákaznícky servis akceptované v teórii, bude pojem cenoveho rozdielu vytlačený zo svojho dominantného postavenie."* Aj v odbore Business Administration sa záujem sústreďuje na cenovú politiku. Toto jednostranné zameranie na ceny je v praxi však menej viditeľné: spoločnosti uskutočňujú rozhodnutia z

rôznych dôvodov, spomedzi ktorých je cena jedným z mnohých. Akú stratégiu koniec koncov použijú, závisí do značnej miery na tom, kde možno dosiahnuť najlepšej kalkulácie nákladov a výnosov.

Európske pravidlá hospodárskej súťaže majú osobitné postavenie, pretože musia sledovať nielen zachovanie účinnej hospodárskej súťaže, ale aj súčasne zabezpečiť dosiahnutie cieľov zmluvy. Neobsahujú žiadne konkrétne poznatky zakazujúce systematické znižovania cien. To znamená, že Európska komisia a Európsky súdny dvor museli vyvinúť kritériá pre hodnotenie takéhoto správania. Európska komisia, pokiaľ ide o hodnotenie koncentrácií, vzniesla otázku, či predátorské ceny je možné zaradiť pod článok 82 (teraz článok 102 Zmluvy o fungovaní EÚ). Ak spoločnosť využíva svoje dominantné postavenie, napr. počas dlhého obdobia realizácie predaja pod cenu aby prinútila konkurenciu k fúzii, je to považované za rozpor s článkom 82 (teraz článok 102 Zmluvy o fungovaní EÚ). Debata na túto otázku nadobudla na význame v rozsudku ESD v prípade AKZO.

Po výroku vplyvného profesora McGee, že predátorské ceny sú natoľko iracionálne, aby mohli byť využité v praxi, sa americké súťažné právo začalo detailnejšie zaoberať otázkou ako toto správanie rozpoznať od súťažného správania. Odpoveď na túto otázku poskytol Areeda a Turner prostredníctvom svojho ekonomického testu stojacom na porovnaní cien a nákladov. Toto však neuspokojilo väčšinu odbornej verejnosti a medzi ich kritikmi začala diskusia ohľadne ďalšieho prvku pri preukazovaní cenového predátorstva. Rozdiel v doktríne na oboch kontinentoch sa naplno prejavil v prípadoch Brooke a AKZO. V prvom menovanom prípade Americký najvyšší súd uviedol ako podmienku preukázania predátorstva tzv. recoupment, kým v prípade AKZO zámer dominanta. Od prelomového rozhodnutia v prípade Brooke je v americkom súťažnom práve jednou z dvoch podmienok preukázania predátorského správania práve spomínaný recoupment. Na európskom kontinente ESD síce odmietol túto podmienku ako predpoklad predátorstva, avšak odborná verejnosť sa častokrát pripája k opačnému názoru. Toto presvedčenie odôvodňujú tým, že pokiaľ spoločnosť nezvýši svoje ceny a následne si nezačne vynahrádzať svoje



straty ktoré utržila, spotrebitelia nemôžu byť poškodený a neexistuje potreba potrestania dominantna (t.j. bez spomínaného dôkazu recoupmentu). Voči tomuto tvrdeniu stojí názor, že kompenzácia utržených strát nie je totožná s poškodením spotrebiteľov, pretože, v prípade kedy správanie dominantna nebude úspešné ku kompenzácii nedôjde, môže mať za následok oslabenie súťaže a teda negatívne doliehať na spotrebiteľov.

Kým v USA sa vyžaduje preukázanie kompenzácie strát v rámci preukazovania predátorských cien, na európskom kontinente na prvom mieste je predátorský zámer dominantna. V prípade AKZO súd *expressis verbis* uviedol, že pokiaľ sa ceny pohybujú medzi priemernými variabilnými a priemernými celkovými nákladmi dochádza ku predátorskému správaniu, len ak spoločnosť v dominantnom postavení sa pokúsila o vytlačenie konkurencie z trhu. V Spojených štátoch bola otázka predátorských cien skúmaná po prvý krát už v prípade Standard Oil Company. V EÚ, Európsky súdny dvor a Európska komisia mali možnosť sa zaoberať otázkou predátorských cien takmer 100 rokov po prípade Standard Oil Company v prípade AKZO a následne v prípade Tetra Pak a Irish Sugar.

Svoju analýzu môžem rozdeliť do nasledovných bodov: I časť začneme s úvodom do problematiky predátorských cien (str. 19 a nasl.) → II časť predstavuje pohľad na teoretické prístupy a riešenia politiky hospodárskej súťaže v súvislosti s predátorskými cenami (str. 32 a nasl.) → III časť predstavuje klasifikáciu stratégie cielených predátorských cien v súvislosti s článkom 102 Zmluvy o fungovaní EÚ (str. 80 a nasl.) → IV časť skúma EÚ/US prístup súdov k predátorským cenám (str. 107 a nasl.) → Posledná V časť obsahuje návrhy na posudzovanie predátorskej stratégie v súlade (str. 149 a nasl.).

Cieľom tejto dizertačnej práce je objasniť vývoj predátorských cien prostredníctvom analýzy rôznych prístupov z oboch strán Atlantiku, pretože fenomén predátorských cien ponúka široký priestor na analýzu nielen z pohľadu práva EÚ ale aj samotného amerického práva (pomocou

trojstranného porovnávania ekonomickej, právnej a obchodnej stratégie). Zvolená metóda tejto dizertačnej práce nebazíruje tak na číslach alebo iných kvantitatívnych elementoch, ale predovšetkým na slovných formuláciách. Rozhodol som sa pre túto metódu, pretože predstavuje najlepší prístup na pohľad k predloženej problematike. Tiež prípadové štúdiá rozoberané v práci sa neupínajú len na jeden konkrétny prípad. Porovnávací analýza právnych názorov sa snaží reflektovať názory z oboch strán Atlantiku. Informácie použité v práci som čerpal z relevantných ustanovení ZFEÚ, Európskej a Americkej judikatúry a literatúry pojednávajúcej o teóriách predátorských cien.

Moje hlboké uznanie smeruje k vedúcemu mojej práce Doc. JUDr. Pavlovi Svobodovi, Ph.D., D.E.A., za jeho cenné rady pri realizácii tohto diela.

Taktiež by som sa rád poďakoval jednému z popredných Amerických odborníkov na súťažné právo, Prof. Dr. John E. Lopatka, J.D., LL.M., (A. Robert Noll Distinguished Professor of Law; Pennsylvánska Štátna Univerzita – Dickinsonova Fakulta práva) za jeho prvotný komentár. Rovnako oceňujem úvodnú pomocnú ruku od Prof. JUDr. Luboša Tichého, CSc., vedúceho ústavu právnej komparatistiky na Právnickej Fakulte UK v Prahe.

V Prahe, 2011

**Kľúčové slová:** Predátorské ceny, Zneužitie, Súťažné právo

## **CHAPTER I. INTRODUCTION TO THE REVIEW OF PREDATORY PRICING**

Predatory pricing, which can be described as one of the oldest business conspiracy theories, concerns a phenomenon for more than 100 years. Under the term "*predatory pricing*" we understand the situation where the predator first, lowers its price below the average cost of its competitors. Then, other competitors must lower their price below average cost. When not doing so, they lose their market share, but when doing so, they may eventually go bankrupt. Finally, when the competitors have been forced out of the market, the predatory undertaking can raise its price and recoup its losses originated during the previous period. The predator has two options: he can either lower prices for the same performance (so-called open predation) or leave the price equal to the competitors price and therefore offer a higher-quality output (so-called hidden predation). The predator is willing to accept short term losses, because he assumes that he will be able to realize in the monopolized market, after successful suppression or deterrence of competitors, above competition offers. In this way he can compensate or even overcompensate the earlier losses suffered in the previous period. Similarly, the predator can (if he operates in various geographic markets and/or is a multi-product company) "*subsidize*" its predatory pricing actions through profits in other areas. Predatory pricing is always a temporary phenomenon, since it can only be a rational strategy for an undertaking when the initial losses can be recompensated by subsequent winnings. The profits must be so high, that in addition to the suffered losses, also the forgone interests will be earned.

Because price has influence on suppliers and customers as well, the abuse of market power is regarded as illegal in terms of price manipulation. Price can be thus defined to be predatory if all three following conditions are met. "*First, the choice of that price must have no legitimate business purpose. Second, that price must threaten the existence or the entry of rivals that are at least as efficient as the firm (call it firm F) that has adopted the*

price at issue (price *P*). Third, there must be a reasonable prospect of recoupment of at least whatever initial costs<sup>11</sup> to firm *F* were entailed in the company's adoption of the price in question, that recoupment taking the form of monopoly profits made possible by reduction (as a result of price *P*) in the number of competitors facing *F*.<sup>12</sup> Market power is the power to influence market prices, output, innovation, and other elements of competition on the market for a substantial period of time. The U.S. Supreme Court defines the market power "*as an economic matter*" and "*market power exists whenever prices can be raised above the levels that would be charged in a competitive market.*"<sup>13</sup> From an economic perspective competition may be seen as effective when no undertaking on the market is able to exercise the so called substantial market power. Important to mention is, that market power and monopoly power are related but not the same.

Targeted predatory pricing is not a necessary precondition for prices that are below their own costs. Losses are to be understood in a broader sense: if an undertaking deviates downward from the maximum attainable price of its products, it suffers a loss equal to the difference between the maximum obtainable price and the price actually realized. We speak about the so-called "*soft predation*" if the predator achieve the cost recovery. The importance of market access barriers for the overall success of a predatory pricing strategy has been emphasized mainly by representatives of the limit-price theory. According to this theory, a monopolist does not choose the monopoly price, if he has to worry about the market entry or expansionary measures of potential competitors. Rather, he chooses a price that is between the monopoly price and competitive price, on the level that a

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<sup>11</sup> Cost can be seen as a multi-dimensional concept.

<sup>12</sup> Baumol, W. J. (1996): Predation and the Logic of the Average Variable Cost Test, *Journal of Law & Economics*, New York, 39 (1), p. 52

<sup>13</sup> Case: *Jefferson Parish Hospital District No. 2 v. Hyde*, 466 U.S. 2, 27 n.46, (1984); also in the *U.S. v. Microsoft Corp.*, 253 F.3d 34, (D. C. Cir. 2001) the court held similar position when stressed that "a firm is a monopolist if it can profitably raise prices substantially above the competitive level."

market access is no longer profitable.<sup>14</sup> It is a special case of soft predation because the monopolist brings with its Limit-Price-Strategy other competitors into the loss zone.

Price-squeezing is a subcase of targeted predatory pricing strategies, which can occur in vertically integrated undertakings. An undertaking that is both a supplier of a primary product as well as provider of a final product can displace its competitors from the market by increasing sales prices for the primary product, while lowering the price of the finished product.<sup>15</sup> The competitors are thus exposed to a price gap. This may be the result of profit-maximizing market strategy of the vertically integrated undertaking which inevitably brings with it the price discrimination. It can be also deliberately used as part of a targeted predatory pricing strategy.<sup>16</sup>

In the recent literature there is a growing attention given to the so-called "*non-price predation*". Because of this it should be briefly discussed in contrast to the predatory pricing strategies. Under non-price-predation we should understand a behavior that drives up the costs of competitors in the air, by contrast to predatory pricing which reduces the profits of competitors. The non-price-predation differs significantly from predatory pricing in the conditions and consequences: while by predatory pricing the predator have to calculate with losses in the hope of being able to recoup them through higher profits later on, by non-price-predation strategies there are no specific sacrifices there. If he succeeds in driving up costs of its

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<sup>14</sup> By the examination of the question whether predation may be profitable, Milgrom wrote that this can apply only for undertakings with large internal funds. He suggested in this context that "*when a firm in an industry with rapid product change might cut prices sharply in answer to new entry in order to discourage the new entrant from continuing an active product development program. Whether the entrant attributes its lack of profitability to its high costs, to weak market demand, to over-capacity in the industry, or to aggressive behavior by its competitor, it will properly reduce its estimate of its future profits. If its capital has other good uses, this might lead it to withdraw from the industry. If not, it may nevertheless be dissuaded from making new investments in and developing new products for the industry. At the same time, other firms may be deterred from entering the industry. If any of these things happen, the predator benefits.*" see further in Milgrom, P. (1987): *Predatory Pricing*, The new Palgrave Dictionary of Economics, Macmillan, London, p. 937

<sup>15</sup> Möschel, M. in Immenga, U./Mestmäcker, E. J. (1997): *EG-Wettbewerbsrecht*, München, § 22, Rn. 121

<sup>16</sup> Mestmäcker, E. J. (1984): *Der verwaltete Wettbewerb. Eine vergleichende Untersuchung über den Schutz von Freiheit und Lauterkeit im Wettbewerbsrecht*, Tübingen, p. 181

rivals, he will benefit from an overall disproportionate price increase and be able, by drop in production of its rival's, to expand its own market shares. Unlike by predatory pricing, it is not necessary that the predator is acting on several markets and be a multi-product company. The position of any undertaking will be relatively improved through increase of cost of competitors. It is not even necessary that the undertaking holds a dominant position on the market.

The competition law nature of decoy offers, which can be primarily found in the area of consumer goods retailing, is only a marginally subject of predatory pricing debate. The sale of individual goods below the acquisition cost or cost price is typically characterized by misleading the consumer about the calculation of the entire range of the supplier. The attracted customers should be encouraged to buy not only the decoy offers, but also to acquire the higher calculated goods, with which will compensate the losses and the total revenue can be increased. The decoy offers can be part of a comprehensive predatory strategy to attract customers of other competitors which have been forced out of the market.

### 1.1. Predation versus non price predation

When compared non-price predation with predatory pricing it must be stressed that non price predation is more effective. This is because predatory pricing is in general more costly and more risky. As Posner mentioned, predatory pricing should not be forbidden until the predator is "*as efficient in the long run as his competitors.*"<sup>17</sup> Non price predation is often different than the price predation because it is less expensive to the predator. The Raising Rivals Costs (RRC) represents a form of non price predation. In the literature some scholars have expressed their view that RRC could be anticompetitive.<sup>18</sup> According to the RRC the predator raises its costs with

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<sup>17</sup> Posner, R. A. (1979): The Chicago School of Antitrust Analysis, 127 University of Pennsylvania Law Review, p. 943

<sup>18</sup> Williamson, O. (1968): Wage Rates as a Barrier to Entry, The Pennington Case in Perspective, Harvard Quarterly Journal of Economics, 85, pp. 90-101

the aim to increase the price of an input of other competitors. The competitors must decrease their output. With the raise of the costs above market price, the competitors business will be unprofitable. When the marginal costs of a particular undertaking increase, its output decreases. When the alleged predator increase the marginal cost of other competitors it will lead to the situation where the competitors supply will decrease the market supply and the market price will raise. The predator will have several options, either not to change the output and have high market price, expand the output and have high market at the primary market or make up a part of other competitors reduced output and have a high market share by a little increase of price. The RRC can be used by the predator to raise the market price or to hinder the price from declining. With predatory pricing the predator is selling its products at prices that force other competitors out from the market. After it, the predator increases prices to recoup its losses. Certain conditions must be met, namely the predator must be in a position to eliminate competitors in a short period because selling below cost is expensive. Barriers to entry must be also high. The new market entrants should not be able to enter quickly. Apart from the above mentioned the RRC will be not effective if market entry is easy. The predator can not anticipate to win long term supra-competitive profits when the supra-competitive prices entail entry.

## 1.2. Are Predatory pricing common? Evolution and the most cited definitions

The most cited article on predatory pricing was written in 1958 by American economist John McGee. It has been, for a long time, the only coherent theory declaring that predatory pricing was *irrational*.<sup>19</sup> This view came under pressure by Chicago economists like Areeda, Bork<sup>20</sup> or

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<sup>19</sup> McGee, J. S. (1958): Predatory Price Cutting: The Standard Oil (N. J.) Case, Journal of Law and Economics, New York, pp. 137-169

<sup>20</sup> Bork spoke about a “phenomenon that probably does not exist”. See Bork, R. (1978): The Antitrust Paradox, New York, p. 154

Easterbrook who argued that the original treat to predate is not reliable. Their common claim was that because the predatory pricing are so rare there is no need for further legislation. This was supported by Jonathan Baker who suggests that predatory pricing is rarely rational.<sup>21</sup> Areeda and Turner argued that *"Predatory pricing would make little economic sense to a potential predator unless he had (1) greater financial staying power than his rivals, and (2) a very substantial prospect that the losses he incurs in the predatory campaign will be exceeded by the profits to be earned after his rivals have been destroyed."*<sup>22</sup> The most recognised definition of predatory pricing has been provided by the U.S. Judge Frank Hoover Easterbrook who wrote in the Poultry Farms Case that *"Predatory prices are an investment in a future monopoly, a sacrifice of today's profits for tomorrow's. The investment must be recouped. If a monopoly price later is impossible, then the sequence is unprofitable and we may infer that the low price is not predatory. More importantly, if there can be no "later" in which recoupment could occur, then the consumer is an unambiguous beneficiary even if the current price is less than the cost of production."*<sup>23</sup> The Chicago Law School supporters proposed that it must be irrational when an undertaking is cutting the price in response to new entrants actions, because it causes a profit loss in the short-run. Broadly spoken, predatory price-cutting can cause consumer harm. The market dominant undertaking is not exposed to a competition and may therefore offset its losses in the future and require excessive prices.<sup>24</sup> Contrary to this, one of the today's top ranked U.S. scholars Aaron Edlin from University of California, Berkeley argues that predatory pricing can, under certain circumstances, be an

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<sup>21</sup> Baker, J. B. (1994): Predatory pricing after Brooke Group: An economic perspective, 62 Antitrust Law Journal, New York, pp. 585–603

<sup>22</sup> Areeda, P., Turner, D. F. (1975): Predatory Pricing and Related Practices Under Section 2 of the Sherman Act, 88 Harvard Law Review, pp. 697-698

<sup>23</sup> Case: A.A.Poultry Farms, Inc. v. Rose Acre Farms, Inc. 881 F 2d 1396, 1397 (7th Cir. 1989), para. 21

<sup>24</sup> see under footnote 15: Möschel, M. in Immenga, U./Mestmäcker, E. J. (1997): § 86, Rn. 165



*effective and profitable*<sup>25</sup> business strategy. In Europe, Massimo Motta also supports the idea that predatory pricing are not so rare when declaring that *”Predatory pricing occurs when a firm sets prices at a level that implies the sacrifice of profits in the short-run in order to eliminate competition and get higher profits in the long-run.”*<sup>26</sup>

### 1.3. Chicago (post-Chicago) School theory summary on Predatory pricing

The abuse of market power is considered as illegal. The concept of predatory pricing means that price competition has a positive impact on consumer welfare in the short-run while on the other hand it can be disadvantageous in the long-run (because of return of the supra-competitive prices). This is because consumers are neither interested about the company strategic motives nor for the problems associated with predatory pricing by competing companies. Predatory prices may, however, as well as discount schemes lead to force competitors off the market or deter them the market access, which in the medium to long term is not in the consumer interest. Predatory pricing disadvantage can lead to reduce investment and innovation as well as expansion. In the U.S., the debate about enforcement of predatory pricing and its exercise can be divided into two parts, namely the Chicago School theory (and the Post-Chicago School theory). The first one is more supported by the U.S. Supreme Court, and suggests that Predatory Pricing is not a logical business practice for an undertaking because it could not be rational if the price is below short-run AVC and legal if the price is above AVC (average variable costs). Chicago scholars support the notion that rigorous predatory pricing policies might restrain competition and thus have negative economic and legal effects.<sup>27</sup> Also in the Matsushita Electric Industries Case (discussed on page 142), the U.S. Supreme Court adopted the notion of the Chicago School that predatory

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<sup>25</sup> Edlin, A. S. (2010): Predatory pricing, UC Berkeley, p. 4 and follows; Edlin argues that for successful predation there is a need for low prices, credibility and no re-entry.

<sup>26</sup> Motta, M. (2004): Competition Policy, Cambridge University Press, p. 412

<sup>27</sup> see under footnote 21: Baker, J. B. (1994): pp, 585-586

pricing is a scarce activity.<sup>28</sup> Thus the core arguments of the Chicago School on predatory pricing are summarized below (followed by the counter arguments from the Post-Chicago School):

- (1) The Chicago School supporters believe that aggressive prices are generally pro-competitive. This leads to the assumption that rational firms will not engage in predatory pricing until they cannot be successful.
- (2) The Chicago School supporters follow the notion that predatory pricings are irrational and rare. This is because they are more costly for the large undertaking due to its larger market share.
- (3) The Chicagoan argument was based on the notion that predatory pricing is costly during the period when it will be applied (so called a price-war). The price war must be followed by a period with high prices which allows the predator to recover its early losses.
- (4) The Chicago School relied on *neo-classical economics*<sup>29</sup> which has been criticised for adherent on unrealistic assumptions. One of the assumptions was not being able to take advantage of market imperfections in a situation where an undertaking can make profits without being efficient.<sup>30</sup>
- (5) The criticism of Chicago School has been based on the assumption that antitrust should protect only economic efficiency.<sup>31</sup> Modern theories of predatory pricing have added some elements to Chicagoan model arguing that it can be profitable to predate.<sup>32</sup>

The Post-Chicago School, which has been on the rise during the Bill Clinton

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<sup>28</sup> Case: Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 589-90 (1986)

<sup>29</sup> Funtá, R. (2011): Abuse of a dominant position in EU and U.S. Law, 2nd Edition, Tribun EU, Brno, p. 102

<sup>30</sup> Hovenkamp, H. (1985): Antitrust Policy After Chicago, 84 Michigan Law Review, 213, p. 261

<sup>31</sup> Munková, J., Svoboda, P., Kindl, J. (2006): Soutěžní právo, 1. vydání, C. H. Beck Praha, p. 18

<sup>32</sup> Contrary to this there are more profitable ways (e.g. acquisitions) to eliminate competitors.

Administration (1993-2001), support the idea that predatory pricing can be a *logical business strategy* when speaking about the key player in a monopolistic market.

- (1) The Post-Chicago theory supports the idea that markets are not perfect and not self-correcting.
- (2) The Post-Chicago School has the view that predatory pricing can be rational in certain situations. They argue that recoupment can occur without monopoly power and that above-cost prices are never predatory.<sup>33</sup>
- (3) Because the theory of the Post-Chicago School was too complex they were criticized a lot.<sup>34</sup>
- (4) The success of the Post-Chicago theories before the courts was very rare. They won on credibility by cases dealing with tying agreements to monopolize the market (i.e. mostly in areas not dealing with predatory pricing).
- (5) According to the Post-Chicago School, small competitors are mostly destroyed during price wars because of lack of resources in comparison to the predators.

#### 1.4. Predatory pricing as an instrument of abuse

Predatory pricing can be seen as an instrument of abuse. This is the case when the predator wants to achieve his longer-term objective by offering its goods or services at unrealistically low prices (an undertaking is accused of predatory pricing because it is pricing at levels that are unreasonably low e.g. below some measure of cost). Until low prices are beneficent for the customer there is nothing wrong with the low pricing. One of the

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<sup>33</sup> Lopatka, E. J. (2008): Economic authority and the limits of expertise in antitrust cases, p. 241, in Marshall, K. S. (ed.): *The Economics of Antitrust Injury and Firm-Specific Damages*, Lawyers & Judges Publishing, Arizona

<sup>34</sup> Hovenkamp, H. (2001): *Post-Chicago Antitrust: A Review and Critique*, 257 *Columbia Business Law Review*, New York, pp. 277-278

preconditions for predatory pricing is that an undertaking is setting the price below costs. Before the AKZO landmark case the theory agreed that predatory pricing requires a second (recoupment) phase where the dominant can recoup its losses that occurred in the first phase. The predator in the first stage attempt to deter its rivals the entry on the market (or to force them out of it) seeking to recoup its losses, and making more profits by holding the prices on high level, from the previous period. Also the so called deceptive pricing, where customers are intentionally misleading with price promotion, is seen illegal in the U.S. under the Federal Trade Commission Act (1914) and the Wheeler – Lea Act (1938).

#### 1.5. The classical view of predatory pricing and its criticism

From classical look on predatory pricing a dominant undertaking is selling below cost with the aim of elimination its rivals and earning monopoly profits. When applying the traditional theory of predatory pricing both sides, the predator and its rivals, suffering losses. Whether the strategy will be rational the predator must believe that his losses will be recouped in the future. This classical definition has been heavily criticised for its gaps. Going out from the illusion that the predator is larger than the rivals, by any price reductions the predator would have to book greater losses than the rival's. Thus *"the cost of predation equals the loss per sale multiplied by the number of units sold."*<sup>35</sup> Another critic point is that the predator and its rivals have sufficient information about each other costs. Modern economics oppose this classical theory of predatory pricing arguing that predation is more costly to the dominant undertaking.

#### 1.6. A Summary of the Evolution of Predatory Pricing in the EU and USA

When we look at the above mentioned text, I adopt a definition that Predatory pricing is a practice by which prices are lowered to an irrational

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<sup>35</sup> Brodley, J. F., Hay, G. A. (1981): Predatory Pricing, Competing Economic Theories and the Evolution of Legal Standards, 66 Cornell Law Review, New York, p. 738

level, mostly below cost, in a particular market with the aim to eliminate or prevent the entry of the rivals. I also believe that whether predation will be successful depends on whether predator and other competitors believe it will be a successful strategy. The evolution of Predatory Pricing in the EU and USA is summarized here below:

- 1890 Sherman Act (Sherman Act was enacted to prohibit concerted activity which restrains trade including price fixing, and monopolization).
- 1911 Standard Oil Co. v. United States (U.S. Supreme Court has seen the Standard Oil Trust monopoly position which was an unreasonable restraint on trade under the Sherman Antitrust Act. Standard Oil was found guilty because it had employed predatory Pricing strategy).
- 1910 Clayton Act (Prevents activity which may tend to restrain trade (declares illegal specific types of restrictive or monopolistic practice like price-discrimination (section 2), exclusive dealing and tying contracts (section 3), acquisitions of competing companies (section 7) and interlocking directorates (section 8). The § 2 of the Clayton Act allowed as a possible defense the "*demonstration that the price concession was made in good faith to meet competition.*")
- 1914 Federal Trade Commission (FTC) Act (Prohibits "*unfair methods of competition*" and "*unfair or deceptive acts*" in commerce).
- 1936 Robinson-Patman Act (Prohibits price discrimination). As it was held in the U.S. Supreme Court decision in the Sun Oil Co. Case the aim of the Robinson-Patman Act is "*to protect only the price discriminations in order to meet an equally low price of a competitor.*"<sup>36</sup>
- 1938 Wheeler-Lea Amendment (Gave the FTC the power to check false advertising of foods, drugs, medical devices, and cosmetics (to protect consumers and competitors).
- 1967 Utah Pie Co. v. Continental Baking Co. (Producers in California

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<sup>36</sup> Federal Trade Commission (FTC) v. Sun Oil Co., 371 U.S. 505 (1963)

were accused of charging less for their pies in Utah than in markets closer to their plants after Utah Pie's entered to the market. The U.S. Supreme Court decided in favor of Utah Pie. The Court argued that consumers benefited from lower prices and that this increased competition in Utah. Continental Baking Co., engaging in predation, charged lower prices in the market where it faces its rivals like Utah and a higher prices where not. Continental's below-cost price forced Utah Pie to reduce its price).

- 1975 Areeda-Turner Average Variable Costs (AVC) Rule (Areeda-Turner Rule proposed that prices below marginal costs (MC) are predatory). Average variable cost are equals variable cost divided by quantity produced.
- 1986 Matsushita Electric Industrial Company v. Zenith Radio Corporation (changed the basic ground rules for proof of conspiracy).
- 1986 *AKZO* (the ECJ held that (a) prices below average variable costs (AVC) are presumed illegal, (b) prices between AVC and average total costs (ATC) are illegal if they are set up to eliminate a competitor, and (c) prices above ATC are conclusively legal.).
- 1993 Brooke Group v. Brown & Williamson Tobacco case can be seen as a victory for the Chicago School of antitrust. Important to mention is that in cases before Brooke Group, the U.S. Supreme Court strongly supported the idea that low-cost pricing was a precondition in a predation case.
- 1996 Tetra Pak II (the ECJ held that "*prices below average variable costs must always be considered abusive*". ECJ refused to require proof of recoupment).
- 1996 *Compagnie maritime belge* (The court held that recoupment "*should be part of the test for abusively low pricing by dominant undertakings*").
- 1999 United States v. AMR Corp. (The Tenth Circuit accepted the DOJ view that, in some predatory pricing cases, dimensions other than AVC

that more directly reflect the specific incremental costs dedicated with alleged predation may be seen as the most adequate benchmark of the defendant's costs).

- 2001 Deutsche Post (The European Commission decided that the incremental costs encompass only costs caused by providing a specific parcel service but not the fixed costs).
- 2003 Wanadoo (The European Commission returned to the AKZO test when relied on pricing below average variable costs and pricing above average variable costs but below average total costs).
- 2010 up to now - Evolution continues... In the EU, according to the EU Commission and the ECJ, the current practice is characterized by the use of economic methods, which play a crucial role in identifying predatory pricing. However, there is a criticism that the economic context is not sufficiently considered. In the U.S. the Obama administration has declared to reinvigorate the antitrust enforcement. The U.S. Administration is willing to improve its standards in order to best promote economic growth and enhanced consumer welfare.

## **CHAPTER II. THEORETICAL COMPETITIVE APPROACHES AND COMPETITION POLICY SOLUTIONS**

### 2.1. Introduction

The difficulties in understanding between economists and lawyers are often complained. Especially in the area of competition, the gap between the model world of economists and its applicability in practice appears very large. This may partly lie in the research object of the competitive economy as an integral part of societies' development processes. But there is, however, some progress there. In particular, through the application of game-theoretic approaches it has been possible to display the interdependent decision-making patterns. This can, at least, draw conclusions about the conditions under which predatory pricing can be taken by undertakings as a rational strategy. The theoretical discussion about the requirements and effects of predatory pricing strategies and the resulting competition policy conclusions have been primarily conducted in the United States. For a long time the importance of predatory pricing was at very low level and initially only in connection with price discrimination.

The economist McGee<sup>37</sup> came in 1958 with an article on predatory pricing based on a thorough analysis of the famous Standard Oil Case,<sup>38</sup> in which he came to the conclusion that rational entrepreneurs would not try to destroy its competitors through predatory pricing, but they would rather buying-up them. Therefore such predatory pricing strategies, with the aim to destroy the competitors, should not exist.

This idea has drawn a flood of releases where the importance of predatory pricing has been controversially discussed.<sup>39</sup> The discussion focused initially on the question whether predatory pricing can be a rational

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<sup>37</sup> see under footnote 19: McGee, J. S. (1958): p. 137 and follows

<sup>38</sup> Case: Standard Oil Co. of New Jersey v. United States, 221 U.S. 1 (1911)

<sup>39</sup> see e.g. Elzinga, K. (1970): Predatory Pricing: The Case of the Gunpowder Trust, 13 Journal of Law and Economics, Michigan State University, p. 223 and follows or Easterbrook, F. H. (1981): Predatory strategies and counterstrategies, University of Chicago Law Review 48, p. 263 and follows



strategy or not. Several years ago a couple of research papers have been published which affirm this idea under certain conditions.<sup>40</sup> A number of research papers are dealing with competition issues, as how predatory pricing should be recognized and treated under competition law.<sup>41</sup> The solutions cover a wide spectrum. They range from purely cost-based rules or overall analysis to total analysis, that make the price-cost relationship entirely out of consideration.

Since there are detailed interpretations from American literature only those theoretical models which are necessary for the further course of the investigation will be presented. A special attention is given to those theories and competition policy solutions that have influenced the Commission's practice and the jurisprudence of the Court of Justice of the EU. In particular, the game theory approaches have emphasized the importance of strategic consideration for predatory pricing and thus given us a new quality to the theoretical considerations. This requires a very complex modelling and considerable mathematical apparatus. As for the legal assessment, on the first place, the conditions and results are of core interest, we will not focus our primary attention to a detailed description of the models.

## **2.2. Theoretical Explanations**

### **2.2.1. The McGee's thesis<sup>42</sup>**

Until McGee published in 1958 his essay on predatory pricing, the Standard Oil case<sup>43</sup> was regarded as a classic case of predatory pricing strategies. McGee took, using the court records, a detailed analysis of the

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<sup>40</sup> Philips, L. (1987): Predatory pricing, Office for Official Publications of the European Communities, Luxembourg, pp. 2-65

<sup>41</sup> see under footnote 22: Areeda, P., Turner, D.F. (1975): pp. 637-733; Scherer, F. M. (1976): Some Last Words on Predatory Pricing, Harvard Law Review, 89, pp. 901-903; Williamson, O. E. (1977): Predatory Pricing: a Strategic and Welfare Analysis, Yale Law Journal, 87, pp. 284-340; Baumol, W. J. (1979): Quasi-permanence of price reductions: a policy for prevention of predatory pricing, Yale Law Journal, 89, pp. 1-26; Joskow, P. L., Klevorick, A. K. (1979): A Framework for Analysing Predatory Pricing Policy, Yale Law Journal, 89, pp. 213-270

<sup>42</sup> Möschel, W. (1979): Die Idee der rule of law und das Kartellrecht heute. Am Beispiel der gezielten Kampfpreisunterbietung, Ordo 30, Tübingen, pp. 295-312

<sup>43</sup> see under footnote 38: Standard Oil Co. of New Jersey v. United States

corporate strategy of Standard Oil, and came to the conclusion that the undertaking has not applied predatory pricing strategies to maintain its market power, but reached this goal through business combinations. This McGees result is underpinned by a theoretical model, by which he demonstrated the superiority of a merger against predatory pricing strategies.

2.2.1.1. The superiority of the merger solution vis a vis the destruction through predatory pricing - the superiority of the merger solution

McGee supports his theory on a static model with a monopolist which is only a single-product undertaking. The following assumptions underlie this model:

- (1) There is an infinitely fast reaction time. Market access always takes place when a newcomer can enter the market without making losses.
- (2) The costs of establishment of an undertaking are by incumbents as well as by newcomers at the same level.
- (3) There is perfect information situation, which means that all involved parties have full knowledge of all relevant factors, e.g. on the cost structure of their rivals, etc.

Faced with the alternative of either to destroy competitors through predatory pricing or an acquisition, the dominant undertaking has to engage with the considerations which lead to the conclusion that the merger or the purchase of competitors are cheaper, as their destruction through predatory pricing:

- (1) For a single-product undertaking is an offset with profits, earned from the sale of other products, not possible. Additionally, high market entry barriers have to ensure that after successful destruction of competitors there will be no newcomers looking to enter into the market. Otherwise, the dominant

undertaking would not be able to compensate its losses through monopoly profits.

(2) The dominant undertaking has usually a very high market share. McGee estimated this for Standard Oil in the high of 75%. In this case the dominant undertaking sold three times as many of the products, like all its competitors combined. If he chooses the price reduction strategy, then he makes three times as much losses as its competitors in total. Furthermore, the dominant undertaking must be able to attract the increased demand. This also increases the loss.

(3) If the dominant undertaking compares the possibility of a buyout or a merger with predatory pricing, it shows the superiority of the merger solution. Apart from the under (2) mentioned considerable losses of predatory pricing, the price war furthermore causes opportunity costs in terms of foregone monopoly profits that might be released with the takeover of rivals. In fact, if the dominant undertaking would immediately buy up its competitors he could afford to, taking into account the discounted value of expected monopoly profits, provide a purchase price that is above the competitive level. Instead of taking losses into account, the monopolist can in case of a purchase of the undertaking reach the monopoly profits in full. Moreover, by price reductions the already uncertain monopoly profits are to be discounted, because they can be released only in the future.

(4) If the predator is still trying to oust competitors with predatory prices, there are two conclusions resulting from the assumption of perfect information: the competitors can recognize the pricing policy of the dominant undertaking as a sacrifice price strategy. Moreover, they know that this strategy is more expensive than the merger solution. Therefore they will either withstand the below-cost sales or abandon their business, to leave all the losses occurred to the predator and re-enter the market at a later date.

Overall, the comparison of the advantages and disadvantages of both alternatives is that for a one-product undertaking, under the assumption of perfect information, the merger solution compared to the predatory pricing strategy is more effective.

McGee once more time reiterated in another article from 1980 his assessment of predatory pricing as irrational and therefore rare.<sup>44</sup> Bork<sup>45</sup> and Easterbrook<sup>46</sup> represent, in general, the same position. During the discussion the following additional arguments have been put in place that supports this view:

(1) By a price war runs the dominant undertaking under risk that a third party will benefit from the price war when buying up weakened competitors at an especially favourable price. The dominant undertaking would then sit on its losses.

(2) The victim is not condemned to passivity, but can undertake marketing activities and thwart either the predatory price strategy through long-term contracts or start an offensive in another, by the dominant undertaking operated market and thus thwart plans of the dominant undertaking to minimize losses. The risk of the price war for the dominant undertaking is hardly predictable and will therefore, very likely, force him to abandon his strategy. Easterbrook stressed that the competitor will have a chance to conclude long-term contracts with the consumers through clarification of the anticompetitive nature of the pricing policy of the dominant undertaking and explanation of its short term profitability. But from the long term perspective it will have more harmful effects through long-term price increases.

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<sup>44</sup> McGee, J. S. (1980): Predatory pricing revisited, *Journal of Law and Economics*, 23, pp. 238-330

<sup>45</sup> see under footnote 20: Bork, R. (1978): p. 144 and follows

<sup>46</sup> see under footnote 39: Easterbrook, F. H. (1981): p. 263 and follows

(3) Edwards developed the theory where large undertakings are, because of their financial strength, in a position to lead price wars against their competitors (so called "deep pocket theory").<sup>47</sup> The criticism of the so called deep pocket theory is that it sees the predation as irrational because merger or takeover represent a less costly alternative. Another criticism of the theory is that it assumes that victims of the predatory strategy are subject to financial pressure but the predator itself not.<sup>48</sup> Within highly diversified market power undertakings, high-profit sections may be used to subsidize predatory price strategies. This hypothesis was drawn in doubt from the McGee supporters. McGee himself countered that financial reserves represent costs for the undertaking (in terms of opportunity costs) and not an inherent advantage. In particular, Stigler argued against the financial strength with the argument, that this assumption could be true only under conditions of an imperfect capital market.<sup>49</sup> Then the potential victim would have difficult access to capital markets and would not receive the necessary financial resources to withstand a price war with the predator.

#### 2.2.1.2. Doubts in the thesis of irrationality of predatory pricing - objections to the thesis of the irrationality of predatory pricing

The statements made by McGee and the supporters of his theories are indeed consistent with each other, however they are in practice unconvincing. McGee represents his considerations regarding the likelihood of predatory pricing strategies only in relation to mergers. Thus, the view is obstructed on the fact that in reality predatory strategies offers far more alternatives than just sacrifice price strategies and mergers. Conceivable are, i.e. sacrifice price strategies as a part of a marketing mix, making the losses at a reasonable and predictable level. In this context, the possibility of

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<sup>47</sup> Edwards, C. D. (1955): *Business Concentration and Price Policy*, Princeton University Press, pp. 329-355

<sup>48</sup> see under footnote 19: McGee, J. S., (1958): pp. 137-169

<sup>49</sup> Stigler, G. J. (1967): *Imperfections in the Capital Market*, *Journal of Political Economy*, University of Chicago Press, 75, pp. 287-292

market fragmentation must be observed. The McGee reasoning that the one-product undertaking, because of its high market share, has to accept the multiple of the losses than potential victims have to, will not be applied if the undertaking has previously opened sub-markets. As a result, expenses and income of the price competition will be made predictable. The market fragmentation prevents the effects of a price reduction on the entire market.<sup>50</sup>

The alternative merger or predatory pricing are in their conditions, from the viewpoint of the monopolist, not comparable. While a merger is hardly to conceal, this is possible for the predatory price cuttings. Also the corporate acquisition is without a problem only in theory. In practice there are often discrepancies. Moreover, the wave of mergers in the past has shown that expected synergy effects are often not there. This can result in significant costs.

Telser put, in the discussion regarding the McGee thesis, a strategic and tactical value to sacrifice price strategies in connection with the preparation to a merger. The predator is interested in a favorable purchase price. Especially if the competitor wants to reach a much higher price, the predator sets the undertaking under pressure through targeted predatory pricing. This is undertaken by the predator with the intention to align with the price expectations. The overall value of an undertaking will be influenced by the extent of this behavior, because the predatory price affects the competitor profitability. Insofar the predatory pricing can gain the dominant undertaking a favorable bargaining position. This approach is only rational if an isolated predatory strategy, without acquisition of an undertaking, causes more losses as the predatory pricing strategy oriented on the reduction of the undertaking's purchase price: if the costs of the isolated predatory strategy are lower than the achievable price reduction of the rival

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<sup>50</sup> see under footnote 16: Mestmäcker, E., J. (1984): p. 207

undertaking, such acquisition is not rational unless other strategic considerations (expansion) are taken into consideration. In addition, the costs resulting from the merger - as explained above – are also to be taken into account. The case AKZO is showing us that such considerations are applicable in the real world where the undertaking had thoroughly considered, in preparation for a merger, to use predatory pricing.<sup>51</sup>

McGee has based his assumptions on the fact that the conditions for the market entry and exit are usually not symmetrical, nor can be assumed that the market entry depends exclusively on the price-cost ratio. Even if - as Bork mentioned – we go out from the low fixed costs that help with the market withdrawal, it can not be concluded that the market entry of potential competitors will be also easy. By the market access probability an overall expectation of the concerned undertaking is playing a significant role.<sup>52</sup> The expectations will be on the one hand influenced by the experience of the past developments, and on the other hand on the future market opportunities. The assessment of a potential competitor, in terms of its own opportunities, could be influenced through the so called intimidation effect linked to the successfully completed ruinous price war. Furthermore, if the production structure is characterized by high fixed costs and sunk costs, such experience could have additional weight, because of considerable risk increase by the entering undertaking.<sup>53</sup> Sunk costs are such costs which have been made and cannot be recovered even in case of a withdrawal from the market. The prospective losses that would occur in the failure of the new entrant can prevent him from entering the market. They increase the risk by entering into the market because they cannot be recouped by the exit from the market. They create also a cost disproportion between market entrants and incumbent undertakings.

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<sup>51</sup> Commission Decision of 14 December 1985 relating to a proceeding under Article 86 of the EEC Treaty (IV/30.698 - ECS/AKZO), OJ L 374, para. 26

<sup>52</sup> see under footnote 16: Mestmäcker, E., J. (1984): p. 191

<sup>53</sup> Contrary to sunk costs, fixed costs are ongoing expenditure. In general, fixed costs tend to be less of a barrier to entry than do sunk costs.

The assumption of equality of the cost structure of incumbent undertakings and new market entrants does not correspond to reality. Empirical studies are showing us that the costs of incumbent undertakings are typically much lower than those of new entrants. The reason lies in the so-called learning or experience curve effect. The production and marketing activities constitute learning processes that lead to an increase in know-how and experience. It is therefore assumed that the unit costs decrease exponentially with the accumulated amount. This learning curve effect therefore leads to significant cost differences between incumbent undertakings and potential entrants. Through the learning curve the undertaking has a motive and an opportunity to produce more and also to lower its price in order to force the rival to leave the market.

The assumption of perfect information is for the assessment of predatory pricing, in terms of frequency and rationality, of central importance. In reality, the potential competitors are missing all those informations that McGee assumed that everyone knows. If this assumption will be dropped, predatory pricing measures can certainly lead to success. Especially game theory contributions can provide this evidence.<sup>54</sup> The possibility of the victim, mentioned in particular by Easterbrook, to defend against predatory pricing strategies, is classified as impractical.<sup>55</sup> Especially, while in the reality prevailing incompleteness of information, it is rather doubtful whether the victim of a predatory pricing strategy is in a position to convince the buyers of the anticompetitive nature of the action. Finally there is the possibility that the dominant undertaking dispose about a superior technology or other cost advantages compared to its competitors.

The possibilities of competitors affected by an aggressive pricing policy, through offensive marketing strategies in other markets where they are also in competition with the dominant undertaking, to harm this dominant

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<sup>54</sup> see under footnote 40: Philips, L. (1987): pp. 17 and follows

<sup>55</sup> see under footnote 39: Easterbrook, F. H. (1981): p. 270



undertaking with the aim to force him to take distance of this strategy, seems not very realistic. The competitor's market shares must be sufficiently large to affect the price level in the respective markets. Moreover, they should be in a position, through the price reduction – by a normal price elasticity - to satisfy the increased demand. Only then could the sacrifice price level be maintained and the dominant undertaking will be affected by it. In addition, the competitors must have the financial power to fight on all fronts of the battlefield. If all these conditions are met, it is very unlikely that the dominant undertaking will be in a position from which he will consider a price war as a successful strategy.

Equating the chances of success of predatory strategies appears with unequal financial power of rivals as not applicable. More important for the success is rather the situation on the commodity markets with their specific supply and demand structures. The financial power may be an additional criterion, but is not the most important one. Therefore the objection of Stigler, that the disciplining of rivals due losses is only possible if these dispose over a comparatively worse access to capital markets, does not come into question.<sup>56</sup>

### 2.2.2. The limit-price theory

It is the gain, in particular, of the limit-price theory which has demonstrated how undertakings can charge prices that are above the competitive level without provoking new market access.<sup>57</sup> The reason is that incumbent undertakings can take advantage from the market entry barriers. The classic and most frequently mentioned barriers to entry are economies of scale in production, absolute cost disadvantages (e.g. through industrial property rights) and product differentiation, which requires by newcomers great marketing effort.

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<sup>56</sup> see under footnote 49: Stigler, G. J. (1967): pp. 287-292

<sup>57</sup> Bain, J. S. (1968): Industrial Organization, 2nd Edition, New York, p. 269 and follows

On the example of an optimal business size, we can demonstrate the limit-price strategy: by numerous production technologies the so-called economies of scale are of considerable importance. Positive economies of scale are present when by growing output coming into being quantity disproportionate cost savings, through capacity advantages, specialization or division of labor, etc. The optimum size is reached by those factors of production capacity, where the minimum of unit cost begins. The importance of economies of scale as a barrier to entry rise on importance, the higher is the market share that the market entrant must reach in order to produce with the same efficiency, as the established competitors. The incumbent undertaking that exploits the whole of the economies of scale is in a position to call for a higher price than the competitive price. However, no market entrant will be ready to enter the market. This is because the required production capacity to achieve the optimal business size, where the economies of scale are exhausted, is higher than the rest of unsatisfied demand.

Some hypothesis may be created because the market entrant, by the time of its market entry, has no knowledge about the behavior of the incumbent undertakings. Bain believes, that it is very likely that the market entrant assumes that incumbent undertakings is pursuing a limit-price strategy, i.e. it would hold steady the output by his market entry.<sup>58</sup> This would lower the unit price and drive the market entrant immediately into the loss zone. Foreseeing this, any potential competitor will recognize it that he would be unsuccessfully on the market. The market entry remains undone, even if the market entrant could produce equally efficient as the incumbent undertaking.

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<sup>58</sup> see supra under footnote 57: Bain, J. S. (1968): p. 264

These statements are based on a model of Scherer and assume that the monopolist's optimal operating size always conforms to the demand.<sup>59</sup> Williamson, in contrast, assumes in his model that the monopolist do not temporize the market access, but this is already anticipated in the strategic choice of the business size.<sup>60</sup> Thus the undertaking is trying to create as much space as possible for expansion of its quantity of sales in the event of a market entry. The optimal operating size includes the possibility that, by the entry of a new undertaking there is an option to expand the production in the short term. This leads to the own cost optimum and the new entrant can not find more sales opportunities. Any potential competitor, who recognizes the excess capacity of the monopolist, will be deterred from the market entry, because he will see no chances of profit.

The limit-price theory exhibits some weaknesses:

Limit pricing and predatory pricing strategies have similarities but also differences. Both strategies could be applied against competitors to make their life unfavourable. On the contrary they differ not only in terms (when they are initiated) but also in terms of their objective. While limit pricing strategy is aimed at potential entrants, predatory pricing strategy at established competitors. The limit price can be determined in practice only with great uncertainty. This applies not only regarding the assessment of market possibilities through the market entrant, but also for the incumbent undertaking. Moreover, such strategy can only work successfully if the market entry of competitors depends on the price of the established products. If this is not the case, the limit price can not keep new competitors from entering the market. McGee therefore raises the following question *"If the limit pricing works well, why the first member of each branch did not*

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<sup>59</sup> Scherer, F., M. (1976): Predatory Pricing and the Sherman Act: A Comment." Harvard Law Review, 89, p. 869 and follows

<sup>60</sup> see under footnote 41: Williamson, O. E. (1977): p. 284

*practice it from the start and keep everyone else out without exception?*<sup>61</sup>

The limit-price theory has been developed especially with regard to sophisticated markets. This also explains why only a little importance is attached to the innovation competition. If the market entrants are able to come up with new processes or products on the market, the limit-price model does not work. The innovation competition is suitable to leave meaningless such high market barriers. The incumbent undertaking must take into account this risk, especially when it is considering whether to build overcapacities. These can become useless overnight. Seen in this light, it is more likely that the monopolist use its financial strength for research and development to maintain its leading position in the market, as bind it into overcapacities. In the model of Williamson it should be remembered, that the higher the overcapacities are, the higher are the operating capacities. However, this also increases the costs because the marginal costs, depending on the technique, possibly rise exponentially.

### 2.2.3. The game theory approaches

The game theory deals with the analysis of such decision-making situations where consequences of the decision maker (player) are not affected by random events, but by the goal-oriented activities of other decision makers, each pursuing its own goals. The game theory is therefore suitable to demonstrate strategies by price policy decisions. The game theory has been developed and deployed mainly by Neumann, Nash and Morgenstern. Shortly, the overall aim of game theory is to win the game by maximization of gains or minimization of losses. There are various situations to which the game theory could be applied, e.g. when undertakings are competing for business. When we look on the Nash equilibrium this can exist when each player is taking the best action but no players want to deviate. Criticisms against the game theory arise because

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<sup>61</sup> see under footnote 44: McGee, J. S. (1980): p. 299

some games possess solutions but some not. Apart from this, the game theory is playing an important role in the economic analysis.

#### 2.2.3.1. Selten's Chain Store Paradox

Selten demonstrated on the basis of the game theory that even if the predator is not only active as a one-product undertaking in a market - as suggested by McGee - but operates in several markets, predatory pricing is also an irrational strategy. Selten called the result of its investigation, as the Chain Store Paradox<sup>62</sup> because it is intuitively accepting that price undercuttings are worth in general, while the game theory comes to the opposite conclusion.

The game designed by Selten lasts 20 periods and is based on the following assumptions:

A chain store (called player A), has branches in 20 towns, numbered from 1 to 20. In each of these 20 towns there is a small businessman (a potential competitor) who is able to raise money in order to establish a second similar shop. The potential competitor at town k is called player k. Thus the Selten game has 21 players, the chain stores, the player A and 20 potential competitors. Important to mention is that apart from the above mentioned 20 players the chain store does not face any other competition.

None of the 20 small businessmen has enough owned capital to be able to obtain a credit from the local bank, but all of them have saved enough to increase its owned capital, from the player 1 to the player 2, etc., to the required amount. As soon as the player k is faced with this issue, the player k must decide from two options. First, whether he wants to establish a second shop in his town or second, whether he wants to use his capital in a

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<sup>62</sup> Selten R. (1978): The Chain Store Paradox, Theory and Decision, Vol. 9, p. 127 and follows

different way. If the player k decides for the second option, the player k stops to be a potential competitor of player A.

Contrary to this, if a second shop will be established in town k, the player A has to decide between two price policies. He may either cooperate or be aggressive. The first option will generate higher profits for both players in town k. By the decision for the second option, for player k profits will be better not to establish an another (second) shop if player A responds in this way.

Selten further assumes that because of the existence of perfect information of all concerned parts, i.e. all players are aware of each of the relevant data, the players are acting isolated from one another and a co-operation between all or a part of them is excluded. The player A has only the two alternatives described above. There is no option of buying up competitors.

It is clear that the player A will not be able to realize the full monopoly profit, since has to respond at least in one market with predatory pricing in order to deter potential competitors. Possibly, it requires further similar actions in other markets to strengthen its reputation as an aggressive undertaking. Such considerations can not help the player A to maximize its income, because all players have overall perfect informations. Potential competitors are therefore aware about the fact that for the player A it is more favorable to cooperate than to fight them. As a result, the player A will choose the cooperative solution. Predatory pricing is thus irrational.

Selten moves away from the restrictive assumption of a one-product undertaking. Both models (Selten's as well as McGee's one) are characterized by the unrealistic assumption of the existence of perfect information. Based on the Selten's game theory, Easterbrook made critical remarks on the question of the deterrent effect of predatory pricing strategies which needs therefore be assessed carefully. Easterbrook believes

that the predator who operates in several markets has no opportunity, through suitable strategy in a particular market, to build a dissuasive reputation in the rest of the market. Potential competitors would be in a position to understand the threat, because they knew that the predator makes higher profits when he shares the markets with new competitors. Specifically about this knowledge the competitors do not know in reality. The uncertainty can make predatory pricing a rational strategy.<sup>63</sup>

#### 2.2.3.2. Approaches that provide proof of the rationality of predatory pricing

Selten's game-theoretical approach was the starting point for the research papers of Milgrom/Roberts and others, who recorded for the first time the assumption of imperfect information into their models. Potential competitors can not assess whether the prices of the incumbent undertaking are predatory prices or competition prices. The uncertainty about the true nature of the price is the determining factor, which can bring the predatory pricing strategy into success. The model is confronted with the potential competitors an established undertaking that is either a fanatic predator or equally fanatical pacifist. The incumbent will decide according to the model for a price reductions in order to build an appropriate reputation, otherwise potential competitors does not need to calculate with predatory pricing from its side. This model - as well as that of Selten's - is limited on gradual market entries, so that the simultaneous entry of several (in the same market) or in different markets can not be explained. Thus, the model is seeing only predators who, once they have carried out predatory pricing, will always do this practice. Despite this very restrictive model Milgrom and Roberts have managed to provide evidence that established undertakings are able to use predatory prices in one market in order to protect a different market. Herein lies the central point of the model.<sup>64</sup>

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<sup>63</sup> see under footnote 39: Easterbrook, F. H. (1981): pp. 263-283

<sup>64</sup> Milgrom, P., Roberts, J. (1982): Predation, Reputation, and Entry Deterrence, *Journal of Economic Theory*, 27, p. 280 and follows

Finally, Easley, Masson and Reynolds have been able to relax the unrealistic assumptions of Milgrom and Roberts. As a result, the model shows the following connections:<sup>65</sup>

The market entrants are faced with a pricing policy of the already established competitor, which can have either predatory character, or a normal competition. Therefore, the market entrant can not be sure whether there will be sufficient demand for him in that market. Through price reductions, the monopolist operating in several markets can, due to this uncertainty, give the impression to potential competitors that there is no chance for the market entrants to establish themselves successfully in the market.

Easley and others have relaxed the restrictive assumptions of a successive market entry. Hence the market entry is allowed into several markets dominated by monopolists. Moreover, the monopolist has an option to cut prices, and also to delay the market entry (but not to prevent it). The behaviors of the incumbents in Milgrom/Roberts model were also abolished. The predator may, upon one or two periods, stop the predatory pricing strategy.

Easley and others came to the conclusion that predatory pricing strategy may be a widespread eliminating strategy, which is also applied to delay the entry of new competitors by low market entry barriers. The most recognised authors consider to be extremely difficult to provide the proof of it. The incentive for predatory pricing and its success is as greater, as likely, due to specific market conditions, the predator can be certain not to be discovered.

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<sup>65</sup> Easley, D., Masson, R. T., Reynolds, R. J. (1985): Preying for time, *Journal of Industrial Organization* 33, London, pp. 445–460



## 2.3. Competition policy solutions

### 2.3.1. Introduction

With the theoretical assessment of predatory pricing are corresponding the respective competition policy proposals. McGee, Bork and Easterbrook pull out of their belief, that predatory pricing strategies are irrational, the conclusion that competition policy intervention is harmful. The fear of wrong interpretation of competitive structures and thus preventing effective price competition is too large compared to the small number of predatory pricing cases.

Authors estimating that predatory pricing is a rational strategy, discuss ways to recognize such behavior. Two general directions can be distinguished: either per se rules are implemented, setting up strict price limits from which the predatory pricing is under consideration, or the preference of a rule of reason doctrine is applied, which enables the assessment of each individual case. Great influence on the American - and more recently also on the European case-law - have Areeda and Turner - with their per se - price-marginal cost rule. In American law, we can even speak of a triggered change in the law interpretation.<sup>66</sup>

The Areeda/Turner rule reached so high popularity probably due to the fact that it seemed to be the formula which is equally applicable to all legal cases. Areeda/Turner stated that *“courts in predatory pricing cases have generally turned to such empty formulae as ‘below cost’ pricing, ruinous competition, or predatory intent in adjudicating liability. These standards provide little, if any, basis for analyzing the predatory pricing offense.”*<sup>67</sup>

The questionable theoretical foundation and in particular the practical problems led in the United States to a certain disenchantment. Therefore,

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<sup>66</sup> Müller, D. C. (1986): Das Antitrustrecht der Vereinigten Staaten am Scheideweg (The Antitrust Law of the United States at the Parting of the Ways), Zeitschrift für deutsches und europäisches wettbewerbsrecht (WuW) 36, pp. 533-555

<sup>67</sup> see under footnote 22: Areeda, P., Turner, D. (1975): p. 699

alternative cost rules have been set up in the theoretical discussion. In the widest goes the limit-price theory proposal where also the pricing policy of the dominant undertaking, which lies above a full-cost level but prevent the market entry, has to be classified as anti-competitive.

As previously shown, the theoretical basis got further in the meantime through the approaches proposed by Easley, Masson and Reynolds. The conclusion to be drawn from it is that the economic policy approaches are focused on an overall analysis, whereas no (or at least a small) importance is put to the application of cost arrangements.

The Commission moved however the importance of strategic considerations into the forefront and highlighted also the possibility to see the full costs prices as an abuse within the meaning of Article 102 TFEU if the market entry is prevented or impeded. The special status of EU competition (antitrust) rules as an integration instrument played a significant role by this assessment.

### 2.3.2. The cost-based approaches

#### 2.3.2.1. Short-run cost based rule of Areeda/Turner

Areeda and Turner have tried, in their first essay of 1975, to establish objective criteria for distinguishing anticompetitive prices from competitive prices using the price-cost ratios.<sup>68</sup> In the course of this comprehensive discussion, Areeda/Turner changed their original results a little. This later version will be used in the following presentation.

Areeda and Turner request to set the short-run marginal costs as the lowest-price limit for monopoly undertakings. Prices that are above are competitive, but those one below this threshold are anti-competitive predatory pricing. Both authors have come to the conclusion when

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<sup>68</sup> see under footnote 22: Areeda, P., Turner, D. (1975): p. 697 and follows

comparing prices and output quantity in the profit maximum of a monopolist and a price taker by a perfect competition. The monopolist is facing the falling demand curve and is capable to vary its volume of supply. The maximum profit is reached where marginal costs equal marginal revenue. In contrast, an undertaking maximizes its profit under the condition of perfect competition if the price equals marginal cost.

A comparison of the two equilibrium points is showing a welfare loss in the case of monopoly, which is caused by the fact that the monopolist set up prices that are above the competitive price and therefore satisfies only a part of the demand, which lies under the conditions of perfect competition. The condition of price equals marginal cost provides for an optimal allocation of resources in a way that the criterion of Pareto optimum is met: None of the participants can improve its position without deterioration of the others.

Areeda and Turner draw the conclusion that monopolists should be encouraged to set prices at marginal cost. At the same time, this is known as a lowest-price limit, because it ensures optimal resource allocation. Below this limit, the supplier would make losses, which equates to a waste of resources.

Since marginal costs are only a theoretical figure Areeda and Turner have compared, for the practical application of the marginal cost rule, the marginal cost with average variable costs. Behind this are the following considerations: Marginal costs are those costs incurred in production of extra unit. The marginal costs are thus a function of variable costs, because they change with the change in output quantity. Thus, Marginal cost (MC) represent the increase (decrease) in total cost of increasing (or decreasing) the level of output by just one unit. This means, that MC are the change in total cost/change in quantity of output. Regardless, however, behave fixed costs. These occur always, even by a production volume of zero.

An example: A software undertaking produces 50. 000 units of the Product X and the entire cost is 5 million \$. Had the undertaking produced 1.000 units less, then the cost would be reduced by 12,000 \$. The marginal costs are therefore 12 \$ per unit.

Basically, we can divide costs into fixed costs and variable costs. Fixed costs (e.g. rent) are those which do arise, because the production equipment is already present. Variable costs (e.g. materials) are those that arise when being produced and accrue only when products are manufactured. One can see that the fixed costs remain the same, while the variable costs increase with increasing volume. The appropriate time period for defining variable costs is not a short run period but the medium to long run period (lets say 18 months).

If the monopolist would offer its products under the marginal cost, it would not only fail to earn a part on the already existing fixed costs, but would need to report an additional loss (with each additionally produced unit) equal to the difference between the additional cost and the prices charged. The means of production would therefore be used inefficiently. The loss could be minimized if the dominant undertaking would resign from additional output. Therefore Areeda and Turner keep such price setting as anti-competitive.

Areeda and Turner also discussed the price margin between the average total cost and average variable cost.<sup>69</sup> The dividing line of the average total cost is significant only insofar as prizes that lie above are not classified as predatory pricing, and insofar they are below average total costs but still above average variable cost, the pricing has simply an indicative significance. Areeda and Turner explain this by saying that undertakings due to fluctuations in demand or other market conditions fall under the total

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<sup>69</sup> Areeda, P., Turner, D. (1978): Antitrust Law, Aspen Publishers, New York, p. 154

cost. The undertaking did not want to go voluntarily these losses, but this happen on the basis of factors lying outside its sphere of influence. When an undertaking left the market because another competitors are pricing above the average of all total costs which have been used in production, this particular undertaking will be seen as less efficient and its presence in the market would not make sense because of making losses. Despite the competitors inefficiency in production, this one should be protected from any predatory behavior when helping keep prices low. Promotion of lower prices through competition is thus seen as the aim of competition law.

#### 2.3.2.2. Long-run cost based approaches

Posner defines as predatory pricing prices that are calculated in such a way that an efficient or equally efficient competitor will be forced out from the market. In a case where an undertaking prices below AAC, then the undertaking may exclude potential rivals. With prices that are above AAC the undertaking may only exclude less efficient market entrants. This is because the fact that if a market entrant will be equally or more efficient due to lower avoidable cost, probably this market entrant will be in a position to be successful on the market when competing against a price above its cost. Average avoidable cost (AAC) are costs that could have been avoided if the undertaking had not produced a certain amount of output over certain period of time. Baumol and Posner jointly agree that the equally efficient competitor standard is requiring *"the challenged practice is likely in the circumstances to exclude from defendant's market an equally or more efficient competitor."*<sup>70</sup> Such prices that exclude an equally or more efficient competitor are seen as predatory. He therefore proposes that selling under short-run marginal costs and selling below long-run marginal cost (if there is an intent to exclude the competitor), should be classified as predatory

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<sup>70</sup> Posner, R. A. (2001): Antitrust Law, 2<sup>nd</sup> edition, University of Chicago Press, pp. 194-195

pricing.<sup>71</sup> If an undertaking prices below AVC, in this case the undertaking may exclude rivals who could be in a position to produce efficiently. They jointly argued that prices above AAC exclude less efficient market entrants because if the potential entrants were equally or even more efficient (e.g. if they would have lower avoidable cost), probably these market entrants would be in a position to be successful by their business activities when competing against a price above their cost. In practice we can presume a situation where a market entrant, whose products are not for a long time on the market (or even better if these products are unknown to the customers), could have difficulty to reach its goals without remarkable marketing expenses (the products of the less efficient market entrants are not really equally good enough because they suffer one important element, “*being known*”).

As Posner stressed, the short-term marginal costs are usually below the long-run marginal costs, because many costs are independent (fixed). This applies, for instance, for rent, capital costs or depreciation. Posner referred also on the average cost of the undertaking (as they result from the operational cost), for the easier measurability. This rule is not suitable for the implementation of his theoretical considerations. Posner emphasizes the need to consider the long-run marginal costs, which would require a prediction about the future impacts of predatory behavior. No progress vis a vis the Areeda/Turner rule has been reached.

### 2.3.2.3. Criticism of the cost-based approaches

#### 2.3.2.3.1. Criticism of the theoretical foundations of the model

The cost efficiency criterion is based on the model of neoclassical, static price theory. It describes a situation of optimal resource allocation, which has nothing to testify about the competitive processes. In this case the competition, due to the optimal distribution of resources, has come to a

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<sup>71</sup> Posner, R. A. (1976): Antitrust Law: An Economic Perspective. University of Chicago Press, p. 188

standstill. As Möschel correctly pointed out, the assessment of competitive processes is equal to the conclusion of the model of perfect competition of an as-if- concept.<sup>72</sup> The behavior of a price-taker will be given to the dominant undertaking, which differs from others, because it is able to influence market prices with his behavior. Due to the static of the model, the strategic considerations that are largely determined by predatory pricing could not be considered.

The marginal or average cost rule of Areeda and Turner is showing weaknesses of both theoretical and practical difficulties in the legal assessment of cost accounting issues.

(1) The assumption that the marginal costs are approximately equal to the average variable costs and thus could serve as a substitute for the application of the law, applies only in the case of a normal utilization. The marginal costs can be both below as well as above the respective average variable costs. In the former case, the monopolist can not fully utilize its capacity. There is overcapacity, caused for example by a downturn in demand. The result is that equally efficient undertakings are forced out of the market or their market access is prevented. This effect is according to Areeda and Turner desired, because due to poor resource utilization resources are disappeared. On the basis of the average cost rule only those undertakings remain in the market whose costs are lower than the marginal cost of the monopolist. The possibility of the decrease of intensity of competition (due to the displacement of competitors), compared to the consumer benefit through lower prices, is not a determining factor. The accuracy of this hypothesis is seen over the time as doubtful, since the decreasing intensity of competition could lead to price increases, which led to a price that is above the competitive price. Also undesirable welfare losses would be associated with this practice.

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<sup>72</sup> see under footnote 42: Möschel, W. (1979): p. 305

(2) The second case is describing the area of supraoptimal utilization of existing capacities. In this constellation the application of marginal cost rule would mean that a higher price level would be required, as it would be required to cover the average costs. Areeda and Turner admit that the aspired optimal allocation of resources would not be met by applying the average cost rule. Therefore, in this case the assumption that lower prices are predatory, is exceptional refutable.<sup>73</sup>

Apart from the fact that the equation of marginal cost and average cost apply only for the cost performance by normal capacity utilization, additional concerns are taken into consideration in connection with above and below utilization. In particular, the representatives of the limit-price theory have criticized that the Areeda/Turner rule include only a short-term analysis and strategic aspects of corporate behavior as well as the deterrent potential of monopolistic undertakings will be ignored.<sup>74</sup>

#### 2.3.2.3.2. Problems in the practical implementation

All cost-oriented rules throw equally immense difficulties by the practical application. How extensive the effort can be and what dubious results are achieved may be illustrated on the famous Standard Oil case.<sup>75</sup> This case was, among other, about the issue of relative cost differences. Standard Oil granted to a wholesaler a discount of 0.5 cents per gallon gasoline. There was a question to be clarified whether it was price discrimination or not (for further explanations see page 139 and follows).

The department of the Federal Trade Commission examined for a few months standards cost accounting, and prepares a 133-page report. Standard Oil itself dealt with the question of costs on 2300 pages (of a total of 8057 pages). The Standard lawyer took the Federal Trade Commission

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<sup>73</sup> see under footnote 22: Areeda, P., Turner, D. F. (1975): p. 718

<sup>74</sup> see under footnote 41: Williamson, O. E. (1977): pp. 306-310

<sup>75</sup> Case: Standard Oil Co. of New Jersey v. United States, 221 U.S. 1 (1911)



investigator for 13 days under cross-examination. After nearly 17 months and 77 days of hearing this part of the investigation was completed. The representative of Standard Oil stated: *"... after I heard and carefully analyzed all the testimony, and after I examined the accounting problems, which in this case result from the question of the compatibility (the term" cost justification ") with the various interpretations of the word "costs", I do not know how can I assure my company's management that such a price difference with the requirements of the law (...) matches or not."*

The question of why the cost determination raises such difficulties can be answered only through appropriate knowledge of the cost accounting systems. Therefore, it is needed a brief overview of the operational cost accounting methods to facilitate the insight into the problem. It will be shown that the theoretically simple sounding rules, in practice, do not show these advantages. Comparability and objectivity of the facts will be simulated, which in reality do not exist.

a) The full cost accounting

There are two fundamentally different cost accounting systems. The full cost accounting and the direct costs (or contribution) calculation. They differ only in the offsetting, not in terms of capturing of all cost. The full cost accounting is the traditional accounting system that was primarily developed for the purpose of pricing calculations (for the determination of net cost price). In this method, initially all cost types incurred in the undertaking will be recorded. Cost categories include e.g. personnel or material costs. These types of costs are distributed in a second step to cost centers. Cost centers are functional, organizational or through other criteria separated parts of an undertaking such as purchasing, manufacturing, distribution (this would be a functional classification). The cost centers are in practice very deep structured and must be attributed through an allocation formula of the main costs. In the next step, the costs of the main cost centers

will be allocated, through common costs categorisation, to each individual cost unit.

The common costs categorisation is necessary because there are not only costs that arise directly and clearly for a cost bearer, but also those that do not relate to individual output units. These common costs can be divided by a multi-stage allocation process only until a proportionate cost amount is determined, which according to the cost calculator should be eliminated by the cost bearer. The categorisation of common costs means that exactly only the total ascertainable and measurable cost amount, purely mathematically, will be divided between cost bearers.<sup>76</sup>

The particular choice of a category depends on the entrepreneurial decision. There are for example time, quantity, value or manpower categories. On a simple example can be very clearly shown that different categories can be applied without arbitrariness, which lead to very different results. Supervised a craftsman two production departments, we may spread his salary in proportion to both departments. For this purpose it is advisable to use either time category or manpower category. If we decide for the application of the time category the number of the hours of the craftsman will be particularly considered. By the second option (manpower category) however, we will use the number of employees working in a department for the division of the craftsman salary. It is evident that depending on the classification possibly different impressions of the profitability of the viewed cost centers will be considered, without the option to be said that, the one or another allocation method is right or wrong.

The full cost accounting passes all incurred costs on the final product units; the performances are confronted with the full costs. A distinction between variable and fixed costs is not met. The objective of the full cost accounting

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<sup>76</sup> Hummel, S., Männel, W. (1986): Kostenrechnung, Band 1: Grundlagen, Aufbau und Anwendung, 4. Auflage, Wiesbaden, p. 53

is to give an answer to the question: What does the costs unit, the piece and the order cost? To this simple question, because of different options in the common costs categorisation, there is no clear (objective) answer. The quantified unit costs include added costs, as a result of the cost accounting, that do not depend from the amount of the generated volume.

The full cost accounting does not provide for the Areeda/Turner rule the necessary data. This is because variable and fixed costs are not shown separately. With this alone can be determined the threshold from which the full cost of a product is covered, whereby an attention must be given to the reservation that these full costs always contain a part of common costs.

#### b) The direct costing

Particularly with regard to the difficulty with common costs the full cost accounting is not suited as a basis for the pricing policy of an undertaking. With the more recent cost accounting systems only parts of the overall operating costs are attributed to the different objects of calculation. Depending on the accounting practices are these variable or single costs that can be directly recorded to an objects of calculation. Of the numerous cost accounting methods are described herein only the methods of direct costing in its very basic form. The direct costing was developed in the USA between 1959 and 1969 and found there broad dissemination. It seems that Areeda and Turner have based their deliberations on this cost accounting system, because by the direct costing - as proposed by Areeda/Turner - those costs will be charged, on particular product, that vary directly with the employment of an undertaking (employment-variable costs).<sup>77</sup> In Germany, in particular, the fixed cost and unit cost analysis have been developed.

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<sup>77</sup> The term "direct" refer to the relationship between cost changes and employment change. Direct costs in this sense are not unit costs. Variable allocated overhead costs and variable material overhead cost are "direct" costs.

The direct costing considers not only the cost side, but sets it in relation to revenue, and thus allows an analysis of successes. Mathematically, only the variable cost of provided services will be opposed to revenues. In contrast, the fixed costs<sup>78</sup> are not allocated to cost units, but appear globally as fixed costs block. The contribution (profit) margin per cost unit results from the difference between variable costs and revenue. It indicates how much each cost unit has to pay to cover the fixed cost block.

By all recent cost accounting systems, the question of what costs a cost unit is no longer made. Rather, it is asked how large the contribution margin for each product is. This reflects the fact that for the undertaking's success is not crucial to cover the cost of each product, but only the full coverage of the total cost. Therefore, it can be perfectly reasonable and commercially sensible decision to produce a product that can be offered only at the price by which the undertaking has to calculate with losses, but still provides a positive contribution margin. If an undertaking produces, for example 10 product types and makes with 9 product types a real profit of 1,000 Euro, while with the 10th product type a loss of 200 Euro, so that the overall profit is only 800 Euro, it would be wrong to assume that by shutting down the production of the 10th product type the loss of 200 Euro will be avoided and consequently a total profit of 1,000 Euro will be created if the total cost of the 10th product type is composed e.g. from fixed costs (300 Euro) and variable costs (600 Euro). By shutting down of the production of this product type only the variable costs can be saved, and the fixed costs must be covered by the other 9 product types, so that the total profit is not 1,000 Euro, but only 700 Euro, also less than if the production (which creates losses) of the 10th product type would continue.

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<sup>78</sup> In the literature we can find confusion when using the term "fixed costs." While Baumol defines fixed costs to exclude sunk costs, Areeda, Turner, and Hovenkamp are different meaning. They suggest that "fixed costs are costs that would continue even if the firm produced no output at all." See Areeda, P., Hovenkamp, H. (2002): Antitrust Law, Aspen Publishers, New York, p. 366 or see under footnote 69: Areeda, P., Turner, D. E. (1978): p. 156

With the fundamental division in total costs and variable costs provides the direct costing method relevant cost factors to the Areeda/Turner rule. However, also the direct costing analysis suffers from inaccuracies and can't exist without entrepreneurial discretion. This means that the hoped objective cost data can not be delivered. Difficulties arise particularly by those types of costs that comprise both fixed and variable elements. Moreover, the problem is that variable costs are not always direct costs, and thus can not be directly attributed to one product. In particular, by joint (coupled) production are dropping variable common costs, so that here again a classifications is needed. The details about the delineation between fixed and variable costs are covered in detail (by the discussion of the AKZO case) in the Chapter IV of this work.

#### 2.3.2.3.3. The negligence of the essential pricing factors

The Areeda/Turner rule requires from undertakings a cost-oriented pricing policy. This requirement is similar to the obligation of a car driver to drive a car with the help of the rear view mirror. It assumes a false causal relationship: The undertakings do not need to look on cost-oriented prices, but on reasonably priced costs.<sup>79</sup> The lethal consequences of a practice where an undertaking would align its pricing policy on the cost, is showing us an impressive example. It has still validity and is entered in the cost accounting theory under the heading of by-the-market- calculation.

For further clarification we can present an example, where a travel agency had ordered for a series of Sundays special trains and has undertaken to pay for each train 250 Euro. The train should have 400 seats, all third-class. On the first Sundays the travel agency set up the ticket price at 2 Euro, and there were 125 participants. The gross earnings were at total 250 Euro, as much as spending. But we come with this price as it is only on cost price,

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<sup>79</sup> Möschel, W. (1998): Preis- und Konditionendifferenzierung durch marktbeherrschende Unternehmen nach EG-Recht, RIW, p. 506

but we need to earn something, and thus the price increase to 3 Euro. Next Sunday came 50 participants. The result was 150 Euro in earnings, and a pure loss of 100 Euro. The average cost is 5 Euro for one person, and we carry the passengers for 3 Euro, so it is totally unacceptable to continue with this model. Thus, the price has been increased to 6 Euro, with the result that the train carried on the following Sunday, only six passengers. The loss increased now to 214 Euro. Finally, after in depth examination of the situation regarding this story with the cost, the price must be nonsense because it brings us only losses. Thus, the price was reduced to 1 Euro. The success was brilliant: the number of travelers amounted to 400 on next Sunday, there was a surplus of 150 Euro, and the strangest thing of all was that the original costs had dropped to 62.5 per person.

The example makes clear the relationship between prices and demand (expressed by the so-called price elasticity of demand) on the one hand and prices and costs on the other. The turnover of an undertaking depends on the prices. At the same time, when decided about the pricing policy, it will be decided about costs. Besides that, also the market structure has an importance for the pricing policy. In the example, the supplier was a monopolist. Even in this situation, the supplier has to take into consideration, when doing the pricing policy, the potential reaction of other competitors. The more important is the aspect of competitive situation when potential competitors advertise with current supplier for the favor of consumers. Depending on the type of market the competitive situation will be a more or less important pricing factor.

In summary we can say, that cost, demand and competition are the three main pricing factors. When applying the Areeda/Turner rule, through the exclusive focus on the price-cost ratio, the sight for these connections will be bared. There is a danger that behaviors which are in reality caused by

competition can be classified as anti-competitive. The Areeda/Turner rule is only apparently objective and justiciable.<sup>80</sup>

Also in the U.S. American jurisprudence the Areeda/Turner rule is not uniformly applied by the Circuit Courts: the 1st, 2nd, 5th and 8th Circuit Court applies the Areeda/Turner rule, but there are significant differences in the assessment, which costs should be classified as variable and which as fixed. Some Circuits have decided that prices above the average total costs are lawful but such between average variable and average total costs could be seen as unlawful. The plaintiff has then the burden of proof to ensure that prices between average variable costs and average total costs have a predatory character. The 8th Circuit Court assumes that prices above average variable costs represent a strong presumption of illegality. The 9th Circuit puts the burden of proof on the plaintiff. The 10th Circuit Court has pointed out that prices between average variable costs and average total costs are lawful, unless there is further evidence of a predatory strategy. The U.S. Supreme Court held in *Brooke*<sup>81</sup> that another prerequisite for a successful predatory pricing lawsuit is that: in addition to the proof that the defendant offered prices below cost is also necessary to provide the proof that the defendant has a reasonable probability for a recoupment of the investment in the prices below cost after elimination of rivals. The 6th, 8th, 9th, 10th and 11th Circuits have recognised that marginal, variable and total costs measures are relevant by an inquiry of predatory pricing. Pricing is always part of a competitive strategy of an undertaking.

#### **2.4. Total analysis**

From the recognition of the inadequacies of the exclusive cost-based approaches have been put forward proposals that favor an overall analysis. This need is derived from the strategic aspects of the predatory pricing. The predator presents his strategic plannings to reflect the strategic market

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<sup>80</sup> Zerbe, R. O., Mumford, M. T. (1996): Does Predatory Pricing Exist? *Economic Theory and the Courts after Brooke Group*, *Antitrust Bulletin* 41, p. 949

<sup>81</sup> Case: *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993)

development and the reaction of competitors, because he wants in such a way (with his short-to-medium term price campaign) to change the market structure (in the long term) to his favor. In the short run the Areeda/Turner rule – argued especially by supporters of the limit-price theory – may be true, however, the impact of predatory pricing on optimal resource allocation and consumer welfare must be considered. In comparison, Areeda and Turner suggested that the long-term effects are very uncertain and hardly to estimate. Therefore it is not possible to establish here a justiciable rule.<sup>82</sup> As Areeda/Turner were not able to establish a justiciable rule, there is no reason to dispense with the overall analysis. Only the observance of the long-term effects of predatory-pricing behavior fulfill the competition assessment.<sup>83</sup> The total analysis is particularly suited to provide insights into the complex competitive relationships.

#### 2.4.1. Scherer

Scherer's criticism of the Areeda/Turner rule is particularly based on the fact that long-term aspects of predatory pricing strategies are not considered.<sup>84</sup> Therefore, he essentially proposed five criteria that are necessary for establishing the price levels and which in the long-term guarantee the lowest business losses:

- (1) The relative cost efficiency of monopolies and the edge firms.
- (2) The minimum optimal business size.
- (3) Are edge firms driven out or just intimidated?
- (4) Extends the monopolist the production in order to compensate the failed amounts or limits the offer after the expulsion of rivals from the market?
- (5) Will the expulsion of rivals from the market result in the increase in capacity of the monopolist positive effects of economies of scale?

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<sup>82</sup> see under footnote 69: Areeda, P., Turner, D. E. (1978): p. 197

<sup>83</sup> see under footnote 41: Joskow, P. L., Klevorick, A. K. (1979): p. 222

<sup>84</sup> see under footnote 59: Scherer, F. M. (1976): pp. 869-890



Edge firms arise because some undertakings did not manage the advertising escalations and retreat to the edge as not having to leave from all parts of the industry.

Furthermore, Scherer also underlined the importance of the elasticity of demand in the long-term perspective. The determination of the facts, that Scherer consider as necessary, to find out the "*right*" price level, is in reality often not possible or, if, possible only with an unreasonable expense. The determination of the relative cost position of the dominant undertaking requires an almost insurmountable effort, because not only the accounting of the dominant undertaking, but also the accounting of the potential victims would have to be investigated. Moreover, the result would be of doubtful significance, because undertakings generally have different cost structures. The comparability of the accounting rules would be required in order to put these together into a meaningful relationship.

While according to market studies the minimum optimal size of an undertaking could be approximately determined, are the criteria (3) to (5) extremely problematic. If the competition law will not be seen as a dulled weapon, an investigation of the questions mentioned above under paragraphs (3) to (5) has to be made. This forecast may have, due to many influencing factors, more than speculative character. On the other hand, if an ex post consideration will be taken into question, the anti-competitive market structure changes were almost completed because the victim had already left the market. The competition (antitrust) law would have no power to protect the competitors against predatory pricing measures. Scherer is credited as one of the first personalities who have pointed out the need for an overall analysis. His investigation has fruitful impulses in terms of provoking the functional interconnections of predatory pricing. But his competition policy proposals are not feasible in practice.

#### 2.4.2. Williamson

Williamson placed emphasis on a long-term analysis, supporting particularly the strategic aspects of predatory pricing which, by the application of the Areeda/Turner rule, proactively encourage the undertaking in building up overcapacities. Williamson stressed that monopolist build overcapacities as deterrent potential. Thus he suggested that any production volumes increase of the monopolist, by the threat of new market entrants, should be considered as predatory strategy independently of the average cost level. Therefore, it should be forbidden to the monopolist to change within a certain period of time after market entry of new competitors the production quantity, unless in response to demand fluctuations. This is to ensure that the monopolist is forced, even if there is no market entry, to offer a production volume that is higher than that of a monopolist and, ideally equal the amount that would be offered in effective competition.<sup>85</sup>

The rule of Williamson is doubtful because it is based on assumptions that comprise only one of many of the entrepreneurial behavior alternatives. It is very doubtful whether the monopolist builds overcapacities in order to prevent the entry of new competitors into the market. Overcapacities bind financial resources without bringing revenue and therefore adversely affect the profitability of the undertaking. Such strategy could be seen as useful only if the production methods are so designed that additional units can be produced without great expense. Moreover, it is also conceivable that the monopolist prefers to implement safe monopoly profits, even if the market entry will be provoked. The entrepreneur is not limited in regards to the pricing policy. He may try, for example, to create product preferences through targeted advertising and thus promote the customer loyalty or create market niches through product diversification. These measures would be much closer to the market than investing in overcapacities. Finally, the

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<sup>85</sup> see under footnote 41: Williamson, O.E. (1977): p. 284 and follows

dominant undertaking can not be sure that his strategy of over-capacity will not be destroyed through market events or innovation.

While also the theoretical foundations of the Williamson rule will apply only in very exceptional cases, it is not feasible in practice. Undertakings have often a need to quickly respond to changes in demand. This flexibility is not guaranteed if the competition authority must be asked for a permission to adapt supply to changes in demand. It should be also remembered that it can be entrepreneurial reasonable to produce in stock, for example, to stabilize production and to ensure a uniform level of machine load optimization. It probably not needs to be mentioned that hardly any competition authority would be administratively in a position to monitor compliance with the law. Apart from these detailed questions, the Williamson rule is also exposed from fundamental concerns. The role of competition (antitrust) law is to secure the freedom of competition. It is not the role of competition law, to strictly prescribe an economically correct and recognized behavior.<sup>86</sup>

#### 2.4.3. Baumol

Baumol sustain his solution proposal on a long-term analysis and goes in the same direction as Williamson. According to his concept the monopolist should be prohibited, temporary, to take back price reductions made to eliminate competitors.<sup>87</sup> The pressure to keep prices low should, according to Baumol, take five years and be under the provision that price adjustments may be applied only if the undertaking can show that this is needed due to changes in costs or other price determining factors.

The principal concerns, which have been put forward against the Williamson rule, prevail here as well, but Baumol does not want to manage the quantity offered, but the price. Baumol would allow the monopolist to

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<sup>86</sup> see under footnote 16: Mestmäcker, E. J. (1984): p. 218

<sup>87</sup> see under footnote 41: Baumol, W. J. (1979), p. 1

realize price cuts. On the contrary he did not allow these prices after the market entrant leaves the market. Edlin holds a different view arguing that the Baumol rule should be rejected because it does not fit the standard Grinnell definition. This famous definition maintain the monopoly power by excluding rivals from the market.<sup>88</sup> Baumol price limit applies to any undertaking whose low prices are suspicious from the practice to force its competitors from the market regardless this competitor was a recent market entrant. This test creates some problems. During the examination a question arises that what happens if the predator increases prices before the entrant exits? Undertakings enter and exit the market due to different causes. Baumol allows the predator to sign-off a price cut under the condition that the market entrant is still operational.

A cost control to determine whether a predatory pricing exist becomes, according to Baumol, unnecessary, because it is left to undertakings to assess whether they can live in the long term with their choice of price reductions. The rule however does not saves the finding that the original price cut was not made due to competitive pressure, but as part of a predatory strategy. If any price reductions, by the entry of a new competitor, would be interpreted per se as predatory, the undertakings could fear of being detained at the low prices, refrain from price reductions, even if they were required by competitive pressures. Moreover, courts and public authorities have to monitor over the years, when using the Baumol rule, the price compliance.

#### 2.4.4. Joskow/Klevorick

Joskow and Klevorick are summing up the results of the proposed competition policy and legal implications of predatory pricing and provide a two-stage solution approach (two tier approach), which is based on a

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<sup>88</sup> Edlin, A. S. (2002): Stopping Above-Cost Predatory Pricing, Yale Law Journal, 941, p. 978

dynamic analysis. Joskow and Klevorick support in general Areeda and Turner, as long-term considerations include speculative elements and uncertainties. Because predatory pricing is essentially carried out by dominant undertakings, as they expect to profit in a long-term from a short-term forgoing of profit, it can not be applied it a long-term perspective.<sup>89</sup>

#### 2.4.4.1. First stage: market analysis and the undertaking structure

At the first stage are examined the concerned market and the alleged predator on those structural features, which appear as likely or at least useful for a dominant undertaking by his predatory pricing activity. Joskow and Klevorick divide the structural features into three categories: (1) Factors, which indicate short-term monopoly power; (2) Market entry conditions; (3) Dynamic effects, which have impact on production costs and product quality.

##### Under (1)

The short-term monopoly power of an undertaking which is suspected of predatory pricing may be measured, in particular, at its market shares and their resistance in the past, the number and size of its competitors, and profits made in the past. Also the elasticity of demand give information on the consistency of the market power.

##### Under (2)

The conditions of market entry are determined by the financial requirements of the market entry, product preferences, in particular by creating strong preferences by the dominant undertaking, the transfer of resources from one undertaking to another, the admission modalities, for example, whether there are opportunities to engage through upstream markets, from flow of information in the market about existing market risks.

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<sup>89</sup> see under footnote 41: Joskow, P. L., Klevorick, A. K. (1979): pp. 213 and follows

The market entry conditions are considered as essential factors for the occurrence of predatory pricing: even if an undertaking disposes of a substantial short-term market power, he can not exploit this power (after the predatory pricing has been taken) if the market access conditions are favorable. The excessive prices would immediately hinder the entry of new competitors into the market.

Under (3)

To the dynamic effects caused by the competitors and new market entrants we include in particular the innovation competition, for example, technological innovations, new production processes to reduce costs, etc. Also the market conditions play a role in this phase.

These three categories of structural features describe the authors as essential, but not as exclusively determining factors for the assessment of predatory pricing probability in the market. The conditions for systematic price reductions are more favorable, the larger is the short-term monopoly power of the alleged predator, the more difficult are the conditions of market entry and the lower are the dynamic effects that relate itself to the market or the behavior of competitors. If the structural analysis provides results that predatory pricing appear as unlikely, the undertaking behavior is not further investigated.

#### 2.4.4.2. Second stage: analysis of price-cost ratio

At the second stage, which only deals with those markets that were in the first stage filtered out as susceptible to predatory pricing, Joskow and Klevorick partially modified the scheme that represents the one of Areeda and Turner and apply the aspects of the proposals of Williamson and Baumol. The following stages are performed:

(1) prices that are below average variable cost, are not compatible with the postulate of short-term profit maximization. As such, these pricing schemes could have only one purpose, to sacrifice short-term profits in favor of long-term monopoly profits. As a result, the authors therefore suggest (and also Areeda and Turner), that prices that are below average variable cost should be seen as anticompetitive.

(2) prices that are between average variable cost and average total costs may be also predatory. In competitive markets prices are generally cost-covering and could lie temporarily, due to changes in the market, above or below this cost limit. It is highly unlikely that, on any market that is structured as monopolistic or oligopolistic, the existing undertakings will be forced (due to the market access) to apply prices that are below cost. Below cost prices of the incumbent pose a risk in itself, that an equal or a higher efficient competitors are excluded from the market. Finally, the decisive factor for the assessment of these prices as systematic predatory pricing, however, is the fact that at the first stage of the investigation business-and market-specific structures have been identified that promote this behavior.

The accusation of predatory pricing can be invalidated by the undertaking with the evidence that his strategy has a sign of a short term profit-maximization. This is possible only in case of overcapacities. Overcapacities arise normally for three reasons: first, the incumbent operates in a shrinking market; second, the market entrants select a business size which causes such a large increase in capacity so that below-cost pricing would lead to an under-utilization; and third, the incumbent pursues a strategy of overcapacities as described by Williamson. In the latter case, the undertaking is not justified if it has to increase its production output due to a market entry.

(3) By prices that are above the average total cost, there is no safe way to decide between predatory price and price which is caused by normal

competition. The threat to stop the desired price competition, due to incorrect forecast, is therefore too big. Nevertheless, the undertaking should enjoy the possibility to demonstrate the necessity for the price reduction, within a period of about two years, proving that the price increase was justified by an increase in production costs or changes in demand. The antitrust authority may intervene in this case only when the process of predatory strategy is complete. This rule has a deterrent effect on undertakings because they would take, by the price reduction, into consideration the fact whether they could keep this level of prices in the long term.

#### 2.4.4.3. Critical assessment

Although several other authors have emphasized the importance of market structures for the rationality and thus highlighted the incidence of predatory pricing strategies, it is the merit of Joskow/Klevorick who have proposed a comprehensive analysis. Those criteria that make such behavior as a practical alternative must be first filtered out. However, the result of the investigation will be in the reality hardly so clear that after discourse of the first stage the possibility of predatory pricing can be with certainty excluded. Therefore, in cases where there are still doubts - and that will be an issue in the overwhelming cases - the investigation must be extended on the second stage.

The problematic nature of identification of price-cost-ratios has already been presented in detail. The embedding of this analysis into a global analysis relativized its significance for assessing of the anticompetitive nature. The price-cost-ratio has thus only an indicative function. Nevertheless, on the second stage the examination should be extended to other pricing factors, namely the demand and market situation.



The Joskow/Klevorick cost proposals are to be rejected when following the Baumol proposal. It is because undertakings need to demonstrate, according to Baumol, within two years by prices above the full cost, that the price increase was due to market conditions. This Baumol proposal is also neither practical nor compatible with the postulate of legal certainty.

#### 2.4.5. Yamey

In the case AKZO/Commission Yamey was brought in the process as a consultant. Therefore, his proposals should be also briefly presented. In contrast to the study performed by McGee, Yamey represents the view that, predatory pricing exist not only if prices are below costs, but whenever, when a lesser price that is under normal conditions of competition is required. The cost limit is irrelevant, since any release in profits creates a loss and the intention to eliminate competitors exist even with prices that are above the full cost.<sup>90</sup>

Yamey deems appropriate to define predatory pricing as setting price below cost of the victim. Not the costs of the predator are significant, but those of the competitors. Because predatory pricing is difficult to identify, Yamey propose to reverse on the displacement intention of the predator. Although it is not easy to discern this intent, thorough an overall analysis of all the connections, such intention could be detected.

Yamey points out that price wars could have a dissuasive effect also for those who were not involved, but consider to enter into the market. Predatory pricing requires not only high entry barriers, but represents a one. It is undisputed that undertakings can achieve by even slight price reductions a deterrent effect by their competitors.

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<sup>90</sup> Yamey, B., (1972): Predatory Price Cutting: Notes and Comments, Journal of Law and Economics, 15, p. 129 and follows

The assessment made by Yamey that the proof of predatory pricing strategies is equally difficult, whether in the case of full cost recovery or loss prices, is not true. Also, the implications are different. First of all it is questionable just how could be the exclusionary intent detected with only a slight price reduction. Moreover, in the case of full cost recovery he requires to take the decision on whether the knowledge of the competitive price will be seen as predatory. The price required before the price reduction may not be seen as a reference price, because there is some uncertainty about its competition conformity. Due to these uncertainties there is the risk that the concerned undertaking will be forced to a price level that is above the competitive price, and the competitors who are not as efficient, can survive under this price umbrella. Last to remember is, that Yameys question whether the dominant undertaking requires competitive prices depends on circumstances which lie outside the sphere of influence of the undertaking, namely the cost of the weakest competitors.

#### 2.4.6. Philips

Philips has shown in a report prepared for the European Commission the examination of predatory pricing based on game theory. He also favored a rule of reason solution, which is based largely on the game theoretic results of Easley, Masson and Reynolds. In the study, he abandons the price-cost limit. Predatory pricing has the following implications that form the fundamental basis for policy recommendation:

- (1) There must be an undertaking that operates in several markets, otherwise the objection of McGee that the merger is the cheaper alternative will apply.
- (2) The predator is lowering its prices upon the successful market entry.
- (3) The predator localizes the price war on one of the dominant market. Therefore, the price level on this market will be pushed below the one, by

which the market entrant will reach sufficient profits if being handled in an effective competition market. The market where the price war is fought, do not necessarily need to be the same, in which the market entry was made. It can also be a market where the concerned undertakings have been competitors for a longer period of time.

(4) The price war leaves to fall the value of the market entrant future revenues under the sunk costs associated with the market entry, so that he can not survive in the long term.

(5) Due to the existing imperfect information, the potential victim of a price war can not assess whether the price of the established undertaking is targeted on the displacement of competitors or not.

From the findings explained above Philips deduces following competition policy approaches: one-product undertakings are not able to apply the predatory pricing as a rational strategy. These undertakings should be therefore excluded from this consideration. The situation is different by multi-product-or-market undertakings. The antitrust authority has to prove in these cases that the alleged predatory pricing has changed the positive market entry into a negative one. Firstly, this requires a proof that the present discounted value of the future profits of the market entrant is higher than that associated with the sunk costs by the market entry. Secondly, there must be evidence provided that the price reduction of the predator has pushed this present value of the future profits under the sunk costs. The predatory pricing must be the sole reason that under normal competition conditions profitable market entry fails. Philips admits itself that it would be difficult to prove this result. He supports his thesis with the doubts about the true nature of price behavior which is typical to the phenomenon of predatory pricing. Nevertheless, Philips is confident that the antitrust authority can find the reference point for determining the competitive price.

This market entrants and already established undertakings normally would have the knowledge about the competitive price.<sup>91</sup>

The suggestion to completely eliminate the price behavior of a one-product undertaking from the competition policy analysis is not convincing. A detailed discussion based on McGee analysis has shown that these conditions, from which the analysis goes out, are in reality not there. Strategic preparations for a price war, such as market divisions, create necessary conditions for the successful predation. Moreover, a possible merger is usually not as smooth as presented. The assumption that the antitrust authority can determine the competitive price has still not been proved in practice. If this so called philosopher's stone had been found, the antitrust policy could solve this central problem as such.<sup>92</sup> Apart from this, the proposal made by Philips is linked with other unwanted implications. The lawfulness of the pricing behavior of the dominant undertaking is made dependent on the profitability of the market entrant. The dominant undertaking can never be sure if his price reductions are anti-competitive or not. This effect is not compatible with the postulate of legal certainty. Vice versa, the rule causes a price umbrella under which inefficient undertakings have the opportunity to enter the market.

The evaluation of the future revenues is a forecast. Without a doubt the victim will try to explain his estimations as positively as possible. The resulting inaccuracies are not lower than those associated with the cost-based rules. Assuming that the future revenues of the market entrant could be predicted, it has to be defined through which factors these future values are discounted. Returns are always the result arising from the difference between revenues and costs.

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<sup>91</sup> see under footnote 40: Philips, L. (1987): p. 62

<sup>92</sup> Schwarz, D. (1987): Wettbewerbspolitische Problematik des Predatory Pricing, Zeitschrift für deutsches und europäisches wettbewerbsrecht (WuW) 1, p. 99

#### 2.4.7. Ordoover and Willig

The definitions of predation based on Ordoover and Willig is based on the so called sacrifice theory. Ordoover and Willig define predation as “*a response to a rival that sacrifices part of the profit that could be earned under competitive circumstances, were the rival to remain viable, in order to induce exit and gain consequent additional monopoly profit.*”<sup>93</sup> The introduction of a new product may, according to Ordoover and Willig, represent a predatory strategy if this practice is aimed to force the competitors from the market in order to achieve higher profits. Also the argument of a necessary price reduction is not really meaningful when it comes to the introduction of a new product on the market. Rather the below-cost pricing is significant. For Ordoover and Willig a situation when the market entrant did not exit because it would not be profitable but when the exit occurs it will be, is seen as predatory.<sup>94</sup> They propose a two-stage process to find out whether a dominant undertaking has made a profit sacrifice. On the first stage they examine the post-innovation pricing while on the second the undertaking's R&D investment decisions. The R&D investment should not be seen as predatory if the overall expense is lower than the anticipated net revenue. The willingness for a predatory innovation exists when the market entry (or re-entry) is difficult, the predatory undertaking must have a dominant position and the predatory undertaking may not be able to gain the monopoly profit. In cases where the dominant undertaking will be able to force buyers to purchase not only the main (but also the auxiliary unit) and at the same time to price the auxiliary unit above marginal costs (MC) it will be able to substantially increase its monopoly profits.

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<sup>93</sup> Ordoover, J. A., Willig, R. D. (1981): An economic definition of predatory product innovation, New York University, p. 1

<sup>94</sup> Farrell, J., Katz, M. L. (2005): Competition or Predation?, The Journal of Industrial Organization 2, Berkeley, p. 203

## **2.5. Partial conclusion**

Remarkable on the theoretical discussion of predatory pricing is that very different, even opposing views are represented. This is due to the fact that the models are based on very different assumptions and the methodology is also completely different and often not comparable. On the other hand the fact that the empirical findings on predatory pricing is very meagre opens a wide field for speculation about whether, and if so, under what conditions predatory pricing is a serious appearance of predatory competition.

Nonetheless, there are some statements about which exist a largely consensus. There is a broad consensus about the fact that predatory pricing can, under certain conditions, be for the market-dominant undertaking a rational strategy. This requires in particular that the competitors operate under imperfect information. The dominant undertaking should operate in different geographic markets. Easley, Masson and Reynolds have succeeded with their game-theoretic approach to provide the theoretical evidence.

Most of the economic policy proposals refer to the importance of market structures for the success of predatory strategies. An element that promotes the predatory pricing strategies is often seen in high barriers entries which after completion of the price war prevent new entry into the market. Only through the barriers to entry, the monopolist or dominant undertaking can celebrate the fruits of the price war. Again and again the importance of demand elasticity (of the price) will be highlighted. How big may be the volume effect due to a price reduction, has been shown above under 2.3.2.3.3. Perhaps the closest consistency is that the aggressor (predator) must have a powerful market position, which is expressed particularly by high market shares. Only if the predator has a high market share, he can substantially reduce the general price level for the product. In addition, the predatory strategy would not be successful enough, if there were several

competitors with relatively high market shares in the market, and the predator would be able to force only one (or a few) less efficient competitors out of the market. After completion of the price war, the predator would have to share the revenue from the price increase with its rivals. But the importance of a superior financial strength for the success of a predatory strategy is controversial. It is certainly helpful, but not a necessary prerequisite for the implementation of predatory pricing strategies.

The economic policy instructions for assessing whether there is predatory pricing in place include more or less strongly emphasized cost orientation. The exclusive cost standard proposed by Areeda and Turner is not in a position to provide a reliable benchmark for the assessment of predatory pricing. The results of cost calculations depend too much on business decisions, as to be the sole basis for a final decision. Nevertheless, the view of Philips that cost considerations should be entirely disregarded can not be followed. Rather, the cost can give us *"important and useful suggestions, without prejudice the overall assessment of the behavior."*<sup>95</sup> In any case, the competition authorities should take into consideration that cost regulation can keep the objective standards.

The per se rules are unsatisfactory because they cover only partial aspects of the predatory pricing strategies and ignore their strategic components. Recommended is an overall analysis taking into account all available facts in each individual case. An overall analysis is already advisable because the depiction of the different concepts and approaches has shown that they are all subject to considerable uncertainty. Wrong decisions can be easily avoided if there is as broadest as possible basis for decisions by which the uncertainties of the individual studies may be qualified.

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<sup>95</sup> see under footnote 16: Mestmäcker, E., J. (1984): p. 194

Most convincing appears the proposal by Joskow and Klevorick. The task of the V. Chapter will be, among others, to examine whether this concept can be used in the European competition (antitrust) law.



**CHAPTER III.**  
**CLASSIFICATION AND SUBSUMPTION OF TARGETED**  
**PREDATORY PRICING STRATEGIES UNDER ARTICLE 102**  
**TFEU**

3.1. Introduction

The economic analysis of predatory pricing aims to provide standards for the legal assessment. The justiciability of the economically evaluated criteria can be answered only in regard to a particular legal system.<sup>96</sup> In European competition (antitrust) law the problem of predatory pricing strategies is settled down in Article 102 TFEU, which prohibits the abuse of a dominant position. Due to the fact that Article 102 TFEU is not explicitly mentioning the constituent elements of predatory pricing there is a need to clarify the content and scope of the term in broader terms. The European competition rules have a unique feature compared to all other jurisdictions, as they are exploited for the creation of a single market. Since predatory pricing strategies are appropriate to prevent competitors from the market entry, there is a fear that markets will be sealed off. Both the integration of national markets within the internal market as well as the creation and maintenance of a system of undistorted competition would be thus prevented or at least delayed. Both represent the essential objections laid down in Art. 2 and 3 g) of the Treaty establishing the European Community (in accordance with the new (Lisbon) numbering of the Treaty on European Union, the old Article 2 has been replaced, in substance, by Article 3 TEU and the Article 3 g) EC is now laid down in the Protocol No. 27 attached to the Lisbon Treaty).

**3.2. Subsumption of predatory pricing strategies under Article 102 TFEU**

The prohibition of Article 102 (1) TFEU requires three constituent elements to be met: the existence of a dominant position, abuse and the

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<sup>96</sup> see under footnote 16: Mestmäcker, E., J. (1984): p. 201

possibility to affect trade between Member States. The first two conditions require a detailed discourse in relation to predatory pricing. In this regard, the so-called Interstate Commerce Clause does not indicate any special features and is therefore not discussed. Neither the concept of dominance, nor that of abuse is defined in the Treaty, so it was left to the Commission and the ECJ to interpret these terms for the application of law.

a) The interpretation of Article 102 TFEU in the light of the objectives of Article 3 TEU and ex Article 3 g) EC (now the Protocol No. 27 attached to the Lisbon Treaty)

Following the principles of legal interpretation of the ECJ, it is to be proceeded as follows: The interpretation of the standards established by the EU legal order is firstly based on the text of each provision which meaning is provided through literal and logical interpretation. Arise from this interpretation no clear result, the factual context has to be taken into account in the second step. Finally, the significance and function of the provision of the entire treaty is to be set in relation.<sup>97</sup> The Court therefore does not consider the norms of the Treaty as selective governing rules. Rather, the single norm must be placed within the overall context of the Treaty. This method corresponds to the principle of unity of the legal system in which all parts are free of contradiction in relation to each other.

The Court therefore emphasized in its early decision on Article 101 TFEU the relationship between the competition rules (Articles 101 TFEU and follows) and in the preamble and Articles 3 and others of the Treaty stipulated goals and activities of the community. The Court has thus tapped the interpretation which was represented in particular by Mestmäcker.<sup>98</sup>

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<sup>97</sup> Case: C-15/60, *Simon v Court of Justice*, [1961] ECR 115

<sup>98</sup> Mestmäcker, E. J. (1974): *Europäisches Wettbewerbsrecht*, C.H. Beck, München

The ECJ stated in the decision *Italy v. Commission* that the competition rules were used to achieve the provisions of Articles 3 and others of the Treaty ("*activities of the community*"). Therefore, the competition rules should not only be in accordance with these objectives, but also be designed to realize them. One of the main objectives of the Union (Article 3 TEU) shall be the establishment of the internal market. Particularly important prerequisites for achieving this goal are contained in the Treaty preamble, especially the "*removal of existing obstacles*" and "*guarantee fair competition.*" Now, the Protocol No. 27 attached to the Lisbon Treaty stipulates that "*the internal market as set out in Article 3 of the Treaty on European Union includes a system ensuring that competition is not distorted*".<sup>99</sup>

In the first handled decision to Article 102 TFEU the Court specified the interpretation as he made clear that the activities listed in the ex Article 3 EC (in accordance with the Lisbon Treaty Article 3, paragraph 1 has been replaced, in substance, by Articles 3 to 6 TFEU and the Article 3, paragraph 2 has been replaced, in substance by Article 8 TFEU) are not seen as non-binding objectives, but results from the obligatory force of these objectives.<sup>100</sup>

In all decisions the Court takes, by the interpretation of Articles 101 and 102 TFEU the rule laid down in Article 3 g) EC (now, the Protocol No. 27 attached to the Lisbon Treaty), as a standard principle a system where the competition is not distorted. Partially the Court is satisfied with this reasoning, partially the Court tries to reach one or the other objective lay down in Art. 3 TEU. Although the Court is predominantly focused to achieve conditions analogous to those of an internal market, he is also mentioning other contractual objectives. Through the competition it should

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<sup>99</sup> Case: C-32/65, *Italy v Council and Commission*, [1966] ECR 389

<sup>100</sup> Case: C-6/72, *Europemballage Corporation and Continental Can Company Inc. v Commission of the European Communities*, [1973] ECR 215, para. 7 and 25

be promoted the harmonious development of economic activities within the Union. However, there is skepticism, since it is conceivable, that the promotion of one or more objectives not laid down in the Protocol No. 27 attached to the Lisbon Treaty will collide with that just-mentioned goal of an undistorted competition. A fundamental limit should therefore result from the competitive system within which the undertakings may not even be indirectly required to achieve the Union goals in an anticompetitive way.<sup>101</sup>

The ECJ stressed in the *Eco Swiss* case that "*according to Article 3 (1) g) EC, Article 85 of the Treaty constitutes a fundamental provision which is essential for the accomplishment of the tasks entrusted to the Community and, in particular, for the functioning of the internal market.*"<sup>102</sup>

### 3.2.1. Dominant position

#### 3.2.1.1. The term of dominance

The ECJ is emphasizing since the 70s, that the constituent element of market dominance should be interpreted in the light of Article 3 g) EC (now, the Protocol No. 27 attached to the Lisbon Treaty) in the same matter as all the other criteria set out in Article 102 TFEU. On this basis the Commission and Court are using, since the *United Brand's/Hoffmann La Roche* decision, the following standard definition of dominance: "*Article 86 prohibits any abuse by an undertaking of a dominant position in a substantial part of the common market in so far as it may affect trade between member states. The dominant position referred to in this article relates to a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by giving it the power to behave to an appreciable extent independently of its competitors, customers and ultimately of its*

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<sup>101</sup> see under footnote 98: Mestmäcker, E. J. (1974): p. 388

<sup>102</sup> Case: C-126/97, *Eco Swiss China Time Ltd v Benetton International NV*, [1999] ECR I-3055, para 36

consumers."<sup>103</sup> A dominant undertaking enjoys, according to this definition, such a high economic power that this is no longer controlled by effective ("undistorted") competition. The definition of dominance contains two elements (the ability to prevent effective competition and the ability to behave independently). It was put under criticism because an undertaking can not act to an appreciable extent independently of its consumers. It is due to the fact that the higher the price of the product the lower the quantity demanded. I can imagine that the United Brands definition of dominance could be thus formulated more economically, which means replacing the "*behave to an appreciable extent independently*" with the wording "*reserved by the independent actions*".

In fact the dominant undertaking is in a position to make decisions which have influence on the competitive situation. The market dominance is only than characterized by the independent economic behaviour of competitors when it comes to the assessment of vertical relationships, or between that concerned undertaking and its customers. If the exercise of market power is oriented against competitors - as by predatory pricing strategies - the dominant undertaking is not planning independent but reactive. In these cases (like in the above mentioned Hoffmann-La Roche & Co AG v. Commission Case) the ECJ is examining the ability of the dominant undertaking to respond to the competitors activity. The independence of the dominant undertaking does not lie in the lack of connectedness to the dispositions of the competitors, but in the ability to freely influence these dispositions through own decisions.

Only the abuse of a dominant position is sanctioned by the European competition rules (not the pure existence of a dominant position). Therefore,

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<sup>103</sup> Case: C-27/76, United Brands Company and United Brands Continentaal BV v Commission of the European Communities, [1978] ECR 207, para. 64-65; see also under footnote 6: Case: 85/76, Hoffmann-La Roche & Co AG v. Commission, para. 38

the concept of dominance is an objective one, to which adhere no condemnation.

In the U.S. the term which corresponds to “*dominant position*” is “*monopoly*”. Monopoly power is the power to control prices or exclude competition. In the Alcoa case the U.S. Supreme court identified three elements associated with monopoly power: a dominant undertaking has excessive power over price, this excessive prices reduce efficiencies, create loss and that monopolies with unchallenged economic power “*deadens initiative, discourages thrift and depresses energy.*”<sup>104</sup> An undertaking with monopoly power may use predatory pricing to exclude rivals from the market or prolong its monopoly power.

#### 3.2.1.2. Criteria for the detection of dominance

The definition of dominance includes market structure, corporate structure and market related behavioural elements: the economic power of the dominant undertaking makes possible the independent market behavior (which reacts back on the market structure) of customers, suppliers and competitors while the effective competition is prevented. Three stages of examination are used by the determination whether a particular undertaking holds a dominant position, namely market definition, market share analysis and analysis of competitive constraints. High market share is indicative of market power but all in all is not sufficient. Depending on the circumstances of each individual case, the market structure and the market related behavioural elements are to be measured differently. “*The existence of a dominant position arise in general from the coincidence of several factors which must not be are not necessarily decisive.*”<sup>105</sup>

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<sup>104</sup> Case: United States v. Aluminum Co. of America (Alcoa) 148 F.2d 416, 428 (1945)

<sup>105</sup> see under footnote 6: Case: 85/76, Hoffmann-La Roche & Co AG v. Commission, para. 39

By the market structure test, the market shares of the assessed undertaking and those of the competitors, as well as the market entry barriers are in the foreground. The ECJ and the CFI (now the General court) have consistently held that particularly high market shares - except in extraordinary circumstances – can be seen as an evidence for the existence of a dominant position.<sup>106</sup> Market share of around 50% meet the Court requirement when the other competitors have a large distance to the dominant undertaking. Barriers to entry are also a criterion for assessing the market dominance, as these can prevent the potential competition. High barriers to entry may lead to concentrated markets where collusion is expected. Such as scale economies can not create an entry barrier. Generally, entry barriers are seen as costs that must be calculated by an undertaking that wish to enter into a market. Entry barriers did not applies to undertakings already established on the market. Only when the market entrant long-run costs, after entry, are higher than those of the dominant undertaking, the barriers to entry exists.

The assessment of the corporate structure is based inter alia on the technological edge, the degree of integration of the undertaking, particularly the degree of vertical integration and the economic and financial power.

The analysis of market behavior is usually considered in addition to the market and corporate structure test, because its significance is often ambivalent: the market behavior can be a consequence of an effective competition, or be part of an anticompetitive strategy of the dominant undertaking. Especially by price reductions is this ambivalence evident.<sup>107</sup> They can be due existing competitive pressure or expression of a predatory strategy. The long-term studies on the pricing policies of both the dominant undertaking as well as competitors are giving us the necessary exposure. When the dominant undertaking is setting up, for a long time, strong price

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<sup>106</sup> Case: C-53/92 P, Hilti AG v Commission of the European Communities, [1994] ECR I-667

<sup>107</sup> see under footnote 15: Möschel, M. in Immenga, U./Mestmäcker, E. J. (1997): Art. 86 EGV, Rn. 94

reductions without changing the parameters of competition then this can be seen as a price leadership.

3.2.1.3. The definition of the relevant product market by targeted predatory pricing strategies

3.2.1.3.1. General provisions

By the examination of the relevant product market<sup>108</sup> the European Commission is looking on several factors, like the product characteristics, evidence of price discrimination as well as marketing studies. Also the U.S. Department of Justice (DOJ) is examining similar criteria by defining the relevant product market. The undertakings market power can be only reliably assessed, if defined, where, when and with what products or services they are in competition with products or services of other undertakings. It therefore requires defining the relevant geographic, temporal and product market. The associated problems have been already discussed in the literature in broad details. Therefore, the focus will be given only to the specific features, which needs to be taken into consideration by targeted pricing strategies with regard to the product market.

3.2.1.3.2. Criteria for the definition of the relevant product market

Predatory pricing strategies are an expression of supplier's power. The European Commission and the EU/U.S. Court are taking the relevant product market into serious consideration. The decisive criterion for market definition is the interchangeability of the products from the perspective of the opposite market side. As Lopatka mentioned "*... courts insist on the consideration of all sources of substitution, both in demand and supply, that may affect consumer welfare and thus influence the definition of product and geographic markets.*"<sup>109</sup> The Commission more emphasizes the aspect

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<sup>108</sup> Also the relevant geographic market, which can cover the whole market or be focused only on an urban area must be economically significant.

<sup>109</sup> see under footnote 33: Lopatka, E. J. (2008): p. 219, in. Marshall, K. S. (edt.)



of subjective equivalence, while the Court puts the functional equivalence on the top. According to established case law of the ECJ *"when considering the possibly dominant position of an undertaking, the possibilities of competition must be judged in the context of the market comprising the totality of the products which, with respect to their characteristics, are particularly suitable for satisfying constant needs and are only to a limited extent interchangeable with other products."*<sup>110</sup>

The relevant market concept pay attention exclusively on the consumer interest judging the market conditions on the basis of the choices of the opposite market side. This method of market definition is not sufficient in cases of anti-competitive abuse. Characteristic for the anti-competitive abuse are behaviors that are directed against competitors and especially in the case of predatory pricing strategies can have impacts on third markets. The consumer side is affected only indirectly and is therefore only of secondary importance for the detection of dominance and the related issues of market definition.

The pure product-oriented market definition does not consider the market structure and the market conduct of the undertaking, which indicates the dominance. The task of the Article 102 TFEU is to determine, whether an undertaking is in a position to prevent the maintenance of an effective competition and to act, to an appreciable extent, independently vis a vis its competitors and trading partners. The assessed behavior and the overall economic context are giving insight into the dominance in a particular market.<sup>111</sup> Therefore, it is needed to identify not only the product but also to undertake the competition-related investigation. Competition-related investigation of the market means that competitive conditions and the structure of demand and supply in the market are taken into account. These

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<sup>110</sup> Case: C-31/80, NV L'Oréal and SA L'Oréal v PVBA "De Nieuwe AMCK, [1980] ECR 3775, para. 25

<sup>111</sup> see under footnote 15: Möschel, M. in Immenga, U./Mestmäcker, E. J. (1997): § 19, Rn. 22

two methods of market definition are not isolated, but are showing interdependencies as the functional interchangeability of products from the customer perspective features at the same time the proximity of competitors on the dominated market and thus the reaction connectedness among the competitors. The greater the reaction connectedness, the greater are the displacement strategies.

#### 3.2.1.3.3. Divergence between dominant market and the market on which the abuse is applied

If a dominant undertaking conducts exclusionary strategies against competitors through predatory pricing in a market other than that on which the undertaking holds a dominant position, a question arises whether this has an influence on the determination of the relevant market. By defining the relevant market on which the undertaking has a dominant position remains basically out of consideration the fact, that the abusive behavior is observed on different product or geographic market.<sup>112</sup> However, the close proximity of the associated market to the dominant market gives some insights to what extent has the dominance the influence on the competitive conditions of the connected market. In a temporal sense, the dominance has to be present when the abuse takes place.

#### 3.2.2. Abuse

Article 102 TFEU is divided into paragraph 1 and paragraph 2 that explain what we understand under abuse of dominant position. They have an essential role in determining the content and scope of the term abuse. However, it is generally agreed that the list of abusive practices has only an exemplary significance and therefore gives no conclusive interpretation of the general clause. This arises itself from the wording of Article 102 TFEU

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<sup>112</sup> Joined cases 6 and 7-73, *Istituto Chemioterapico Italiano S.p.A. and Commercial Solvents Corporation v Commission of the European Communities*, [1974] ECR 223, [1974] 1 CMLR 309, para. 21

that introduce the list of examples and was also confirmed by the ECJ in the Continental Can decision. Apart from this basic consensus, the views about the importance of the rule examples are divided.

### 3.2.2.1. Concept of Article 102 TFEU – various literature reviews

#### 3.2.2.1.1. Categories of abusive behavior

It seems purposeful to systematize the facts of the abuse elements from the widespread distinction between anti-competitive, exploitation and structure abuse. Fikentscher's classification of customer-focused and competitor-driven abuse of a dominant position does not contribute to clarity and is therefore not presented. Similar classifications are also made in the foreign literature.<sup>113</sup> Such a distinction between "*exploitative abuse*" and "*anti-competitive abuse*" is based on the work from Bellamy and Child, whereby within the exploitation abuse it will be decided between practices with and without anti-competitive effect.<sup>114</sup> Anti-competitive abuse includes those actions made by undertakings in a dominant position, which are mainly directed against competitors in the already dominated or third markets.<sup>115</sup> Predatory price reductions which are focused to drive out competitors from the market represent the classic example of anti-competitive competition. Under an exploitation abuse we understand practices of dominant undertakings which are directed against the market partners. This includes, for example price abuse in the form of overcharged prices. A third category is referred to as structural abuse. This involves situations where dominant undertakings are consciously and deliberately worsening the market structure in the long run. Such effects can be reached by the dominant undertaking, for example, through mergers. Frequently, these categories of abuse are in practice not so easy to distinguish. A

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<sup>113</sup> Fikentscher, W. (1983): *Weltwirtschaftsrecht, Europaisches Wirtschaftsrecht*, Bd. 1, C.H. Beck, München, p. 651

<sup>114</sup> Bellamy, Ch., Child, G. D., Rose, V. (1993): *Common Market Law of Competition*, 4<sup>th</sup> Edition, Sweet & Maxwell, London, p. 616 and follows

<sup>115</sup> Koch, N. in Grabitz, E., Hilf, M. (1999): *Das Recht der Europäischen Union*, C. H. Beck, München, Art. 86, Rn. 51

particular entrepreneurial activity mostly affects various abuse offenses which fall into several sub-categories (for example, certain types of exercises of power over market partners have at the same time an anti-competitive effect). These examples include prohibitions on competition, exclusive dealing, loyalty discounts, etc. Predatory prices have not only an anti-competitive effect, but worse in the long run the market structure when they are applied successfully.

#### 3.2.2.1.2. The controversy in the literature

The content and scope of Article 102 TFEU has been controversially discussed in the literature. In particular Joliet argued that the examples mentioned in Article 102 para. 2 TFEU apply only to cases of exploitation abuse, and this limitation has to be considered when interpreting the general clause. Article 102 TFEU is applicable only in cases of exploitative abuse, because none of the examples listed in Article 102 para. 2 TFEU is showing the intention of the authors, to ensure the maintenance of competition.<sup>116</sup> The Article 102 TFEU wanted only to allow an immediate intervention in cases where the competition has been eliminated through unilateral practices and the customers been exploited or discriminated against other undertakings operating on the same market. This direct regulation of economic power could have an indirect effect on the competitive structure but it does not fall in the context of Article 102 TFEU.<sup>117</sup> The competition law has, according to this view, the task to protect consumers from long-term exploitation.

Related to the problem of predatory pricing it has to be drawn the following conclusions: Successful predatory price reductions can be divided into two competitive periods: The first phase is one in which the predatory price

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<sup>116</sup> Joliet, R. (1973): Der Begriff der mißbräuchlichen Ausnutzung in Art. 86 EWG-Vertrag, Zeitschrift Europarecht, EuR 97

<sup>117</sup> Joliet, R. (1970): Monopolization and Abuse of Dominant Position, Liege, pp. 250-252

reduction is taking place. In this case the competitors are harmed, but consumers and others will benefit from low prices without restrictions. Since the Article 102 TFEU does not include the competition and competitors in scope of its protection, but prohibits only the exploitative abuse, the Commission has in this situation no reason to proceed against the behavior of the dominant undertaking. In the second phase - also after the successful ousting or deterrence of actual or potential competitors, the undertaking will behave in such a way that it will not gain the market shares and with it usually associated lower average unit costs (cost advantage through economies of scale) to consumers, but will raise prices to absorb the monopoly profits. In this situation intervenes the Article 102 para. 2 a) TFEU which allows, according to the view of Joliet, a direct price control. This allows the consumers and purchasers to benefit from the strategy of the dominant undertaking in the long-term.

Joliet gives the justification for such an approach arguing that dominant undertakings would waive on restrictive business practices, because they have to expect that they will be circumcised, through direct interventions, in their entrepreneurial freedom. The position achieved through anti-competitive behavior could not be used for purposes of exploitation. Price wars would no longer be worthwhile. The market power would be neutralized.

The considerations from Joliet remain on the proposals made by Baumol and Williamson. They all have in common that direct interventions into corporate policy will create a situation where certain prices or output may be prescribed. But such interventions are contrary to the regulatory framework concept. The dubious nature of the competition policy thinking is clearly shown by the example of targeted predatory pricing strategies: The concept allows only one curing on the symptoms, but not to fight the causes of it. There are two main criticism points of it:

(1) Through the predatory conduct of the dominant undertaking will be albeit efficient, but not so financially strong undertakings forced out from the market. Even if they will be able at a later date to enter the market, based on appropriate competitive processes, the overall economic impact would be considerable (especially, when high sunk costs are recorded). Thus, the proposed concept of Joliet intervenes only subsequently in already monopolized structures.

(2) Prices are indicators of scarcity conditions and direct price controls distort these. High profits indicate market opportunities and lure the market entrants to enter into the market. Administered price controls originate the misallocations. An intervention in the first phase of the predatory process would have the advantage that both under Point (1) mentioned economic costs as well as the necessary interventions in the second stage would be avoided.

The proponents of this view come to such a narrow interpretation, because they see the Article 102 TFEU isolated from the objectives of the contract arising from the preamble and Articles 3 and others of the TEU. Joliet wanted with his thesis to *"defend the interpretation of Article 86 (now Article 106 TFEU), which takes into account the political decision of the authors of the EEC."*<sup>118</sup> The conception of the European competition law at the Conference of Messina in 1955 and in the Spaak report of 1956 was shaped by the German negotiating team that was strongly guided, in their theoretical competitive conceptions, by the ordo-liberalism. As it could be seen in the Spaak Report, the aim was to prevent that the diminished national borders and sovereign trade barriers will be replaced by functionally identical agreements of private economic subjects. This reflects the view of Walter Eucken,<sup>119</sup> whereby one of the constituent principles of market economy are open markets. The competition rules as mentioned in

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<sup>118</sup> see under footnote 116: Joliet, R. (1973): p. 122

<sup>119</sup> Walter Eucken (1891-1950) was a German economist and father of ordoliberalism

Article 101 TFEU and follows are making clear this goal. Article 102 TFEU must be thus interpreted in the light of this objective and with the result that competition is properly secured.

In particular Mestmäcker takes this approach as the starting point of his considerations.<sup>120</sup> The protection of open markets is characteristic for the economic system of the common market and to be considered by the interpretation of Art. 102 TFEU. Opening of markets through the customs union and a single market allows new competition. This development also means that the established market structures are jeopardized. This implies the tendency to prevent the market access or exclude it. Not only the existing markets but also the expansion into new markets will be organized through competition. The European competition rules have therefore the function that new markets can be formed on the basis of undistorted competition.

For the assessment of predatory pricing strategies this means that: the strategic objective which has to be achieved with price wars is a market foreclosure and monopolization of the market. Predatory price reductions are also suitable to split markets and establish barriers by other means. Thus, predatory pricing counteracts to one of the main objectives of the Treaty, the completion of the internal market. Predatory pricing falls within the meaning of abuse of Article 102 TFEU.

#### 3.2.2.2. The general concept of abuse from the view of the Commission and the ECJ

The interpretation of Article 102 TFEU, in light of the Treaty's objectives, led the Court to a broad interpretation of the Article 102 TFEU as a whole. The ECJ does not followed the proposed narrow interpretation of Article 102 paragraph 2 TFEU made by Joliet: he contradicted his

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<sup>120</sup> see under footnote 98: Mestmäcker, E. J. (1974): p. 17 and follows

interpretation with the wording: *"As (...) the letters c) and d) of the paragraph 2 indicate, the provision is not only aimed at practices which may cause damage to consumers directly, but also at those which are detrimental to them through their impact on an effective competition structure, such as mentioned in article 3 f)."*<sup>121</sup>

Since the European Commission and the ECJ interpret the competition rules in light of the Treaty's objectives the categories for the abuse of a dominant position are thus derived from the Treaty objectives. As a result, there is neither a demand for a proof of any subjective factors, such as fault need, nor the violation of moral principles can be observed. Relevant are the objective relations of the dominant undertaking to the common market. Consequently, the Court held that *"the concept of abuse is an objective concept relating to the behaviour of an undertaking in a dominant position which is such as to influence the structure of a market where, as a result of the very presence of the undertaking in question, the degree of competition is weakened and which, through recourse to methods different from those which condition normal competition in products or services on the basis of the transactions of commercial operators, has the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of that competition."*<sup>122</sup>

With this definition, the Court lies on the in the ex Article 3 g) EC (now, the Protocol No. 27 attached to the Lisbon Treaty) mentioned principle of establishing a system of undistorted competition, and in addition the Article 102 paragraph 2 TFEU opens the possibility to prohibit also the anti-competitive abuse. The ECJ is seeking to effectively combat the deterioration of the competitive structures caused by the exploitation and anti-competitive abuse. The primary object of protection is the competition.

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<sup>121</sup> see under footnote 100: Case: C-6-72, Europemballage Corporation and Continental Can Company Inc. v Commission of the European Communities, para. 26

<sup>122</sup> see under footnote 6: C-85/76, Hoffmann-La Roche & Co. AG v Commission of the European Communities, para. 91



The question of what cost behaviour is considered as abusive pricing within the meaning of Article 102 TFEU requires a further specification without which the degree of legal certainty can not be achieved. Thus, the relationship between the general constituent elements of Article 102 para. 1 TFEU and the rule examples are to be examined. The question, according to which standards - especially cost-related criteria – the predatory pricing strategies are seen by the European Commission and the Court as unfair (as an abuse) will be discussed in the next chapter (in particular when discussing the famous AKZO case).

### 3.2.2.3. Predatory pricing - Art. 102 a) TFEU

The subsumption of predatory pricing strategies under the general constituent element or under the rule example (letter a) and possibly letter c)) is controversial in the literature and also not clearly answered by the European Commission and the ECJ.<sup>123</sup>

The predatory pricing strategies are partly subsumed under Article 102 para 2, letter a) TFEU and partly under the general clause of Article 102 para. 1 TFEU.<sup>124</sup> However, the sale of goods at a price below the purchase is not contained in the list of Article 102 TFEU, the abuse may consist of "*directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions.*" In cases where predatory pricing can be engaged in connection with price discrimination, the Article 102 (2) letter c) TFEU can be also met. This constituent element prohibits the application of different conditions by equivalent transactions vis a vis other trading parties, whereby these will be disadvantaged in the competition.

This is not solely an academic dispute, since there are high requirements on the finding of abuse. This is especially justified by the fact that the general

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<sup>123</sup> Frenz, W. (2006): Europarecht, Band 2, Europäisches Kartellrecht, Springer, Heidelberg, p. 470 and follows

<sup>124</sup> see supra under footnote 123: Frenz, W. (2006): p. 509 and follows

constituent element functions as a catch-all element against the rule examples. The rule examples include type-specific abusive behaviors of dominant undertakings on which presence the element of abuse of dominant positions (para. 1) is met in most cases without further notice. Other behaviors, that might constitute an anti-competitive abuse, justify the allegation of abuse only by existence of additional factual circumstances. These include the lack of objective justification, the violation of the principle of proportionality, the use of unfair or other unfair methods as well as significant impediment of an effective competition.

The concrete subsumption of the abuse element as laid down in letter a) is often not made. We can propose, regarding the letter a) to focus only on the purpose of it. The letter a) governs inappropriate pricing policies, because it is related to a dominant position and is not the result of effective competition. Monopolies often adopt price reduction tactics with the aim to increase their market power. Some scholars compare the wording of the letter a) with the letters b) and c) and draw from the fact that the trading partners are there explicitly mentioned, against which the abusive behavior is practiced, while this is under the letter a) not the case.

Any interpretation should follow the wording that this is the starting point and limit of any interpretation. After that we come to the conclusion that Article 102 (2) letter a) TFEU is not applicable to predatory pricing. Neither unusually low selling prices nor exceptionally high purchase prices vis a vis the market partners can be "*enforced*", but at best - as beneficial for the market partners - be granted.<sup>125</sup> A second point speaks also against the application of Article 102 para. 2 a) TFEU to predatory pricing strategies. This constituent element prohibits the enforcement of unfair purchase or selling prices. To determine whether a price is unreasonable, we need to have a reference point. By abusive excessive prices of a dominant

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<sup>125</sup> Deringer, A. (1962): Das Wettbewerbsrecht der Europäischen Wirtschaftsgemeinschaft, Kommentar zu den EWG-Wettbewerbsregeln, Düsseldorf, Art. 86, Rn. 40

undertaking the prices of competitors will not be taken as an indicator, because the high prices of the dominant undertaking acts as a price umbrella under which the competitors can spread. Also less efficient competitors can survive, because the price level may be potentially above the competitive level.

Of the numerous options proposed for such cases of exploitation abuse, the comparable market concept has been applied most frequently. By this concept we are trying *"to find a market in which the results of the market factors (e.g. cost, demand structure, economic situation, production technology) - apart from the different intensity of competition - are comparable."*<sup>126</sup> Because in reality such analogue markets do not exist, there is a need to make such comparability with corresponding increases and reductions. This methodology is fraught with uncertainty. Therefore we have to define the corridor within which the price competition, with great probability, can be found.

In the event of improperly overcharged prices, this may be an acceptable procedure because the competitive price is in each case under the objected price and thus at least an approximation to the competitive price is achieved. The situation is different however by predatory price strategies. The competition price is here above the (abusive) price of the dominant undertaking. The inaccuracies of the comparative market process can not be accepted. If due to wrong assumptions or judgments on the side of the competition authority or courts the administered price is above the competitive price, the administered anticompetitiveness would be put on the position of the corporate abuse.

Alternatively it could be considered, instead of analogue markets, to see the prices of competitors of the predator as a criterion. But then these prices

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<sup>126</sup> Schmidt, I. (2005): Wettbewerbspolitik und Kartellrecht: eine interdisziplinäre Einführung, 8. Auflage, Lucius & Lucius, Berlin, p. 153

should also be investigated to see whether they are in accordance with competition rules, because eventually the predatory price reductions of the dominant undertaking has an impact on the prices of competitors.

Overall it appears that the criterion of reasonableness for the assessment of predatory pricing strategies is completely inappropriate and should therefore be rejected. As far as predatory pricing strategies are carried out without price discrimination, they are to be assessed by the general clause of Article 102 TFEU.

#### 3.2.2.4. Discriminatory selective prices as part of the predatory strategy Article 102 para. 2, letter c) TFEU

Dominant undertakings often use selective prices as part of predatory pricing strategy to keep the losses as small as possible. The selective pricing strategy may lead to predatory policy, but must not do so.

Selective predatory prices may occur in various constellations: (i) they can be applied in different geographic markets of the same product, (ii) in the dominated market, or (iii) be offered in one with this associated market. Basically it is also possible that the selective predatory price may be applied in a different (non-dominated) market. The theoretical discussions in Chapter II have shown that in these cases the use of predatory pricing seems not probable.

In cases (i) and (iii) it is conceivable that the discriminatory undertaking on the market, where the price discrimination takes place, is not dominant, but on a different (geographical or relevant) market. The term "*associated market*" is indeed repeatedly used by the European Commission and the Court, however it has not been generally defined. Association means, on the basis of the considerations in these decisions (e.g. Tetra Pak II which will be discussed later on), that the actions of the dominant undertaking on the not

dominated market have competition effects not only on this, but also on the dominated market.

Such effect arise, for example, when customers on one market came into question as potential customers on the other market (customer loyalty), or, if the competitor on the non-dominated market is actual or potential competitor on the dominated market and the selective predatory strategy has an impact on the competitive situation of the undertaking in the dominated market (competitors loyalty). The markets can be combined also through product characteristics, when a product is suitable for different uses or this product can be used for the manufacturing of various products (product loyalty).

If the dominant undertaking offers to competitors of the trading partners loss-making prices, but holds the prices for its own trading partners at the original level, then in this case the own trading partners are discriminated. This is because they are not in a position, on the basis of long-term contracts, to reach the equal treatment with the trading partners.

Article 102 para. 2, letter c) sees "*applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage*" as an abuse which shall be prohibited.<sup>127</sup> Trading partners are customers or suppliers, unless they are not industrial or private consumers. If the dominant undertaking is discriminating the consumers in order to discipline its competitors or to displace them, this behavior does not fall under the letter c), however, is a case of exclusionary abuse, must be examined under Article 102 para. 1 TFEU. It is questionable whether discriminatory prices which are applied vis a vis trading partners, and are not aimed to distort competition with them, are to be considered under Article 102 para. 2, letter c) or under the general clause. In these cases, the

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<sup>127</sup> see under footnote 115: Koch, N. in Grabitz, E., Hilf, M. (1999): Art. 86, Rn. 68

distortion of competition at the level of trading partners is merely a side effect. The purpose of selective price discrimination is the ousting or destruction of competitors of the dominant undertaking. Therefore, these cases should be considered under the general clause.

The prohibition of discrimination = principle of equal treatment: The trading partners of the dominant undertaking may not be treated differently in a similar situation regarding prices and conditions. In contrast to this, the Article 102 para. 2, letter. c) does not include the equal treatment of non-equivalent services. Requires the discriminatory undertaking, selective, vis a vis different trading partners the same prices for different services, whereby the differences are in quality or other conditions (hidden predatory price reductions) so this may be a part of a predatory strategy and must be examined under Article 102 para. 1 TFEU.

The Commission in its earlier decisions held that also the discrimination of potential trading partners falls within this rule example.<sup>128</sup> This view has to be rejected, as there is between the dominant undertaking and the potential trade partner no business relationship. The ECJ has endorsed this view expressed in the literature. Such practices are therefore assessed under Article 102 para. 1 TFEU. This also applies in the case of predatory price reductions where the dominant undertakings beats the customers of the competitor with selective predation.

The majority of scholars in the literature suggests that by the benchmark to determine the discrimination only those transactions can be included, that could be subsumed under the relevant market of the dominant undertaking, as the Article 102 para. 2, letter c) TFEU applies only within these limits.<sup>129</sup>

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<sup>128</sup> Case: Gesellschaft für Musikalische Aufführungs- und Mechanische Vervielfältigungsrechte (GEMA) v. Commission of the European Communities, (1971) O. J. L. 134/15, 21

<sup>129</sup> Jung, C. in Grabitz, E., Hilf, M. (2006): Das Recht der Europäischen Union, C. H. Beck, München, Art. 82, Rn. 165

Therefore, in this view, the predator can apply on different geographic markets different prices and terms to equivalent conditions if he is dominant on one of these markets. We could follow this view, as far as the interpretation of the rule example in Article 102, para. 2, letter c) is affected, because the discriminated trading partner vis a vis the discriminatory undertaking suffers a competitive disadvantage in this market. As far as the discriminatory prices are on the non-dominated market, it has to be proved whether or not an abuse under Article 102 para. 1 TFEU is present, otherwise the view would mean that there would be a requirement for a causal link between dominance and abuse. Such causality has to be rejected (see under d). Rather in those cases, in which the discrimination takes place on one with the dominated market associated market, an abuse has to be assumed: the dominant undertaking has due to its market power a special responsibility for the maintenance of undistorted competition - not only closely limited on the dominated market - but also on associated markets. This interpretation is therefore essential because selective prices can be applied in order to achieve a partial separation of territorial sub-markets or fragmentation of the market. If this happens in an associated market we could record the distortion of competition not only in this but also on a market on which the undertaking hold a dominant position.

The injury caused to trading partners alone is not enough to fulfill the constituent element as described above: Article 102 para. 2, letter c) requires another criterion that the trading partners, due to unequal treatment, suffer a competitive disadvantage. This leads to distortion of competition (due to the disadvantage of the undertaking). To have such a distortion of competition, both undertakings (dominant as well as discriminated) have to operate on the same relevant market on which the discrimination takes place. However, it is not necessary that this will be the dominated market.

For the assessment of selective loss-making prices within the scope of predatory pricing strategies the summary can be made as follows:

If it comes to the situation where the dominant undertaking has made offers only to the trading partners of the competitors (potential partners), then the general element is not met, and the Article 102 para. 1 TFEU will be applied. Selective price discrimination against consumers (industrial or private) fall under the scope of Article 102 para. 1 TFEU. The same applies in cases where the discriminatory prices are applied against trade partners but the primary objective is the ousting or destruction of competitors of the dominant undertaking.

If the dominant undertaking offers to trading partners selective prices on the market dominated by him, the scope of Article 102, para. 2, letter c) (subject to all other constituent elements) is satisfied. Contrary to this, if the dominant undertaking applies these practices on a different geographic or product market, which is not dominated by him, this practice has to be examined under Article 102 para. 1 TFEU.

#### 3.2.2.5. Article 102 d) TFEU

Bait prices are often realized in connection with coupled transactions, which are characterized by the fact that a dominant undertaking is offering customers products and services at special rates under the condition that other goods and services have to be removed. It is not necessary that the dominance is also spread on the market for the goods and services, that are subject to bait prices. Bait prices are therefore abusive according to Article 102 letter d) TFEU. In the European competition law there is no per se prohibition of tying regarding dominant undertakings.<sup>130</sup> Tying is seen as legal if performed because of factual constraint or trade practice. Otherwise, it is unlawful, but can be justified by competitive reasons (e.g. efficiency gains, safety reasons, etc.).<sup>131</sup>

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<sup>130</sup> Mestmäcker, E. J., Schweitzer, H. (2004): Europäisches Wettbewerbsrecht. C. H. Beck Verlag, München, § 17, Rn. 23

<sup>131</sup> see under footnote 15: Möschel, W. in Immenga, U., Mestmäcker, E. J. (1997): Art. 86, Rn. 201



### 3.2.3. Causality between market dominance and abuse

The literature partially supports the idea that the special power of the undertaking resulting from the dominant position must be causal for the abusive behavior.<sup>132</sup> If we would agree to this demand, where the dominant undertaking acts abusive on so-called third markets on which he is not in a dominant position, the fulfillment of Article 102 TFEU because of lack of causality between market dominance and abuse must be denied. This can not be mitigated by the fact where we assume that the dominance has anything to do with these resources and is always responsible for such abusive behavior on third markets. Dominance cannot be equated with financial power. This is only one element of several that constitute the dominant position.

The interpretation of Article 102 TFEU in conjunction with ex Article 3 letter g) EC (now, the Protocol No. 27 attached to the Lisbon Treaty) leads to differentiated views: the undertakings in a dominant position have in accordance with the TFEU a special responsibility for maintaining a system of undistorted competition within the internal market, on which the competition is, especially by the presence of the dominant undertaking, already weakened. Is the third market associated with the dominated market due to customer, competitor or product affinity, then the market responsibility of the dominant undertaking covers also the associated market. Abusive practices performed on this third market are to be examined under Article 102 TFEU. The situation is different if the third market is not an associated market: in these cases, the behavior should not be examined under Article 102 TFEU because the competition in this market is not weakened by the presence of dominant undertaking.

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<sup>132</sup> see under footnote 115: Koch, N. in Grabitz, E., Hilf, M. (1999): Art. 86, Rn. 51

In previous decisions the European Commission and the European courts have denied, without further explanation, the requirement of a causal connection between the dominance and abuse.<sup>133</sup>

In Tetra Pak, the ECJ has correctly pointed out that the application of Article 102 TFEU presupposes "*a link between the dominant position and the alleged abusive conduct, which is normally not present where conduct on a market distinct from the dominated market produces effects on that distinct market.*"<sup>134</sup> There is a link between dominance and abuse when the practiced abuses on associated markets have anticompetitive effect on the dominated market. Is the abuse and its impacts related on the associated market, the Article 102 TFEU can be, under particular circumstances, applied on such behavior. Such special circumstance exists in particular when the dominant position of an undertaking has an effect on the associated market and thus - despite the non existence of dominance on the associated market - the undertaking has an opportunity for a largely independent behavior.

#### 3.2.4. Lack of justifying reasons

The dominant undertaking may rebut the allegations of abuse of its dominant position through arguments of objective justification. From the definition of the term abuse that is used especially to maintain undistorted competition follows that subjective motives or circumstances as a justification reason drop out.<sup>135</sup>

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<sup>133</sup> see under footnote 6: C-85/76, Hoffmann-La Roche & Co. AG v Commission of the European Communities, para. 10

<sup>134</sup> Case: C-333/94P, Tetra Pak International SA v Commission of the European Communities, [1996] ECR I-5951, para. 27

<sup>135</sup> see under footnote 129: Jung, C. in Grabitz, E., Hilf, M. (2006): Art. 82, Rn. 127

#### 3.2.4.1. Objective justifying reasons by price discrimination

Even dominant undertakings can make their pricing policy on the internal market in accordance with the market and disposal conditions, and are not obliged to charge everywhere uniform prices. The different prices must be the result of an economically justifiable consideration. Thus, they must be in conformity with the purpose of Article 102 TFEU and with the system and the objectives of the Treaty, particularly ex Article 3 letter g) EC (now, the Protocol No. 27 attached to the Lisbon Treaty). As an objective justifying reason for different prices are considered, for example, different production-, raw material-, transportation-, personnel- and marketing- costs. These justifying reasons may exist in particular within the relevant product market and are showing different geographical conditions of the kinds previously mentioned. Another objective justifying reason may be the stepping in into the lower prices of the competitor.

#### 3.2.4.2. Objective justifying reasons by below cost sales

Objective justifying reasons may be also present if the predatory prices are used without discrimination. Causes may be, for example, over-capacity, due to wrong assessment of the market or an unexpected decline in demand. Also the entering into the lower prices of other suppliers is possible: special competitive conditions, like a very high price elasticity of demand may cause, by the entering into the competitive price, that the prices for their own customers will be similarly reduced.

## **CHAPTER IV. EU/US JUDICIAL APPROACH TO PREDATORY PRICING**

### **4.1. EU Judicial Approach to Predatory Pricing**

The evolution of predatory pricing can be probably best sketched by a summary of the most important cases. The next cases were selected because they represent the most distinguished ones.

#### 4.1.1. AKZO

##### 4.1.1.1. The facts of the case

The case AKZO/Commission<sup>136</sup> is seen as the guideline decision of the Court in the field of targeted predatory pricing. Since then, this issue has been highlighted in another case, e.g. in Tetra Pak II,<sup>137</sup> however, the assessment of predatory price reductions has not played here a central role. As the AKZO case is seen as the guideline decision the following case analysis is focused primarily on it (nevertheless, other crucial decisions from the ECJ and U.S. American Supreme Court are mentioned as well).

AKZO UK a wholly-owned subsidiary of Akzo Chemicals BV (AKZO meaning AKZO Chemicals BV and its subsidiaries), whose parent company AKZO NV is a large Dutch manufacturer of chemical products and artificial fibres. AKZO UK produces and sells in the United Kingdom organic peroxides, especially used in the plastics industry and compounds based on benzoyl peroxide. Engineering and Chemical Supplies Ltd Epsom and Gloucester (ECS), also based in the UK, was at the time of the decision a small independent producer of benzoyl peroxide, an organic peroxide and a number of other flour additives, including potassium and vitamin mixes. Benzoyl peroxide is not only used as a bleaching agent for the treatment of

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<sup>136</sup> see under footnote 51: Commission Decision of 14 December 1985 relating to a proceeding under Article 86 of the EEC Treaty; Case: C-62/86, AKZO Chemie BV v Commission of the European Communities, [1991] ECR-I 3359

<sup>137</sup> Commission Decision of 24 July 1991 relating to a proceeding pursuant to Article 86 of the EEC Treaty (IV/31043 - Tetra Pak II), OJ L 72/1; see under footnote 134: C-333/94P, Tetra Pak International SA v Commission of the European Communities

flour, but also serves as an initiator by the manufacturing of plastic products.

In the United Kingdom and Ireland, three suppliers, AKZO UK, ECS and Diaflex offered complete or near-complete coverage of flour additives. The United Kingdom and Ireland are the only markets in the EU for bleaching agents as flour additives. According to AKZO's estimations the market share of the AKZO group is on the European market for organic peroxides for several years at a constant level of 50%. On the other hand, the AKZO UK had in 1982 a 52% market share on the UK and Irish market for flour additives, followed by ECS with 35% and Diaflex with 13%. The Commission estimated for 1984 on this market a market share shift to 55% by AKZO UK, 30% by ECS and 15% by Diaflex. By the flour additives the customers consist of, firstly, three main milling groups, of comparable size, RHM, Spillers and Allied Mills. They together represent about 85% of demand. Secondly, from the large independents, which represent 10% of demand. Thirdly, from small independents, which represent 5% of demand.

ECS has since its founding in 1969 produced and distributed flour additives, including bleaches based on benzoyl peroxide. In 1979 the undertaking started with additional production of benzoyl peroxide in order to expand in the plastics industry in the United Kingdom and Germany. In September of that year ECS shipped the first order to BASF in Ludwigshafen (Germany), one of AKZO's largest customer. ECS shipped the first order at prices about 15-20% below those of AKZO's.

#### 4.1.1.2. Procedure

ECS has reached on 06.11.1979 before the High Court of Justice in London a decision which prohibited AKZO to reduce its selling prices. AKZO committed itself not to reduce its selling prices for benzoyl peroxide,

either in general or in individual cases, because this could eliminate ECS as a competitor. The declaration of commitment expired in September 1982.

With the claim dated on 15.6.1982 ECS brought proceedings before the European Commission claiming that AKZO had violated the pledge because it practiced an anticompetitive pricing policy. In an interim order, the European Commission prohibited AKZO sales in the United Kingdom and Ireland at a price which is below costs<sup>138</sup> calculated from the AKZO UK's production costs at the time of the decision, exclusive of freight costs and an absolute gross margin which was achieved by AKZO UK before the price reduction (vis a vis ECS) was realised.

Then, the European Commission placed on 14.12.1985 a final decision. It found that AKZO had infringed Article 102 TFEU, by pursuing against ECS a course of conduct intended to damage the business of and/or to secure its withdrawal from the European organic peroxides market.

On 5 March 1986, AKZO brought an action before the ECJ for annulment of the European Commission decision. The ECJ came more or less to the same conclusions as the Commission, though partially with different justifications. The fine imposed by the Commission in the amount of 10 million ECU was reduced by the Court by 25% to 7.5 million ECU. This happened because of three factors. Firstly, because abuses of this kind *"come within a field of law in which the rules of competition had never been determined. Moreover, the limited effect of the dispute between AKZO and ECS must be taken into account, since the infringement did not significantly affect their respective shares of the flour additives market. Finally, the Commission was not justified in regarding the infringement of the interim*

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<sup>138</sup> Prices below average variable costs by which a dominant undertaking seeks to eliminate a competitor must be regarded as abusive. Brinker, I. (2009) in Schwarze, J. (Hrsg.): EU-Kommentar, Nomos Verlag, Baden Baden, p. 976

*measures decision, consisting in alignments on Diaflex' s prices, as an aggravating factor capable of justifying the high amount of the fine.*"<sup>139</sup>

#### 4.1.2. Discussion and Analysis of the decision

##### 4.1.2.1. Commission position

Since AKZO and ECS are competitors both in the market for flour additives in the United Kingdom and Ireland as well as on the EU market for organic peroxides with respect to different concentrations, arose the question which of the relevant market and by what criteria the situation had to be distinguish. Assuming from the relevant market concept, there is a variety of individual markets, both for the smaller market for flour additives as well as for the plastic sector of the organic peroxides.

The Commission mentioned the "*concept of interchangeability*" but did not use it in the final analysis. "*In the context of Article 86, the object of market delineation is to define the area of commerce in which conditions of competition and the market power of the dominant firm is to be assessed.*"<sup>140</sup> On this basis, the Commission accepted that the relevant market is the one where AKZO wanted to force its competitor out of this market, thus the EU sector of organic peroxides. The Commission has therefore recognised the fact that a purely product-oriented market definition does not match with cases of anti-competitive abuse. Rather additionally competition related market definition must be carried out.

##### 4.1.2.2. The ECJ position

The Court assumes - as well as the Commission - that the EU market for organic peroxides, from which ECS was forced out, is the relevant market, and not the one for flour additives on which the abuse has shown. This

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<sup>139</sup> see under footnote 136: C-62/86, AKZO Chemie BV v Commission of the European Communities, para. 163

<sup>140</sup> see under footnote 51: Commission Decision of 14 December 1985 relating to a proceeding under Article 86 of the EEC Treaty, para. 64

seems to contradict the statement of the ECJ in Commercial Solvents Case after which the market, in which the effects of abuse are evident, is without significance for the provision of the relevant market.<sup>141</sup> In the case AKZO we can individualize on one hand the smaller market for flour additives in the United Kingdom and Ireland and on the other hand the market for organic peroxides in the plastics industry. On both markets, AKZO had a stable market share of about 50%. Other factors, such as wide range of products, distribution channels, etc., are indicative. However, the abusive practice was carried out on the market for flour additives, it seems as logical to define this market as the relevant market in the sense of the Commercial Solvents-decision.

The ECJ introduced several reasons, taking into account the particularities of the case, why the plastic market has to be held as the relevant market:

(1) Product connectedness of the market for flour additives with the market for organic peroxides,

benzoyl peroxide is both one of the most important organic peroxides used for the manufacturing of plastics and on the other hand one of the most important meal supplements, which is used in the United Kingdom and Ireland.

(2) Economic position of ECS and AKZO in the flour additives market for organic peroxides in the plastics industry,

while ECS has operated mainly in the flour additives market and only in the course of 1979 began to extend its activities to the plastics sector, AKZO achieved in the plastics sector significantly higher revenue than in the flour additives market.

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<sup>141</sup> Case: C-7/73, Istituto Chemioterapico Italiano S.p.A. and Commercial Solvents Corporation v Commission of the European Communities, [1974] ECR 223, para. 21



### (3) Intention of AKZO

AKZO was according to internal documents not interested in strengthening its market position in the flour additives market, but to keep its dominant position in the plastics sector.

Significant for the ECJ is in cases of predatory pricing strategies the consideration of the competitive situation and the behavior of the alleged predator. In this regard, there is not a contradiction to the Commercial Solvents decision of the ECJ because the competitive conditions in this case were different: In these decisions two markets have to be distinguished: the market for a particular raw material produced by the dominant undertaking from the final product, which was produced, using the raw material, by an undertaking that refused to supply Commercial Solvents, in order to secure itself the access to this market. The Court assumed that the raw material market is the relevant market by the determination of dominance. This also makes sense because the refusal to supply the third party with this commodity is attributable to the dominant position in the raw material market.

In the AKZO case the dominant undertaking practiced a "proxy war" on the less important flour market, in order to minimize its losses. The focus was made on the larger plastics market, for which both competitors had access to the raw materials and where the predator wanted to benefit from his position. The Court therefore correctly viewed the plastics market as the relevant market.

#### 4.1.3. Dominant position

##### 4.1.3.1. Commission position

The Court characterized the dominant position of an undertaking through the ability to behave to an appreciable extent independently towards

customers and consumers. This definition is tailored to cases of exploitation abuse. Therefore, the Commission expanded the definition to the extent that dominance can also express the situation where competitors are displaced from the market or even they will be prevented from the market entry. The Commission recognized, that in cases of anti-competitive abuse the attention must be given to the correlation between the alleged dominant undertaking and its competitors.

The Commission relied on the internal documents from AKZO, from which it emerged that AKZO had a stable market share of about 50%, in the market for organic peroxides, in the period between 1979 and 1982. There was also no evidence that AKZO's share decreased during subsequent years. The Commission characterized this as a situation of a dominant position, but looked also on the product spectrum, which was by AKZO broader than by all other competitors. Also the sales organization and the know-how were by AKZO most widely diversified. In addition, the Commission highlighted the fact that AKZO had not allowed new competitors to expand in the market and thus reached this high market share. Even during periods of economic decline AKZO was able to hold constant the prices and profits. High start-up costs for market entrants and the overall position of AKZO have created a situation where the market entry for the market entrants was made difficult.<sup>142</sup>

As the discussions in Chapter II has shown, the financial strength of an undertaking is not a feature, which plays an important role in the success of predatory strategies. Especially in the AKZO case the financial strength was not decisive. AKZO had chosen for its practice the market, which was important only for the ECS. AKZO was in a position, without having to accept painful losses, to effectively discipline the competitors.

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<sup>142</sup> see under footnote 136: C-62/86, AKZO Chemie BV v Commission of the European Communities, para. 59

#### 4.1.3.2. The ECJ position

The ECJ accepted, in general, the Commission decision. However, the Court emphasized that particularly high market share - such one with 50% market share - already justify the existence of dominance. The Court did not require further remarks by the determination of dominance, as the factors that constitute dominance, were for the following analysis of the abusive behavior without influence: he developed in accordance with Areeda/Turner the so called price-cost-ratio. Market structures and other determinants of dominance are playing in this approach only a subordinate role.

#### 4.1.4. Abuse of dominant position

##### 4.1.4.1. Commission position

The Commission did not clearly decide whether the general clause, or Article 102 para. 2. a) TFEU deems applicable. Anyway, it seems that the Commission does not want to give up the criterion of justification of prices as laid down in Article 102 para. 2. a) TFEU. This is because the Commission examined the cost behavior of AKZO and in this regard pointed out that it might *"be of considerable importance in establishing the reasonableness or otherwise of its pricing conduct."*<sup>143</sup> Regarding rebates, they may be *"used only as the means of performance competition and without any exclusionary intent."*<sup>144</sup>

The Commission investigated first, whether the intention to eliminate a competitor can fall under Article 102 TFEU. The ECJ has already decided on behaviors that fall under this interpretation of Article 102 TFEU (in particular, about granting fidelity rebates and refusals to supply).<sup>145</sup> Thus,

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<sup>143</sup> see under footnote 51: Commission Decision of 14 December 1985 relating to a proceeding under Article 86 of the EEC Treaty, para. 65

<sup>144</sup> see under footnote 129: Jung, C. in Grabitz, E., Hilf, M. (2006): Art. 82, Rn. 179

<sup>145</sup> see under footnote 51: Commission Decision of 14 December 1985 relating to a proceeding under Article 86 of the EEC Treaty, para. 74

price reductions with the intention of ousting competitors represent an abuse within the meaning of Article 102 TFEU.

In a second step, the Commission examined whether AKZO has acted abusive. While AKZO supported its statements with the Areeda/Turner rule, the Commission in the interim order dated 29.07.1983 opposed from a purely cost-based approach.

#### 4.1.4.1.1. A finding of price-cutting

##### a) The price-cost ratio as a measure of the unfairness of price-cutting

AKZO claimed in the proceedings, that the only criterion for the assessment of legality or illegality of its behavior is, whether its prices were above its average variable cost (marginal cost).<sup>146</sup> AKZO commented this criterion with the declaration that its prices were usually higher than variable costs, but not above the full cost. The Commission brought objections against the cost criterion of Areeda/Turner (already known from the Chapter II.).

Two questions played a major role in this context. On one side, the differentiation of variable costs from fixed costs had a controversial character and on the other side there appears the overhead costs problem, which was however not mentioned in the Commission's decision. Both questions will be closer examined below.

##### aa) Variable and fixed costs

AKZO had in its cost accounting, regarding the variable costs, counted only those for raw materials, energy, packaging and transportation. Other costs categories such as labor, maintenance, warehousing and dispatching have been treated as fixed costs.

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<sup>146</sup> see under footnote 51: Commission Decision of 14 December 1985 relating to a proceeding under Article 86 of the EEC Treaty, para. 75

This classification disagreed to the Commission stating that the latter mentioned costs *"usually appear in the accounting systems as variable costs."*<sup>147</sup>

For the classification of costs into fixed and variable there is no objective criterion. Rather the variable and fixed costs are defined in connection to so-called costs influencing factors. Generally speaking, variable costs are dependent from changes by the observed costs influencing factors. Differences in cost structures of competitors can lead to large differences in the assignment to variable or fixed costs. The application of the Areeda-Turner rule leads in these cases to unequal treatment of competitive identical situations.<sup>148</sup>

Some examples may illustrate the influence of the cost structure on the classification of the costs types into variable and fixed costs:

Rent business premises can be agreed as fixed costs or be linked on the turnover. Licenses can have fixed costs character, or be production or business oriented. Also the labor element, regarding its classification into fixed or variable costs, has been disputed in the AKZO case. The structure of labor law is a determinant factor which affects the cost character. Long notice periods and high indemnities ratios, in case of termination, results to the fact that the labor element no longer counts on the side of the variable costs.

Areeda and Turner have also chosen employment as a cost determinant. Their statement that labor elements are linked to variable costs can not be

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<sup>147</sup> see under footnote 51: Commission Decision of 14 December 1985 relating to a proceeding under Article 86 of the EEC Treaty, para.54; The Commission underscored its view with the fact that *"Areeda-Turner emphasize that variable costs must include such direct manufacturing costs as labour, repair and maintenance, (all treated by AKZO as fixed), and they specifically exclude from variable cost only: capital cost attributable to investment in land, plant and equipment."* To this see under para. 76

<sup>148</sup> see under footnote 76: Hummel, S., Männel, W. (1986): p. 101

generalized. Areeda and Turner have provided the reference to the American legal system as a precondition. In America, where employment legislation provides less protection than for example in the EU, the labour staff can be, by appropriate employment fluctuation, promptly hired or fired without having high costs associated with it. Labor element is losing thus the fixed costs character.

aaa) Overheads/indirect costs

The problem of allocation of overheads/indirect costs to cost units has not been raised in the proceedings at any point. AKZO UK's flour additives business forms only part of the entire business. Another area is the Plastics and Elastomers sector. Apparently under this production sector falls an intermediate product with which is processed in the flour additives sector. The Commission complained that the transfer of the intermediate product to the flour additive sector has been charged at the cost of the material only. The AKZO internal audit report is showing that when this transfer had taken place on the basis of fixed and variable costs, the slight profit report in the flour additive sector in 1982 has fallen for a certain amount, so that actually losses were made. However, this is not the problem of fixed and variable costs, but the allocation of overhead/indirect costs.

The term direct and indirect costs should not be confused with the terms fixed and variable costs. The former refers to the attribution of costs to costing objects, the other differentiate the costs by their dependence on the output volume.

AKZO's production in the plastics sector is characterized by the fact that from the same production process arise inevitably several different types of products. This productivity performance is called a joint production. *"Both*

*the fixed and variable costs of a joint production process are real cost unit overheads.*"<sup>149</sup>

For the calculation of joint products is needed the use of the top-down-method. Top-down costing model, the most widely method used for measuring costs, starts from the actual cost and adapts the basis of calculation to meet the cost standard. One of this top-down-methods is geared to the market prices of joint products. Those joint products, for which a relatively high amount of revenue can be generated, wear a relatively high proportion of the total cost of the joint production process. The AKZOs intermediate product in the plastics sector can be burdened only with the material costs. The finding whether AKZO has made shifts in the cost structure (or otherwise) may not be judged without further investigation of the cost accounting. It seems that this review has not been made by the Commission.

(2) The assessment of price reductions in the light of objectives of the Treaty

The Commission assessed predatory pricing strategies under EU law with special attention. Pricing policy can be targetly used to separate markets. Price reductions, which are used for anticompetitive motives, with the sole aim to exclude competitors and thus to establish entry barriers that cause market foreclosure effects, should be banned on the basis of Article 102 TFEU.

Too far goes the Commission with its view that even if the total cost would be covered, there may be an abuse, because the creation of conditions analogous to those of an internal market would be prevented and thus would be contrary to the Treaty obligation. Here it can be considered, even only in

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<sup>149</sup> see under footnote 76: Hummel, S., Männel, W. (1986): p. 308

the short term, a conflict of interests between the promotion of integration on one side and good economic results of the competition on the other. Dominant undertakings, that can cover their total costs at a particular price level, where the smaller competitors can produce only if making losses, signal that they are more efficient than their competitors. If these dominant undertakings will be forced to focus on the price level of their competitors, the efficiency as well as the superior production technology, etc. would be sacrificed. Wrong pricing signals would come out from such an interventionist pricing policy. The consequence will be visible in the misallocation of resources.

#### b) Price discrimination

AKZO applied, according to the Commission, not only predatory pricing in the market for flour additives, but has also selectively proceeded: AKZO kept the price level for their own customers at the same level, while offering a targeted (sacrifice) prices to customers of ECS.<sup>150</sup> The price difference was up to 60%.

The Commission found that discrimination between similarly-placed customers, whereby some undertakings will be disadvantaged is expressly prohibited under Article 102 letter c) TFEU. In the AKZO case the Commission however stressed that *“the anticompetitive effect of AKZO's differential pricing involved not so much direct injury to customers but rather a serious impact on the structure of competition at the level of supply by reason of its exclusionary effect”*.<sup>151</sup> From the discussion regarding the scope of the general clause follows that in cases of anti-competitive abuse the Article 102 TFEU and not the rule example of the letter c) will be applied.

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<sup>150</sup> see under footnote 51: Commission Decision of 14 December 1985 relating to a proceeding under Article 86 of the EEC Treaty, para. 44

<sup>151</sup> see under footnote 51: Commission Decision of 14 December 1985 relating to a proceeding under Article 86 of the EEC Treaty, para. 83



c) Bait prices

AKZO UK had, according to the Commission consideration offered the potassium bromate and vitamin mixes to the customers of ECS at prices far below those then prevailing and involving a considerable loss to fulfill orders for the complete range of flour additives. Therein, the Commission considered this practice as an abuse of dominant position by AKZO UK.

d) Proof of exclusionary intent

Although the Commission mentioned the scope of the term abuse in the ECJ decision in Hoffmann La-Roche, put the predatory intent in the center of its consideration. However, the Commission acknowledged that there may be circumstances *"where the exclusionary consequences of a price reduction campaign by a dominant producer are so self-evident that no evidence of intention to eliminate a competitor is necessary."*<sup>152</sup> Furthermore, the Commission stated, in the absence of direct documentary, the predatory intent could be inferred from all the circumstances of the case. From the objective findings will be then deduced to the subjective element of exclusionary intent. Whether the Commission would see in these cases a violation of Article 102 TFEU, where only the objective abusive practice is present, but the undertaking has not intended such an effect, is not clear.

A certain ambivalence to this question is reflected by the comparison of two basic statements of the Commission: on the one hand, the Commission manage the maintenance of competitive market structures as a goal of the competition rules resulting from the Treaty. On the other hand, the Treaty makes the market dominance possible, solely its abuse is prohibited. In line with this, the Commission stresses that *"it does not consider an intention even by a dominant firm to prevail over its rivals as unlawful. A dominant firm is entitled to compete on the merits. Nor does the Commission suggest*

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<sup>152</sup> see under footnote 51: Commission Decision of 14 December 1985 relating to a proceeding under Article 86 of the EEC Treaty, para. 80

*that large producers should be under any obligation to refrain from competing vigorously with smaller competitors or new entrants.*"<sup>153</sup>

The former point gives us the evidence that price reductions should also fall under Article 102 TFEU, while the second point stands against such an interpretation. It can not be allowed that large undertakings should refrain from competing vigorously with smaller competitors or new market entrants. AKZO denied the claims brought by ECS and held in essence that ECS has begun with price reductions and is trying to "*shift the blame for its own poor performance and bad investment decisions on to other participants in the market and ultimately on to the consumer.*" AKZO had to give up a little regarding its prices (had suffered revenue losses) and was thus forced to accept the new business from the independent mills and the Allied mills. The prices have always contained elements of profit. Having weighed the documentary proof, the Commission counted, on the other hand, for the determination of the exclusionary intent by AKZO three groups of factors:

(1) Direct, written documentary proof showing that in 1979 AKZO has expressed direct threats vis a vis to ECS to displace ECS from the market for organic peroxides.

(2) The price behavior: over time practiced price reductions on unreasonably low level which were partially selective, which means that towards own customers have been charged considerably higher prices.

(3) Other elements, such as scrutinizing system, exclusive purchasing obligation.

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<sup>153</sup> see under footnote 51: Commission Decision of 14 December 1985 relating to a proceeding under Article 86 of the EEC Treaty, para. 81

The specification of the exclusionary intent shows that in the eyes of the Commission, the subjective element has no moral reproach. With the intent is referred not on the motives, but on the economic plan.

e) The decision of the Commission

The Commission decided that AKZO has violated the Article 102 TFEU through the above mentioned three groups of factors (1) to (3) with the aim to force ECS from the market for organic peroxides. The Commission prohibited AKZO to repeat this activity, in particular to perform such pricing schemes. AKZO is not allowed to work again with customers of ECS and can not offer them favourable prices, without taking this advantage to its own customers. In addition, AKZO is prohibited, in the event that ECS should try to regain the former customers, to adjust its prices to the prices of ECS without giving its customers the advantage of this benefit.

4.1.4.2. The ECJ position

a) Criteria for the assessment of price reductions

The Court takes the concept of objective definition of abuse as a starting point for his decision. Thus it is forbidden for a dominant undertaking the *"elimination of a competitor and thereby strengthening its position by using methods other than those which come within the scope of competition on the basis of quality."*<sup>154</sup> The Court concludes that not every kind of price competition can be regarded as legitimate. The Court defined price-cost ratio and supplemented it by adding the intention to eliminate the dominant undertaking:

(1) Prices below average variable cost

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<sup>154</sup> see under footnote 136: C-62/86, AKZO Chemie BV v Commission of the European Communities, para. 70

The Court in this regard stressed that: "*Prices below average variable costs (that is to say, those which vary depending on the quantities produced) by means of which a dominant undertaking seeks to eliminate a competitor must be regarded as abusive.*"<sup>155</sup>

By this criterion is not fully clear whether the finding, that prices are below average variable cost, is sufficient for the assumption of abuse, or whether the desire to eliminate competitors, must be also demonstrated. The Court adds an explanation, that an undertaking "*has no interest in applying such prices except that of eliminating competitors so as to enable it subsequently to raise its price by taking advantage of its monopolistic position, since each sale generates a loss*"<sup>156</sup>

For dominant undertakings this means that we can assume, per se, an abuse in case of a price below variable cost. This applies even if the Commission finds only this objective criterion, but can not provide any additional evidence from which follows that the dominant undertaking's pricing policy is not pursued with the aim to force competitors from the market. The dominant undertaking has the possibility to present objective justification reasons to rebut the presumption of its predatory intent. However, in this case, the prices below variable costs, if they are held for a longer time at this low level, represent no objective justification reason. For example, a warehouse sale due to an economical emergency will be surely not a case discussed in terms of displacement of competitors from the market, because it is already a time-limited measure which for this reason will have little impact to eliminate competitors.

It is significant that the attempt of a dominant undertaking to eliminate competitors was seen as sufficient by the Court for the fulfillment of the

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<sup>155</sup> see under footnote 136: C-62/86, AKZO Chemie BV v Commission of the European Communities, para. 71

<sup>156</sup> see under footnote 136: C-62/86, AKZO Chemie BV v Commission of the European Communities, para. 71

requirements of Article 102 TFEU. An attempt may also lie in the threat of economic disadvantages, without leading to its realization. The Advocate General Lenz held that the limitation of an economic freedom of another undertaking in itself consider an abuse and therefore it does not matter whether this will withstand the pressure or not.

## (2) Prices above average variable costs

The Court applied in this case the following position: *"prices below average total costs, that is to say, fixed costs plus variable costs, but above average variable costs, must be regarded as abusive if they are determined as part of a plan for eliminating a competitor."*<sup>157</sup>

To support this statement the Court pointed out that these prices could force the undertakings (which are perhaps as efficient as the dominant undertaking) out of the market, and because of their smaller financial resources they can not withstand the competitive pressure.

When analyzing the price behavior of AKZO, the Court goes even further and sees prices, which are practiced, without any objective justification, for a longer time vis a vis its own customers below the average total costs as abusive. By this way the competitors will be prevented to turn to the customers of the dominant undertaking.

The fact that a dominant undertaking may well act rationally, if it offers at prices above variable cost but below average total costs, has already been outlined in Chapter II. In case where against the market dominant undertaking can not be demonstrated the predatory intent, a question arises whether the Court would still accept an abuse. In the case outlined above, by the below-cost pricing policy towards own customers over a longer period it

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<sup>157</sup> see under footnote 136: C-62/86, AKZO Chemie BV v Commission of the European Communities, para. 72

will be assumed that the Court would see this without further as an abusive practice. In any case the concerned undertaking must be given the opportunity to present its objective justification reasons for this pricing.

### (3) Prices above average total cost

The Court commented this set of circumstances not explicitly, although the European Commission stated in its decision that even by prices above average total cost does not exclude an abuse.<sup>158</sup> If, however, would be in this case applied the rule of competition on the basis of performance, as used by the definition of the objective abuse concept, this view is to be rejected. Although dominant undertakings impose an increased market structure responsibility, this has its limits, where these undertakings are able to manage its business much more efficiently than its competitors and therefore can bring the concurrence, with its pricing policy, in the loss zone in which they still covers the total costs. The less efficient competitors would have, under the umbrella of the dominant undertaking, less interest to perform its business more efficiently.

This interpretation is also supported by the Court that regarding the question of whether the dominant undertaking has abusively used the predatory practices it will not be relied on the cost structure and pricing policies of the competitors.

The full focus of our attention only on the predatory intent of the dominant undertaking would lead to the situation where we would abandon the objective abuse concept and rely purely on subjective elements. This view would no longer be in compliance with the Article 102 TFEU as this requires no subjective element.

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<sup>158</sup> see under footnote 51: Commission Decision of 14 December 1985 relating to a proceeding under Article 86 of the EEC Treaty, para. 79

b) Expanded market structure responsibility for dominant undertakings - burden of proof

The antitrust suit is dominated by the principle of ex officio examination. The antitrust authorities/courts have to utilize all the facts known to them and also to undertake investigations against undertakings which could rebut the presumption of a violation of the antitrust rules.

The Court has expressed that by prices which are below variable costs as well as by prices that are above, but still below average total costs, these prices are chosen with predatory intent. This assumption leads to material burden of proof for the undertakings and differs from the extent of the Commission's decision and the comments of Advocate General Lenz, which are supporting the fact that the burden of proof for the existence of predatory intent lies by the authorities/courts.

c) Price discrimination

The Commission had seen, by prices charged by AKZO from independent mills as well as those of the Allied Group a price discrimination. The Court followed this only regarding the first point. AKZO had offered his own customers among the major independent mills not the same price as to the ECS customers. These prices were in turn different from the prices that were offered to individual mills of the Allied group. The Court saw in the latter, however, no price discrimination, because the two categories of customers, independent mills and mills of the Allied Group were not comparable with each other.

d) Bait prices

For the assessment whether AKZO has used bait prices (subject to acceptance prices), for potassium bromate, the Court compares the costs and prices of AKZO of potassium bromate and benzoyl peroxide. This

comparison has showed *"that potassium bromate was offered at relatively lower prices than benzoyl peroxide."*<sup>159</sup> The lower prices of potassium bromate, according to the Court opinion should lead to increased attractiveness of the product offered (flour additives). The objections of AKZO, that AKZO - other than this is usually the case by bait prices (subject to acceptance prices) - has always been delivering large quantities of potassium bromate and that this product has been delivered to both ECS and to its own customers, the Court did not see as a justification point.

The Court makes his remarks as follows: bait prices (subject to acceptance prices) may not be accepted if the dominant undertaking calculates for different products of different profit margins. AKZO was aware that customers are tending to buy their entire flour additives assortments by one seller. The price reduction of a product of the entire products assortment could therefore dominate all other criteria for the customers purchasing decision, regardless of whether there will be a linkage of the low-price product to the acquisition of the entire products assortment.

The situation is different by the vitamin mixtures: AKZO had offered this product not to its own customers, but only to customers of ECS at prices that were below their own purchase price. AKZO's justification, that the competitive prices of the firm Vitrition, a major supplier of vitamin mixtures, had forced AKZO to offer these very low prices, the Court did not accept.

e) The decision of the ECJ

When examining the costs, the Court takes as its basis the AKZO classification of costs into fixed and variable.<sup>160</sup> The Court acknowledges

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<sup>159</sup> see under footnote 136: C-62/86, AKZO Chemie BV v Commission of the European Communities, para. 125

<sup>160</sup> see under footnote 136: C-62/86, AKZO Chemie BV v Commission of the European Communities, para. 94 and follows



the fact that these cost categories are not objective quantities, but have to be associated depending on each particular case. The Court comes to the conclusion that by almost all proposals, AKZO's prices were between average variable cost and average total cost. Only in one case, the prices were below average variable cost.

Apart from the accusation of selective pricing, the Court maintained the Commission decision. Thereafter AKZO may not step towards the customers of ECS and offer them low prices, without taking this advantage to its own customers. AKZO may not adjust its prices to the low prices of ECS, when ECS will try to regain its original customers without offering these prices to its own customers. The Court expressly emphasized that AKZO will be not denied to adapt defensively its prices to the prices of ECS in order to retain customers who are part of the AKZO's customers list.

The Court remained under the administrative fine imposed by the Commission, as the market shares of other competitors were not substantially altered.<sup>161</sup> Here we see a significant difference to the in the Chapter II and IV mentioned Brooke decision of the U.S. Supreme Court, which requires as a prerequisite for a successful lawsuit against predatory pricing that the dominant undertaking has the opportunity to recoup the losses through subsequent monopoly profits. The Court's approach is significantly different: the probability of success of predatory pricing is not a factual requirement for the finding of abuse, but the success - measured by a shift in market shares in favor of the dominant undertaking, and not on increased profit - is crucial for the total amount of the fine. This approach is also consistent with the concept of abuse developed by the Court that does not require success, but affects the behavior of dominant undertaking, which can negatively affect the structure of a market.

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<sup>161</sup> see under footnote 136: C-62/86, AKZO Chemie BV v Commission of the European Communities, para. 163

#### 4.1.5. Opinion

To what different results in the assessment of prices we can come are showing us the opinions of Advocate General Lenz. He analyzed on the basis of the presented documents the price behavior of AKZO, ECS and Diaflex and came only in cases of price discrimination against the independent mills and also regarding partially practiced exclusive dealings to the existence of abuse. The price behavior was characterised firstly in 1979 by attempting to impose a price increase. Because the competitors of AKZO, especially ECS, did not follow the decision, AKZO moved down its prices in the following years up to 1983. On the other hand AKZO had held in the years up to 1979 a clear price leadership and regularly increased (every year) the prices by 10%. ECS at a distance followed this practice with 10% increase.

Also in relation to the predatory intent adopted by the Commission and the Court during the period of investigation (1980 to 1983) can be seen some doubts: The only documents that are recording the predatory intent came from 1979. This alone it not sufficient to make a final statement about the persistence of the predatory intent.<sup>162</sup>

Advocate General Lenz saw it as not proven that from the written and oral threats recognizable predatory intent (by AKZO) continued to exist also in subsequent years until 1983. As the Advocate General Lenz wrote *"after AKZO' s hands had been tied to a certain extent by the proceedings in the High Court, ECS made offers to AKZO' s traditional customers (albeit at their request) at prices considerably below those of AKZO. It need not be decided whether ECS thereby intended to intensify competition on prices or to start a price war. From the applicant' s point of view this behaviour could*

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<sup>162</sup> Opinion of Advocate General Lenz delivered on 19 April 1989 in AKZO Chemie BV v Commission of the European Communities, Case C-62/86, para. 204

*have been interpreted as giving it the right to initiate an active pricing policy ("to compete with them as violently as possible")."*<sup>163</sup>

Price-cost ratios as a benchmark for the determination of abuse have been already criticized a lot. It is surprising, however, that the Court does rely on these ratios, but prohibited AKZO, to get in touch with the ECS customers to offer them "affordable" prices, not taking this advantage to its own customers.<sup>164</sup> Thus AKZO may not undertake price discrimination by delivering of services to competitors and comparable own customers. This prohibition applies regardless of whether the offers are below or above the variable or average total costs of the dominant undertaking. The variety of prices in comparable cases is sufficient.

Furthermore, the Court prohibited AKZO for the situations that ECS should try to win back the customers that AKZO has lured illegally to adjust its prices to the prices of ECS without leaving its customers the advantage of this benefit.

This requirement is incomprehensible on the background of the remarks of the ECJ concerning the unfairness of prices below variable or average total cost: Because AKZO has stolen, on the basis of prices below average total cost, the customers of ECS, ECS will be able to win back these customers only if he will be below the prices of AKZO. Does this mean that AKZO may proceed, if these - below the variable or average total costs – prices will be offered to its customers?

To clarify this, the Court also said that AKZO could defensively adjust prices to those customers of ECS, to retain customers, who have belonged from the beginning to his customers portfolio. Questionable is whether this

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<sup>163</sup> see under footnote 162: Opinion of Advocate General Lenz delivered on 19 April 1989 in *AKZO Chemie BV v Commission of the European Communities*, para. 215

<sup>164</sup> see under footnote 136: *C-62/86, AKZO Chemie BV v Commission of the European Communities*, para. 155

is applicable even when prices of the dominant undertaking fall below variable or average total cost. Furthermore, it is not clear whether in this situation the dominant undertaking has to offer to all its customers the same low prices. Is the entering into the price competition an objective justification reason, then the first question is affirmative and the second has to be denied, under the condition, that there are no additional clues from which it follows that the dominant undertaking acts in predatory intent.

The AKZO decision seems partly due to the incomplete fact-finding by the Commission at least doubtful, and the method by which the Court has analyzed the predatory strategy of AKZO, in particular vulnerable. The decision does not give clear handling-instructions for the pricing policies of dominant undertakings, which would be needed for a desirable legal certainty.

#### 4.1.6. Tetra Pak II

The ECJ confirmed here the approach from the AKZO case regarding the test to determine the existence of predatory pricing conduct. Tetra Pak prices have been seen, according to the AKZO test, per se abusive. In this decision Tetra Pak had been found to be dominant in the aseptic packaging market. This was because its prices for non-aseptic cartons were below AVC. Moreover, the Commission found that Tetra Pak pricing strategy was aimed at weakening competition. The EU rejects the recoupment requirement in cases where the defendant price is below the relevant cost. The ECJ expressed its view in the sense that it would not be appropriate to require evidence that the dominant undertaking had a “*realistic chance of recouping its losses.*” Instead, “*it must be possible to penalize predatory pricing whenever there is a risk that competitors will be eliminated. The Court of First Instance*<sup>165</sup> *found, that there was such a risk in this case. The*

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<sup>165</sup> The Court of First Instance itself has admitted that “it may be acceptable for an undertaking in a dominant position to sell at a loss in certain circumstances”.

*aim pursued, which is to maintain undistorted competition, rules out waiting until such a strategy leads to the actual elimination of competitors.*<sup>166</sup> In comparison to the U.S. approach, the ECJ has adopted in this case only the first part of the two-tier test from the Brooke Group decision. On the other hand, the second part "*recoupment*" was not seen as a precondition of predation.<sup>167</sup>

#### 4.1.7. Compagnie maritime belge

The ECJ explained his position concerning predatory pricing that: first, Article 102 TFEU (at the time of the ECJ decision Article 86 EC) does not provide an "*exhaustive enumeration*" of the abuses of a dominant position; second, Abuse may occur in cases where "*an undertaking holding a dominant position strengthens that position in such a way that the level of dominance reached substantially fetters competition*"; third, Costs may not be an reliable guide to the reasonableness of competitive strategies; fourth, The so called "*special responsibility*" of a dominant undertaking must be seen in regard to the specific conditions of each single case.<sup>168</sup>

The Advocate General Fenelly suggested in his opinion that *the "price competition is the essence of the free and open competition which it is the objective of the Community policy to establish on the internal market. It favours more efficient firms and it is for the benefit of consumers both in the short and the long run. Dominant firms not only have the right but should be encouraged to compete on price. ... Normally, non-discriminatory price cuts by a dominant undertaking which do not entail below-cost sales should not be regarded as being anti-competitive. Community competition law should not offer less efficient undertakings a safe haven against vigorous*

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<sup>166</sup> see under footnote 134: Case: C-333/94P, Tetra Pak International SA v Commission of the European Communities, para. 44

<sup>167</sup> Bishop, S., Walker, M. (2002): The Economics of EC Competition Law, Thomson, London, p. 235 and follows

<sup>168</sup> Joined Cases C-395/96 P and C-396/96 P, Compagnie Maritime Belge Transports SA and Others v Commission, [2000] ECR I-1365, para. 111–14

*competition even from dominant undertakings.*”<sup>169</sup> The potential ban on lower prices provided to rival’s customers is not enforced under U.S. antitrust policy. In the EU this form of selective price reductions may be prohibited. Elhauge has criticized *Compagnie Maritime Belge* Case telling that the Advocate General made a mistake in his view when supporting the idea that selective above-cost price reductions could drive out an equally efficient undertaking because of its so called “*lesser financial capacity.*” Elhauge added that this is not possible if the costs will be defined properly (“*and certainly if one defines them to include all long-run marginal costs*”).<sup>170</sup>

#### 4.1.8. Irish Sugar

The European Court of First Instance (CFI) annulled the fact that Irish Sugar had applied selectively low prices to potential customers but upheld the fact that Irish Sugar had been guilty of granting selective rebates to certain customers. Irish Sugar selective price-cutting was above cost. The European Commission comes to the conclusion that targeted rebates offered by Irish Sugar were discriminatory. This has been supported with the fact that they were dependent on percentage increases in purchases instead of absolute purchase volumes. The Commission saw in Irish Sugar practice a violation of Article 102 TFEU (ex Art. 82 EC) because Irish Sugar created a situation where, among others, the undertaking agreed with customers on discriminatory prices who exported their sugar but will not compete with Irish Sugar on the Irish market. Another finding was that Irish Sugar offered special rebate programmes. In this case the Commission combined a finding of exclusionary abuse (now Article 102 (b) TFEU) with a price

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<sup>169</sup> see under footnote 168: Opinion of Advocate General Fennelly in Joined Cases C–395/96 P and C-396/96P, *Compagnie Maritime Belge Transports SA, Compagnie maritime belge SA and Dafra-Lines A/S v Commission*, para. 117 and 132

<sup>170</sup> Elhauge, E. (2003): *Why Above Cost Price Cuts to Drive Out Entrants Are Not Predatory*, *Yale Law Journal*, 112, pp. 725

discrimination abuse (now Article 102 (c) TFEU), but did not argued that selective discounts led to predatory prices.<sup>171</sup>

#### 4.1.9. Deutsche Post

Originally, United Parcel Service (UPS) was competing with Deutsche Post AG (DPAG) in the German market in the parcel services. DPAG was accused of selling its parcel service at below-cost prices to force competitors out from the market. UPS alleged that DPAG was using revenues from its profitable monopoly in the letter mail sector to finance the below cost strategy in the mail order parcel service. The Commission held that “*the cross-subsidisation occurs where the earnings from a given service do not suffice to cover the incremental costs of providing that service and where there is another service or bundle of services the earnings from which exceed the stand-alone costs.*” and by the examination of “*whether the incremental costs incurred in providing mail-order parcel services are covered, the additional costs of producing that service, incurred solely as a result of providing the service, must be distinguished from the common fixed costs, which are not incurred solely as a result of this service.*”<sup>172</sup> By the determination of the long-run incremental cost<sup>173</sup> the Commission examined the overall share of DPAG fixed costs. The Commission concluded that the DPAG costs per item in a mail-order parcel services were much more higher than the DPAG costs per item in the business-to-business (or B to B) parcel services. The DPAG average long-run incremental costs per item were not covered by the revenues earned which, according to the Commission, constitutes DPAG abuse of a dominant position on the market by charging an excessive price. By the examination of the case the

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<sup>171</sup> Case: T-228/97, Irish Sugar plc v Commission of the European Communities. [1999] ECR II-2969

<sup>172</sup> Commission decision of 20 March 2001, Deutsche Post AG, (2001) O.J. L 125/27, para. 6 and 7

<sup>173</sup> “The incremental costs solely comprise costs incurred in providing a specific parcel service. They do not include the fixed costs not incurred only as a result of providing a specific service (the common fixed costs).” see sopra under footnote 172: Commission decision of 20 March 2001, Deutsche Post AG, citation under 7

Commission stated that: *“DPAG's revenue from mail-order parcels was below the incremental costs, which means that every sale by DPAG in the mail-order parcel services business represented a loss. DPAG could increase its overall result by either raising prices to cover the additional costs of providing the service or to discontinue providing the service, because revenue gained from its provision is below the additional costs incurred in providing it. However, DPAG restricted the activities of competitors which are in a position to offer this service at a price that covers their costs.”*<sup>174</sup> The Commission relied on the so called combinatorial test from Faulhaber. Combinatorial tests are needed to ensure that undertakings are not abusing their pricing flexibility. Under this test, a profit-maximizing undertaking will set prices that satisfy the combinatorial incremental-cost test. If it continually failed to do so, the undertaking may simply increase its profits by setting different prices.<sup>175</sup> The Commission thus applied in this case a pure incremental costs approach (LRAIC).

#### 4.1.10. Wanadoo

Wanadoo<sup>176</sup> a provider of High-speed Internet services charged during 2001 and 2002 low prices for the ADSL (technology for the provision of broadband internet). Wanadoo's market share increased from 50 % to 70 % in August 2002, but then dropped to about 60 % in October 2002. On the contrary the share of Wanadoo's closest competitors was about 10 %. In September 2001 the European Commission started an investigation. In the decision from 2003 the Commission found that Wanadoo charged prices that did not cover variable costs (from March to August 2001) and full costs (from August 2001 to October 2002) as a plan to preempt the High-speed Internet access market.<sup>177</sup> The European Commission held the position that

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<sup>174</sup> see under footnote 173: Commission decision of 20 March 2001, Deutsche Post AG, para. 36

<sup>175</sup> Faulhaber, G. R. (1975): Cross-Subsidization: Pricing in Public Enterprise, American Economic Review, Vol. 65, No.5, p. 969

<sup>176</sup> A subsidiary of France Télécom SA

<sup>177</sup> Case: COMP/38.233, Wanadoo Interactive, Commission Decision of July 16, 2003, para. 368



the customer acquisition costs (e.g. marketing activities) have to be considered as variable costs. The European Commission wanted to find out whether Wanadoo's "*services had a production margin sufficient to cover the costs of acquiring new subscribers if the acquisition costs are depreciated over 48 months.*"<sup>178</sup>

A question arose whether advertising expenditure, which was focused on acquiring new customers, for residential broadband cable services should be classified as fixed or variable cost. Wanadoo argued that "*advertising cannot be regarded as a variable cost because it does not maintain a constant proportional relationship with growth in the subscriber base.*"<sup>179</sup> It was according to Wanadoo a fixed sunk cost, because the investment should not have an impact on sales (although according to the Commission they have a clear impact in the short term).<sup>180</sup> Regarding the sunk cost Baumol pointed out that not all sunk costs are fixed costs. Sunk costs are costs that can not be eliminated even by an interruption of production.<sup>181</sup> The Commission held that Wanadoo "*knowingly weighed a shortterm profitability objective against an objective of vigorous penetration of the market*"<sup>182</sup>

In the decision of 2007, the CFI upheld the original decision of the European Commission. The court has provided its argument regarding an analysis of the discounted cash flows which can not be applied because it gives wrong picture about the situation on the relevant market. Another negative answer from the court came in relation to the Wanadoo's claim that its low prices were focused only to meet the competition. On the other hand the court held that the Commission had failed to prove that other

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<sup>178</sup> see sopra under footnote 177: Case COMP/38.233, Wanadoo Interactive, para. 108

<sup>179</sup> see sopra under footnote 177: Case COMP/38.233, Wanadoo Interactive, para. 63

<sup>180</sup> See sopra under footnote 177: Case COMP/38.233, Wanadoo Interactive, para. 20

<sup>181</sup> Baumol, W. J., Willig, R. D. (1981): Fixed Costs, Sunk Costs, Entry Barriers and Sustainability of Monopoly, The Quarterly Journal of Economics, Vol. 96, No. 3, pp. 406-407

<sup>182</sup> see under footnote 177: Case COMP/38.233, Wanadoo Interactive, para. 126

competitors would be excluded from the market. The court also held that Wanadoo's pricing strategy would lead to the elimination of other competitors.

#### 4.1.11. France Télécom

The European Commission stated that although dominant undertaking has a right to coordinate its prices with those of other competitors, the undertaking may not apply this practice in the case of prices which do not cover its costs. Advocate General Mazák's opinion on the France Télécom SA case upheld the European Commission's decision to penalize Wanadoo for illegal predatory pricing. According to Advocate General Mazák the establishment of dominance is based on historical market conditions.<sup>183</sup> He proposed that the dominant undertaking should have an opportunity to provide objective justification reasons allowing the undertaking setting prices below average variable costs. But the ECJ did not follow Advocate General Mazák's opinion<sup>184</sup> stating that proof of possible recoup of losses suffered by the dominant undertaking due to prices below a certain level of costs does not constitute a precondition of concluding abusive prices. The ECJ held that the demonstration of the possibility of recoupment<sup>185</sup> is not necessary in cases "*where the eliminatory intent of the undertaking at issue could be presumed in view of that undertaking's application of prices lower than average variable costs.*"<sup>186</sup> The ECJ decided in this case not to accept a more economic approach to predatory pricing as an additional requirement when undertaking the predatory price test.

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<sup>183</sup> Opinion of Advocate General Mazák delivered on 25 September 2008 in C-202/07 P, France Télécom SA v Commission of the European Communities, para. 76

<sup>184</sup> Wurmnest, W. in Basedow, J., Wurmnest, W. (2011): Structure and Effects in EU Competition Law: Studies on Exclusionary Conduct and State Aid, Wolters Kluwer Law, Alphen aan den Rijn, p. 119

<sup>185</sup> France Télécom SA argued that recoupment was a necessary precondition.

<sup>186</sup> Case: C-202/07 P, France Télécom SA v Commission of the European Communities, [2009] 4 C.M.L.R. 25, para. 110

## 4.2. US Judicial Approach to Predatory Pricing

### 4.2.1. Standard Oil (1911)

One of the first successful applications of the Sherman Act was the Standard Oil Case<sup>187</sup> accused of cutting prices to unprofitable levels with the aim to force the competitors out of the market. When the competitors left the market, Standard Oil raised the prices to earn the monopoly profits. Standard Oil is seen by many scholars as a landmark decision in the development of antitrust law. McGee found that a predatory strategy by a large undertaking would have been economically irrational. He supported his view with the fact that such an undertaking has larger market share than other competitors and thus larger price reductions must have been done by the predator.<sup>188</sup> McGee was the first economist who declared that such practices are very costly for the large undertaking (a predator).<sup>189</sup> If price will be set up below average cost, the predator will have to book the largest losses because of having the largest volume of sales. Second uncertainty represent the fact of how long the price war will last. Third uncertainty is connected with the possibility that the price war will extend to surrounding markets. George Stigler acknowledged McGee's article when once provided a short example about the price war as follows: *“There is a threat of a three-month price war, during which I will lose \$10,000, which unfortunately I do not possess. If you lend me \$10,000, I can survive the price war and once I show your certified check to Rockefeller the price war*

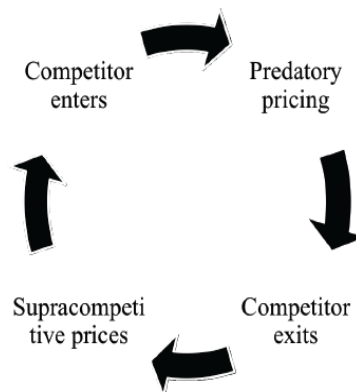
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<sup>187</sup> Case: Standard Oil Co. of N.J. v. United States, 221 U.S. 1 (1911); The Sherman Act prohibits in Section 1 all contract or collective action which has an incidental effect of restraining trade. The Section I states that “Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal.” Section 2 of the Sherman Act, on the contrary, prohibits monopolization or attempted monopolization, saying that “Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony.” In both cases, the Act is setting up high fines by the finding of a violation not exceeding \$10,000,000 by a corporation, or, \$350,000 by any other person with possible imprisonment not exceeding three years in total.

<sup>188</sup> see under footnote 19: McGee, J. S. (1958): pp. 137-169

<sup>189</sup> see under footnote 70: Posner, R. A. (2001): p. 208 and follows

*will probably never be embarked upon. Even if the price war should occur, we will earn more by cooperation afterward than the \$10,000 loss, or Rockefeller would never embark upon the strategy.*”<sup>190</sup> Standard Oil reached its monopoly position through merger and acquisition. McGee argued that Standard Oil has neither used predatory price discrimination nor local price reductions in order to force other competitors from the market. The economic efficiency and not predatory pricing was at the centre of Standard Oil’s success. Although McGee agreed with the finding that Standard Oil discriminated in price, the undertaking has not been doing it with the aim to maximize its profits. In fact, Standard Oil did not use predatory price discrimination in order to reach the monopoly position. McGee argued that other undertakings would know that the predator was incurring large costs. Knowing that this strategy could not be practiced for ages the concurring undertakings would remain in the market and the predatory strategy would not be successful. Also in cases where the concurring undertakings would exit the market the predator would need to recover its below cost investment. He supports his statement with the fact that once the predator put the prices into supra-competitive level other undertakings would probably enter the market. The predator would need than invest money to force this entrants from the market (thus the expectation to recover these money is very low). The following Figure illustrates the cycle of entry by predatory pricing practices:




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<sup>190</sup> see under footnote 49: Stigler, G. T. (1967): p. 289

#### 4.2.2. Utah Pie (1967)

The Utah Pie case can be seen as one of the first cases interpreting the Robinson-Patman Act. Utah Pie claimed against its competitors (three national firms, Pet Milk, Carnation and Continental) that they created a coordinated pricing scheme (which creates conspiracy under Section 1 and 2 of the Sherman Act and violation of Section 2 (a) of the Clayton Act as amended by the Robinson-Patman Act). At the beginning of the story Utah Pie built a plant in Utah and set its prices below those of other competitors. The competitors responded with lowering of their prices. The price war started when Utah Pie's share fell from 66.5%, to 45.5%. Market shares of all involved undertakings can be seen in the table below.

	1958	1959	1960	1961
Utah Pie	67%	34%	46%	45%
Pet Milk	16	36	28	29
Carnation	10	9	12	9
Continental	1	3	2	8
All Others	6	19	12	8

Although Utah Pie was seen as the victim of predation, the price war did not force Utah Pie out of the market.<sup>191</sup> The court suggested that *“that prices above cost may be predatory if united with evidence of anticompetitive intent and a deteriorating price structure.”*<sup>192</sup> The U.S. Supreme Court found that these three national firms had charged less than average total costs (but not less than average variable costs). They charged less in that region where they competed against Utah Pie than elsewhere. The U.S. Supreme Court ruled in favor of the Utah Pie with the words that although Section 2 (a) of the Clayton Act does not forbid the price competition, it does forbid such competition where it injure competition.<sup>193</sup>

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<sup>191</sup> Edlin, A. S. (2000): Stopping Above-Cost Predatory Pricing, UC Berkeley School of Law, Working Paper No. 57, p. 13

<sup>192</sup> Case: Utah Pie Co. v. Continental Baking Co., 386 U.S. 690 (1967)

<sup>193</sup> see under footnote 192: Utah Pie Co. v. Continental Baking Co., point. 702. The U.S. Supreme Court decided in one later case that "territorial price differences that are in fact responses to competitive conditions" are in general defendable. See, e.g. Case: Falls City Industries, Inc. v. Vanco Beverage, Inc., 460 U.S. 428, 448 (1983)

#### 4.2.3. Matsushita (1986)

In this case two U.S. electronics undertakings brought suit againsts 21 Japanese electronics manufacturers (Japanese-controlled American corporations). No allegation was made that the Japanese electronics manufacturers had obtained monopoly power in the USA or recouped their losses. 1953 was the year where, allegedly, the predation period was to have begun. In Matsushita it was applied a two-tier test for demonstrating predation. Firstly, the plaintiff must demonstrate pricing below the “*relevant measure of cost*,”<sup>194</sup> and secondly must demonstrate that there is a prospect of recoupment (by the predator). It was found out, that even if the competitors will be able to force the U.S. undertakings out of the market to reach a success in the manufacturers predation strategy they would have had to agree not only on the division of losses occurred during the predation period but also on the division of profits. The decision in the case was released in 1986 but left some important unanswered questions. The U.S. Supreme Court (in a 5 to 4 decision) accepted the economic literature by citing the work of Easterbrook, and other scholars (e.g. Bork) that “*there is a consensus among commentators that predatory pricing schemes are rarely tried, and even more rarely successful.*”<sup>195</sup> And also it is not enough to achieve the monopoly power, because the success of predatory tactics depends on maintaining this power for a sufficiently long time in order to recoup the losses and to win additional gains.

#### 4.2.4. Rose Acre (1989)

In this case the Court has decided about a price war among egg producers. Between 1978 and 1982 Rose Acre increased the size of its operation although the sales of eggs (nationally) increased by only 1%

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<sup>194</sup> Case: Matsushita Electric Industrial Co. v. Zenith Radio Corp., 475 U.S. 574 ,589 (1986); the Court identified several errors from ruling, among others, that "The direct evidence on which the Court of Appeals relied had little, if any, relevance to the alleged predatory pricing conspiracy; and the court failed to consider the absence of a plausible motive to engage in predatory pricing."

<sup>195</sup> see under footnote 39: Easterbrook, F. H. (1981): p. 263

during the year. Until 1978 Rose Acre delivered its customers with eggs only in the area of Indianapolis. In the next period Rose Acre extended its supply to other markets offering low prices. The court decided to analyze the recoupment possibility before having analyzed the below cost pricing arguing with the statement that this step was easier than to undertake cost analyses. According to the U.S. Federal courts, predatory intent (questions of intent) has to be considered by the examination of the case while at the same time underscored that intent will not help to separate competition from attempted monopolization.<sup>196</sup> This goes in line with both the Chicago School and the Post-Chicago School which support the idea that the undertaking objective is profit maximization (although some economists are asking whether large corporations maximize anything).

#### 4.2.5. Brooke (1993)

The Brooke Group (formerly Liggett) decision gives a new framework for predatory pricing analysis. Liggett had a 2% of the total market while its competitor Brown & Williamson 12% of the total market shares. Brown & Williamson put on the market its own generic cigarettes product but sold it at lower prices than Liggett. A price war began. At the end Brooke Group increased its prices with the result that generic brand prices increased by 69% and branded cigarettes prices by 39% while the costs remained more or less constant. Brooke claimed that its competitor (Brown & Williamson) held prices below AVC for 18 months in combination with discriminatory rebates. This caused losses of millions of dollars. The U.S. Supreme Court

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<sup>196</sup> Case: AA Poultry Farms Inc v. Rose Acre Farms Inc, 881 F.2d 1396, 27 (1989); under para. 22 the The U.S. Supreme court stressed that "*predatory prices are an investment in a future monopoly, a sacrifice of today's profits for tomorrow's. The investment must be recouped. If a monopoly price later is impossible, then the sequence is unprofitable and we may infer that the low price now is not predatory. More importantly, if there can be no later in which recoupment could occur, then the consumer is an unambiguous beneficiary even if the current price is less than the cost of production. Price less than cost today, followed by the competitive price tomorrow, bestows a gift on consumers. Because antitrust laws are designed for the benefit of consumers, not competitors a gift of this kind is not actionable.*"

required proof of below cost pricing,<sup>197</sup> and recoupment although there was a clear documentary of below cost pricing and predatory intent. Predation could occur only through the joint action of the leading undertakings engaged in oligopolistic price coordination. Generally, predatory pricing cases may be brought under Section 2 of the Sherman Act (15 U.S.C § 2) or under the Robinson-Patman Act (15 U.S.C §13) which prohibits price discrimination where the effect “*may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them.*” In Brooke the Robinson-Patman Act was applied (instead of the Sherman Act). The second one requires the proof of a so called dangerous probability of actual monopolization, whereas the Robinson-Patman Act requires only the reasonable possibility of substantial injury to competition. The U. S. Supreme Court established a two-tier test for unlawful predatory pricing, according to which the defendant priced below incremental costs and there must be the probability that the defendant will have the possibility to recoup its losses.<sup>198</sup> The reasoning of the U.S. Supreme Court is linked to the idea that predation requires below-cost pricing.<sup>199</sup> The U.S. Supreme Court presented his view arguing that prices below cost did not create any obstacles from an antitrust perspective. Such prices could be seen predatory only if there is the probability of a recoupment. The U.S. Supreme Court expressly declared that “*without recoupment, predatory pricing produces lower aggregate prices in the market, and consumer welfare is enhanced. Although unsuccessful predation may encourage some inefficient substitution toward the product sold at less than its cost, unsuccessful*

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<sup>197</sup> It was stated that below-cost pricing is a necessary element of predation.

<sup>198</sup> Hovenkam, H. (2010): The Obama administration and the Section 2 of the Sherman Act, Boston Law Review, 90, p. 1644; see also Lopatka, E. J. (2008): Economic authority and the limits of expertise in antitrust cases, p. 217, in Marshall, K. S. (edt.), who wrote that “*...the plaintiff has to prove that the defendant has a reasonable prospect of recouping its investment in the predatory campaign.*”

<sup>199</sup> Case: Brooke Group Ltd v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993)



*predation is in general a boon to consumers,*<sup>200</sup> and thus does not violate the antitrust laws. The plaintiff lost the case because he was not able to demonstrate the second element of predation, namely the possibility of recoupment of losses.

#### 4.2.6. American Airlines (2001)

In 2001, a federal district court ruled that the Department of Justice (DOJ) had failed to prove below-cost pricing and to provide an evidence proving that there was a dangerous likelihood that American Airlines would recoup its losses. DOJ alleged American Airlines and its parent AMR Corp. from the use of predatory pricing practices like price reductions and other anticompetitive practices. In fact, American Airlines cut its prices by 26 %, but afterwards raised it by 84 % after driving out the competition from the market. The victims of the American Airlines predatory strategy were Vanguard, Sun Jet, and Western Pacific which were forced out of the Dallas-Fort Worth airport hub.

The DOJ used by the examination of the case the elements of game theory as well as strategic economic theory.<sup>201</sup> Generally, the Low-cost carrier operators have had positive impact on consumer welfare through their lower prices. Nevertheless, DOJ complained that American Airlines cut its prices to a level that would not make any sense unless the Low-cost carrier operators will be driven from the market. The U.S. District Court granted a summary judgment in favor of American Airlines that American Airlines did not price below an appropriate measure of cost. This was supported with the evidence that the American Airlines matched the prices of its competitors, and there was no dangerous probability of recoupment.<sup>202</sup>

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<sup>200</sup> see supra under footnote 199<sup>cc</sup> Case: Brooke Group Ltd v. Brown & Williamson Tobacco Corp., under 224

<sup>201</sup> The strategic theory gives the answer on the question: When can predatory pricing occur?; For the antitrust the relevant question is different, namely: is predatory pricing the most valid clarification for an episode of low prices?

<sup>202</sup> Case: United States v. AMR Corp., 140 F. Supp. 2d 1141, 1194 (2001)

The U.S. Supreme court has taken under examination the debate about the appropriate measure of cost when held that there is no consensus “*as to what the most ‘appropriate’ measure of cost is in predatory pricing cases.*”

In 2003, the DOJ filled an appeal and the U.S. Court of Appeals for the 10th Circuit upheld the District Court’s judgment with the statement that “*it is uncontested that American did not price below AVC [average variable cost] for any route as a whole, we agree with the district court’s conclusion that the government has not succeeded in establishing the first element of Brooke Group, pricing below an appropriate measure of cost.*”<sup>203</sup> American Airlines competed with the low fare carriers but did not price its fares below cost. “*Whether incremental cost exceeded incremental revenue, Whether long-run AVC exceeded price, Whether price was below American’s 18-month cost measure and Whether incremental cost exceeded price.*”<sup>204</sup> The DOJ argued that the tests mentioned above showed sacrifice and that American Airlines reasonably expected to recoup its sacrifice by reducing competition. Sacrifice theories explore that if a price is below cost this constellation reflects a sacrifice. When this happen a *what for* question is needed? We can come to the answer that this happend in order to exclude competitors. By the examination of cost the U.S. Supreme court held that “*the ideal measure of cost would be marginal cost because as long as a firm’s prices exceeded its marginal cost, each additional sale decreases losses or increases profits.*”<sup>205</sup> But what measure of price and cost? Areeda and Turner and also Ordover and Willig advise to compare price with marginal cost. American Airlines responded that its prices were never below AVC and that it has not undercut the entrants' prices. American Airlines further stressed that the recoupment theory of DOJ was nothing less than speculative. Thus, why Marginal Cost can not be seen as an appropriate

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<sup>203</sup> Case: United States v. AMR Corp., No. 01-3202 (10th Cir. July 3, 2003); As a possible justification for pricing below AVC, through promotional pricing, has been presented in the A. Poultry Farms, Inc. v. Rose Acre Farm case (see above under 4.2.4.)

<sup>204</sup> see under footnote 203: see under II. The evidence showed that Americans conduct failed appropriate cost tests.

<sup>205</sup> Case: United States v. AMR Corp., 335 F.3d 1109 1116 (10th Cir. 2003)

measure of cost? Marginal costs are typically the lowest of the three cost measures. But in practice there are some situations where marginal cost can be higher than the other cost measures (e.g. in the airplane industry if we imagine a situation that a plane is fully booked but there is still one passenger willing to travel; in this situation where a new plane (for this one passenger) will be needed, the marginal costs would be considerable. But if the plane is not fully booked (in majority of cases) and the marginal costs will be adopted as the appropriate measure of cost, no airline provider will be found guilty of predatory pricing when selling tickets above a few dollars arguing with the facts that these few dollars were used for the print of boarding passes, etc. and the airline fuel consumed due to passengers weight). Secondly, why pricing above AVC are to be seen as per se legal? This is because competition law should not hinder an undertaking to undertake business if this is in a position to increase its production at a cost which is lower than someone wants to pay for its product. As an example we can mention an investment into production equipment, where an undertaking will sell its products at a cost that is higher than direct production cost in order to sell enough products (to cover the costs of the equipment). Hence, from a purely economic point of view it is rational to sell at a price that exceeds AVC. In a situation where one undertaking has enough resources to cover its overheads but its competitors have not sufficient resources, it is rational (if we use the under AVC rule) to set prices a little above AVC until elimination of competition.

#### 4.2.7. Weyerhaeuser

In this case, we have two players Weyerhaeuser and Ross-Simons operated hardwood lumber sawmills and purchased alder logs. Ross-Simons began its business in 1962 and Weyerhaeuser in 1980 and became dominant on the market in a short time. The price of alder logs increased in the period from 1998 to 2001 but prices for finished hardwood lumber got down. In 2001, Ross-Simmons had lost nearly 4.5 million \$ and was forced to shut

down its mill. Ross-Simmons claimed that Weyerhaeuser violated Section 2 of the Sherman Act (1890) by attempting to monopolize, and monopolizing, the input market in the Pacific Northwest. Thereafter brought an antitrust claim against Weyerhaeuser. Weyerhaeuser rejected this saying that it had acted lawfully and that the Ross-Simmons was forced to shut down because of other reasons, like inefficient operations, poor management and inadequate capital.

In Weyerhaeuser the U.S. Court established that a plaintiff must show first the below-cost pricing in the short term and the so called dangerous probability of recoupment in the long term. The Court held that because both predatory pricing and predatory bidding are largely similar, the Brooke test for predatory pricing should also apply when it comes to cases of predatory bidding. Salop expressed the view in his article, Anticompetitive Overbuying by Power Buyers, that the Court should apply the consumer welfare rule of reason standard not only in this but also in other bidding cases.<sup>206</sup> Since both schemes (predatory pricing and predatory bidding) require that undertakings are expecting to recover losses in the long run, the Court underpinned that “*successful monopsony predation is probably as unlikely as successful monopoly predation*”.<sup>207</sup> In cases where the undertaking has the ability to increase its output price during the predatory bidding phase, the first part of the test should not be strictly applied.<sup>208</sup>

#### **4.3. Partial conclusion**

Both European and American approaches to competition (antitrust) policy have mounted towards a more economic-based approach. European courts seem to be more aggressive in the competition enforcement. In the

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<sup>206</sup> Salop, S. C. (2005): Anticompetitive Overbuying by Power Buyers, 72 Antitrust Law Journal, pp. 669-715

<sup>207</sup> Case: Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., 127 S. Ct. 1069, 10 (2007)

<sup>208</sup> Blair, R. D., Lopatka, E. J. (2008): Predatory Buying and the Antitrust Laws, forthcoming Utah Law Review, p. 66

EU, the treatment of predatory pricing differs from the U.S. European courts do not apply the recoupment test (that the alleged predator will be able to recoup its losses). European judges mainly rely on the relationship between prices charged, costs and the element of intent. EU competition law has mostly cost based approach to predation. The doctrine regarding predation in the EU Law was established for the first time in the AKZO, followed by the Tetra Pak II case. Although the ECJ approach has been influenced by the U.S. courts cost based approach, there are some differences when it comes to the structural requirements. To these belongs e.g. the possibility of recouping of losses. In the EU law it will be assumed that a dominant undertaking, when imagining a situation of predation without possibility of recoupment later on, can also under these condition cause harm to its rivals (e.g. disciplining them). This, as well as other, difference(s) are laid down in the Guidance on the Commission's Enforcement Priorities in Applying Article 102 TFEU.<sup>209</sup>

The U.S. Federal courts include the notion coming from the research papers of McGee or Areeda and Turner that predatory pricing is in general irrational. Since the 1993 Brooke judgement, the U.S. Federal courts mostly require the proof of below-cost pricing and recouping of losses suffered by the undertakings during the period. This goes hand in hand with the Chicago School hypothesis that the market is self-correcting. In the USA, prices below AVC are seen as unlawful while prices above ATC are seen as lawful. In the last period, American courts have focused their attention on the structural preconditions for successful predation. According to them, it is necessary to prove not only that prices are below cost, but also that the structure of the market allows the predator to recoup its losses. The U.S. DOJ expressed its view that there are no new elements regarding the fact

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<sup>209</sup> Guidance on the Commission's Enforcement Priorities in Applying Article 102 EC Treaty to Abusive Exclusionary Conduct by Dominant Undertakings, [2009] OJ C45/7; The main differences are illustrated in the DOJ Single-Firm Conduct Report, Promoting Consumer Welfare through Clearer Standards for Section 2 of the Sherman Act. Important to mention is that the DOJ Report broadly reflects the Chicago approach to antitrust. Several months later, the European Commission published its Guidance.

that above-cost pricing should be legal. This standard established in the Brooke case has been confirmed in the Weyerhaeuser case. Short summary of the U.S/EU comparison is presented in the table below:

	U.S.	EU
Market dominance	Necessary condition	Necessary condition
Price test	$p < AVC$ as a necessary condition	$p < AAC$ per se illegal
Recoupment	Reasonable prospect	Not necessary
Key Remark	Predatory pricing schemes are rarely tried and even so more rarely successful.	A dominant undertkaing has no intent in applying such prices except of eliminating competitors.

**CHAPTER V.  
PROPOSALS FOR THE TREATMENT OF PREDATORY  
STRATEGIES UNDER ARTICLE 102 TFEU**

5.1. Introduction

Predatory pricing is suitable to hinder the integration of markets and contradicts the interests of consumers regarding permanently affordable and high quality products and thus must be assessed under Article 102 TFEU. Also suggestions that take into account only the short-term implications of predatory pricing strategies are not considered. The task of the European competition law is not only in short term but also in the long-term to secure objectives of the Treaty.

The strategic aspects of systematic price reductions to eliminate competitors are ignored by the Court and reduce the treatment of this behavior on price-cost ratios. These in conjunction with the requirement of a displacement or destruction intent did not meet the phenomenon of predatory pricing. For the implementation of the postulate of free competition in open markets there is a need for a comprehensive analysis that examines the competitive environment of the alleged predator.

**5.2. The Joskow/Klevorick approach as the basis for an overall analysis by the application of Article 102 TFEU**

As a basis for such an overall analysis can serve the Joskow/Klevorick approach. This approach comprises two stages and examining - as illustrated in Chapter II - on the first stage the market and corporate structure to see whether there are favorable conditions for a successful predatory strategy. If this is the case, on the second stage it will be examined, whether the alleged predator has acted abusively. They proposed to rely on “*generally accepted definitions of monopoly power*”<sup>210</sup> to accomplish with this framework. Thus,

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<sup>210</sup> see under footnote 41: Joskow, P. L., Klevorick, A. K. (1979): p. 244

prices below AVC were determined to be predatory per se. Prices between AVC and ATC were determined to be predatory, unless they maximized short-run profits. Prices above ATC were seen in general as legal (because prices above ATC were sustainable).<sup>211</sup> For Joskow and Klevorick prices between AVC and ATC are predatory unless the defendant can prove that this strategy was put in place in order to maximize short run profits. The evidence of intent should be applied only to examine whether the undertaking wanted to increase prices after other competitors have been forced out of the market and whether this practice was aimed to make difficult for market entrants to enter the market.

The structure of the two tier approach can be applied to the scope of Article 102 (1) TFEU. The first stage corresponds to the examination whether the concerned undertaking has a dominant position on the relevant market. Then, at the second stage, the abuse under Article 102 TFEU will be found out. The division between these two constituent elements has to be strictly perseve otherwise business-related structural features can be used indiscriminately as an indication of market dominance and as an indication of abuse. This creates a possible fear, that power-related advantages are not distinguished from market-related advantages.<sup>212</sup> The structural conditions that are discussed in the context of the finding of dominance will be examined in the context of the behaviour of the alleged predator in order to find out whether with the predatory prices associated self-harm is rational.<sup>213</sup>

#### a) Identifying the relevant market and dominance

Essentially the criteria applied by the Commission and the Court correspond to those that Joskow and Klevorick apply to assess the market and corporate structure at the first stage of their proposed solution.

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<sup>211</sup> see under footnote 41: Joskow, P. L., Klevorick, A. K. (1979): p. 255

<sup>212</sup> see under footnote 16: Mestmäcker, E. J. (1984): p. 202

<sup>213</sup> see under footnote 16: Mestmäcker, E. J. (1984): p. 187



## 5.2.1. Determining of the relevant market and dominance

### 5.2.1.1. The definition of the relevant market

When defining the relevant market it can be drawn on the remarks in Chapter III. The delimitation has to be carried out not only according to the demand-side substitutability, but also should be competition-related. This point occurs particularly in many areas of the so called New Economy. Industries, such as the information technology (IT) industry are characterized by a high concentration, which is caused by high investment, coupled with high, poorly predictable risks. In addition, the competitors are despite the high concentration under unprecedented innovation pressure. The delimitation of the relevant market may not therefore occur only due to the current substitutability of products, but has to include the looming market changes (through research and development). As a result, a larger market as the relevant market may be regarded.

### 5.2.1.2. Dominance

Narrowing the analysis to the mere market share, as it is partially performed by the European Court of Justice, is completely unsatisfactory, as it provides, for the subsequent examination of the abuse allegation, no reliable decision support. This is important, because predatory pricing strategies are then especially promising when the behavior of the aggressor can not be unambiguously classified. The finding of market dominance should be placed on a broad basis as possible, so that at the end of the test of the market and corporate structure the important behavioral criteria are known.

Such criteria are essentially those one already mentioned in Chapter II, factors that indicate short-term monopoly power, market entry conditions and the vulnerability of the market dominance through dynamic effects.

In addition there are high market shares in conjunction with a high price elasticity of demand. High market shares indicate that the dominant undertaking, through drastic price reductions, has a strong influence on the price level of the particular product and through this can also force the competitors into the lost zone. However, this requires a correspondingly high price elasticity of demand.

#### 5.2.2. Abuse

The overall analysis usually allows assessing whether the market conditions and corporate structure are able to classify the predatory pricing strategies as promising. Unlike the proposal made by Joskow/Klevorick, the test will be not interrupted when the overall analysis leads to the assumption that predatory pricing strategies are to be seen as unlikely. The price behavior will be examined by the question of whether the dominant undertaking has acted abusively. The major inaccuracies and difficulties with determining of costs have been shown by the discussion of the Areeda/Turner rule. Therefore, the investigation of price-cost ratios should not be the crucial factor for the assessment of price behavior of a dominant undertaking. The development of price-cost ratios can give valuable informations. However, the result should be covered by the analysis of further significant price determining factors such as demand behaviour and market form.

The following cases can be distinguished:

(1) The outcome of the comprehensive analysis by the determination of market dominance shows that the market environment for predatory pricing strategies is promising: If the dominant undertaking is using prices below average total costs, there is a rebuttable presumption for the existence of a predatory strategy. In practice, the dividing line whether prices are above or

below the variable costs is sometimes not clear. A distinction between prices below variable costs and prices that are above the variable costs but below average total costs, with the result that different legal consequences have been mentioned with regard to it, should be therefore discouraged. The dominant undertaking can refute the presumption of predatory pricing strategy by the demonstration of objective justification reasons, such as have been mentioned in Chapter III.

(2) The result of the overall analysis shows that the market environment did not expect successful predatory pricing strategies or, that it can not be clearly established whether these conditions are met:

If we find out that the dominant undertaking has offered prices below average total cost, this finding alone is not enough to accept this practice as a predatory pricing. Rather, the Commission must prove, for example, by submitting documentary evidence that such prices were offered in a predatory intent. The documentary evidence has to prove the predatory intent of the dominant undertaking in which has offered prices below average total costs.

Also in this case the dominant undertaking should be allowed to provide objective justification reasons to demonstrate that it has applied no predatory prices.

(3) Costs, which are located above the average full cost, are generally not viewed as predatory. It is conceivable that the scenario described by the limit-price theory could exist in the real world. Nevertheless, some arguments are against an intervention, if the pricing of the dominant undertaking is not accompanied by other abusive behaviors.

It is not absolutely clear how to distinguish the predatory behavior from appropriate competitive prices, because the competitive price is not known,

and according to the limit-price theory even slight price reductions can hinder the market entry or new competitors.

### **5.3. Conclusion**

The phenomenon of illegal predatory pricing strategies of dominant undertakings has been demonstrated in theoretical models. Although it is often claimed that it was a rare phenomenon, the European law can not ignore it. The competitive effects of predatory pricing strategies contradict the mission of creating a fair competition in the internal market, and at the same time to respect the consumer interest.

The boundary line between permitted and encouraged predatory battle as an engine of competition and illegal predatory pricing strategies with help of the non-performance competition is difficult to identify. Allegedly simple rules, like the price-cost ratios established by Areeda/Turner, which the European Court of Justice has largely followed pose a risk in itself, that the efficiency-oriented competition will be not recognised. Therefore, no way leads around the comprehensive analysis, as presented in this Chapter.

The doctrine of predatory pricing on both continents records steady developments, and also the discussions about these topics are numerous. Therefore we can assume that any decision of the courts, eventually a high valuated scientific publication by a top ranked expert on competition law will stir up further debate on both sides of the Atlantic.

**Abbreviations:**

ATC	Average Total Costs
AVC	Average Variable Costs
CFI	Court of First Instance
DOJ	Department of Justice
DPAG	Deutsche Post AG
ECJ	Court of Justice
EU	European Union
IT	Information Technology
LRAIC	Long-Run Average Incremental Cost
RRC	Raising Rivals Costs
TFEU	Treaty about the functioning of the EU
TEU	Treaty of the EU
UPS	United Parcel Service
U.S.C	United States Code
US	United States

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