

PREDATORY PRICING

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I.	INTRODUCTION	2
A.	COMPETITIVE PRICING	2
B.	MONOPOLY PRICING.....	2
C.	STRATEGIC PRICING	2
1.	Limit Pricing	2
2.	Responses by Rivals to Strategic Pricing	3
II.	PREDATORY PRICING	4
A.	GENERAL THEORY OF PREDATION.....	4
1.	Types of Predation	4
2.	Economic Models Describing Predatory Pricing.....	5
B.	THE MEXICAN THEORY OF PREDATION.....	7
1.	Predation as a Rule of Reason Practice.....	7
2.	Elements.....	7
III.	ANALYSIS OF THE MEXICAN THEORY OF PREDATION.....	11
A.	CONCLUSION	11
B.	THE “BELOW-COST” PROBLEM.....	12
1.	Types of Cost Measures.....	12
2.	Short-Run v. Long-Run	16
3.	Fixed v. Variable Costs.....	16
4.	Choosing the Best Measure of “Cost”	17
5.	The Mexican Cost Benchmark	21
6.	Following in the European Steps	26
C.	THE RECOUPMENT PROBLEM	27
D.	THE COST-ALLOCATION AND CHARACTERIZATION PROBLEM	28
1.	Relevant Costs.....	28
2.	Indirect Cost Allocation.....	29
3.	Relevance on Cost of other Expenditures	29
4.	Parallel Accounting	30
5.	Additional Cost Characterization Problems.....	30
IV.	PREDATION IN PRACTICE: <i>POST SCRIPTUM</i>	33

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I. INTRODUCTION

Pricing is an extremely difficult and highly consequential exercise businesspersons have to undertake. To understand the choices available to rational businesspersons when pricing a product, the following landscape should be visualized: on one extreme we find a perfectly competitive firm. On the other extreme we find a monopolist. In the middle we find scenarios which allow for pricing decisions that seek not only immediate but ulterior goals. These are referred to as “strategic” pricing, and will now be discussed.

The following discussion assumes that all firms, whether perfect competitors, oligopolists, dominant firms or absolute monopolists, price in order to maximize profits.

A. COMPETITIVE PRICING

A perfectly competitive firm faces a horizontal demand curve. It is a price “taker” and, hence, has no control over the market price. The competitive firm can only charge the market price and increase its output to the point that its marginal cost equals price.

B. MONOPOLY PRICING

In contrast to a competitive firm an absolute monopolist faces a downward sloping demand curve and is not a price “taker”. Rather, it is a price “maker” who, to maximize its profits, need only equate its own short-run marginal cost and marginal revenue.

C. STRATEGIC PRICING

As explained, between the two poles mentioned above we find “strategic pricing” which is the result of factoring into the price decision-making process the options of the firm’s competitors with regards to prices or output.

Speaking of strategic pricing should not create the inference that said practice is inherently condemnable. A firm (oligopoly, dominant or otherwise) cannot realistically maximize its profits without giving consideration to the responses of its rivals (including potential ones), and maximizing profits is a legitimate goal. Strategic pricing will be deemed unlawful only when other factors are present.

Only strategic pricing that can be unlawful, although the majority is lawful. The issue is how to identify the types of pricing which should be sanctioned without chilling the aggressive, competitive pricing process competition law seeks to encourage.

1. *Limit Pricing*

In the realm of strategic pricing we find “*limit pricing*” which refers to the strategy pursued by a dominant firm when charging less than its short-run profit-maximizing price with the purpose of deterring entry by rivals. By carefully engaging in limit pricing a firm’s

immediate monopoly profit level will be lower but the monopoly will last for a much longer time or perhaps indefinitely.¹

Limit pricing seeks impairing the opportunities of rivals. If successful, it avoids competition from arising. In the absence of limit pricing, competition might ensue and force prices down.

This strategy could be deemed anticompetitive if its overall cost to consumers, or loss in allocative efficiency, is greater than would be the case under short-run monopoly pricing.²

2. *Responses by Rivals to Strategic Pricing*

The reactions that *actual* rivals can display to strategic pricing are either “hostile” price cuts, “compliant” price increases, or exiting from the market. The responses that *potential* rivals can manifest are entering the market, not entering, entering in a large scale, entering on a small scale, entering in a different market niche, and so on.

¹ Phillip E. Areeda and Herbert Hovenkamp. ANTITRUST LAW. AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION. Vol. III, at 318.

² Idem.

II. PREDATORY PRICING

A. GENERAL THEORY OF PREDATION

Predatory pricing is found within the strategic pricing universe. In its most orthodox form, predatory pricing relates to the practice of driving rivals out of business by selling at a price below cost. The predator will seek to eliminate rivals so as to charge monopoly prices after rivals have been driven from the market or effectively disciplined. The foregoing is deemed the only motive that can make predatory pricing a rational profit maximizing behavior.³

The notion that pricing too little may be unlawful could initially be considered an oxymoron since competition law is usually not concerned with setting a floor-price on competition; but rather the opposite. If monopoly or monopolistic behavior can pose competition concerns as a result of creating scenarios where pricing will be *higher* than that of the competitive scenario, why sanction low prices?

The answer of competition law is as follows. A firm that disciplines, excludes, or drives out competitors by selling at uneconomic prices is not competing on the merits. It is sacrificing present profits by means of non-remunerative prices as an investment to either destroy, discipline or intimidate rivals and then recoup its losses in the post-predatory pricing period by charging monopoly prices. For the behavior to be rational, prices must be sufficient to recoup the immediate losses from the predatory campaign, discounted to present value.⁴

1. Types of Predation

Judge Bork states that three types of predation exist:⁵ (a) price cutting predation; (b) predation by disruption of distribution patterns; and (c) predation by misuse of courts or other agencies of government. Each will now be briefly explained.

a. Price Cutting Predation

It requires predator to bear losses that are larger, both absolutely and proportionally, than those inflicted by the intended victim.

b. Predation by Disruption of Distribution Patterns

In any business, patterns of distribution develop over time which are reasonably believed to be more efficient than alternative patterns of distribution that do not develop. The patterns that do develop and persist may be assumed to be the optimal patterns. By disturbing optimal patterns of distribution one rival can impose costs on another forcing it

³ Herbert Hovenkamp, FEDERAL ANTITRUST POLICY. THE LAW OF COMPETITION AND ITS PRACTICE, West Publishing Co., St. Paul Minnesota, 1994, at 298.

⁴ Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, pgs. 221-223.

⁵ Robert Bork, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF, The Free Press, a Division of Macmillan, New York, 1978, at 148.

to accept higher costs. Should the additional costs be serious, the imposition of costs may conceivably be a means of predation.⁶

It is a more complex phenomenon of predation. It ranges from exclusive dealing (which is an extremely unlikely form of predation) to expulsion from cooperative business groups (e.g., boards of trade) a tactic which may enable predators to inflict losses that may not be larger than their own but so crushing as to be instantly and completely decisive.

c. Predation by Misuse of Courts or other Agencies of Government

This is particularly effective since complex business litigation can be very costly (both by legal costs and diversion of executive resources). The technique of driving a rival from the market by litigation can be particularly effective when a larger firm does so to a small victim since the costs will be proportionately higher.⁷

2. Economic Models Describing Predatory Pricing

The following economic models describing predatory pricing have been put forward:⁸

a. Game Theory

This model is based on a game-theoretical analysis based in asymmetries of information related to the costs of competitors and market conditions. Under the same predation may be more profitable and rational for certain firms than any other strategy.

b. Irrationality

This economic model is based on the assumption of perfect information. The options of a company with market power are either to purchase or merge with the competitor, or evict from the market by means of predatory pricing.

c. Asymmetry in the Funding of the Companies

This theory is based on the limitations that certain firms have in accessing capital. An alleged predator, in addition to having deeper pockets, knows its “victim’s” limitations and the victim will supposedly leave the market after the first credible threat of a predatory attack and avoid wasting resources in an unfruitful battle.

d. Predation Reputation

This theory is based in the relevant information that a predator has of its competitors. A firm with market power may be more aggressive when it considers that its costs are lower or equal to the costs of its potential competitors, and will tend to accommodate if it considers that its costs are equal to or superior than those of its competitors. Under this

6 Bork at 156.

7 Bork at 159.

8 Francisco Javier Soto Alvarez, LA DEPREDACIÓN DE PRECIOS COMO PRÁCTICA MONOPÓLICA, Informe de Competencia Económica, 1997, at 154.

model, reputation for aggressiveness is a factor that requires exploitation, and with which profits may be maximized.

B. THE MEXICAN THEORY OF PREDATION

1. Predation as a Rule of Reason Practice

Predatory Pricing under Mexican law is included as one of the practices contained in the general catch-all provision included in Article 10.VII of the FLEC., Article 10 of the FLEC includes the rule of reason practices under Mexican law. Hence, to establish liability for the same not only does the practice itself have to be evidenced, but the other anticompetitive elements must be established.⁹

2. Elements

I understand predatory pricing to mean pricing below one of two measures of cost by an economic agent with market power which purpose or effect is the driving another economic agent out of the market so as to engage in supra-competitive pricing once the objective has been achieved.

Hence, the Mexican ingredients for a predatory pricing recipe are:

- a) Pricing below one of the applicable measures of cost;
- b) By a firm with market power; and
- c) Which has the purpose or effect of driving a competitor out of the market.

These elements will now be discussed and the concept of recoupment will be touched upon in subsection d.

a. Below Cost Benchmark

i. Cost Measures Adopted

Pricing may be considered predatory when below any of the following two cost measures:¹⁰

- a) Habitual Sales: The systematic sale of goods or services at a price below their average total cost; or
- b) Secular Sales: The occasional sale for prices below average variable cost.

The Mexican Federal Competition Commission (“FCC”) has stated¹¹ that such practice involves pricing at levels lower than the profit maximizing level. Pricing at long-run

⁹ I will not elaborate on the specifics of the rule of reason analysis. Should the reader be interested on the topic, Chapter Two of the following book undertakes this task: Francisco González de Cossío, LAW AND ECONOMICS OF THE MEXICAN COMPETITION LAWS, University of Chicago, 2003.

¹⁰ Article 7.I of the FLEC Regulations.

¹¹ Although the topic has been addressed in several Annual Reports, the most helpful insights were provided in the 1995-1996 Annual Report when reporting the experience of a case that received much publicity and was baptized by the press as the “Bubble Gum War” (“*la guerra de los chicles*”).

unsustainable prices with the purpose of increasing its power after the predatory campaign has succeeded in eliminating rivalry.

Predatory pricing involves the partial profit sacrificing as well as the deliberate incurring of losses for economic reasons other than defensive ones, that is, injuring competition. The purpose of the profit sacrificing is the infliction of losses to competitors by means of pressures that abate their prices in order to run them out of the market. By doing so the predator increases his power as well as his ability to undertake other predatory maneuvers.

ii). Cost Characterization

To address the cost characterization dilemma the FCC has established accounting criteria to shed some light into how the same will be allocated in order to reach a workable “cost” definition.¹²

- Relevant Costs: Historic costs are considered and not only the standard costs used for internal purposes.
- Indirect Cost Allocation: In addition to internal accounting criteria followed by the firm, the FCC will favor an allocation of indirect costs by the share/proportion that the respective rate of return has in the sales costs, since the allocation of indirect costs by returns of total sales tends to hide predatory practices.¹³
- Relevance on Cost of other Expenditures: With respect to excluding other cost concepts from the accounting such as publicity/advertising or the chemical composition of a product, the FCC will evaluate and order expert studies in order to determine its feasibility. The FCC may use the independent studies provided by the investigated firm should it deem them trustworthy.

(Pages 58-63 of the 1995-1996 Annual Report). The investigation began in June 1994 as a result of the claim brought by Chicles Canel's, S.A. de C.V. against Chicles Adams, S.A. de C.V. that the goal of Adams' price policy was to run Canel's out of the market. The FCC concluded that: (1) Canel's case did not unambiguously support the notion that predatory pricing had taken place; (2) the record displayed an intense price competition and an aggressive defensive pricing policy by plaintiff; and (3) predatory prices are those that are unsustainable in the long-run and imply the displacement of competitors. (page 60 of the Annual Report). In this context, I should confess the involvement of my firm in such case on behalf of defendant, including my partial involvement in the same.

¹² Annual Report, 1994-1995.

¹³ This point was restated in the second phase of the Bubble Gum War which involved an *ex officio* investigation (“Informe de Competencia Económica” (“Competition Report”), 1997, at 74). The FCC restated that the allocation of costs should be made between sales costs noting that it did not intend to disqualify other generally acceptable accounting methods nor does it imply an opinion as to their technical accurateness; however, it did note the “incongruence” of allocating indirect costs in terms of sales shares, price per product and prices unrelated to the sum of costs and profits.

- **Parallel Accounting:** The FCC noted the convenience of following a parallel accounting to the normal one using the allocation criteria. When assessing the existence of possible predatory pricing, the FCC will only except from the general rule cases where special reasons exist to determine that other means of allocation are more appropriate for the type of expenses.¹⁴

b. Market Power

A necessary element to be present is that the alleged predator must have market power in the relevant market. Otherwise, the objective of the practice would be economically unfeasible, self-defeating and would not trigger liability for want of meeting the legal elements of the practice.¹⁵ Sufficient strength of the predator to support the losses or reduction in profits as well as the ability to inflict losses to its competitors with less sacrifice to itself must be present in a predatory scheme.

Structural Factors: The existence of factors which delay entry or exit or make it more costly for actual or potential competitors amongst which sunk costs are found. Predatory pricing is usually accompanied of other actions that reinforce it, such as the invasion of intellectual property rights, purchasing competitors, establishment of barriers to sources of supply, etc.

The FCC has made it clear that the existence of the mentioned characteristics does not per se lead to liability. Rather, such elements will be carefully analyzed during the investigation period since they are closely related to such practice. Additionally, the determination of “intent” would be an additional factor in the predatory assessment.

In the 1996 Annual Report states that the FCC followed six predatory pricing investigations. In such context the following criteria was pronounced: “sales ...at prices lower than international levels does not necessarily relate to predatory pricing. Predatory pricing requires, at least, that (1) prices be consistently below long-run average total costs, and (2) that the alleged predator engage in losses.”¹⁶

¹⁴ The FCC may be consulted for cases in which the assessment could be different from that obtained from sales costs.

¹⁵ Chapter IV, Monopolistic Practices and other restrictions to competition (Prácticas Monopólicas y otras restricciones a la competencia). Section 2.5 (Otras Prácticas Monopólicas Relativas). Application of Section VII, Article 10, of the FLEC, at 72.

¹⁶ Vidrios y Cristales Industrializados, S.A. de C.V.; Vidrios Marte, S.A. de C.V. y Espejos Nacionales, S.A. de C.V. vs. Vidrio Plano de México, S.A. de C.V.; Vidrio Flotado, S.A. de C.V.; Vidrio Plano, S.A. de C.V. y Distribuidora Nacional de Vidrio, S.A. de C.V. Competition Report, Second Semester, 1996, at 45.

c. Competition Injury: Driving a Rival Out of the Market

In the 1997 Annual Report the FCC stated that below cost sales will be considered predatory when the economic agent armed with market power seeks the illegitimate¹⁷ displacement of other economic agents from the market and it injures competition in the production, processing, distribution and marketing of goods and services.¹⁸

d. Recoupment

Recoupment is not part of the definition included in the relevant parts of the statute and the researched cases do not shed much light as to the relevance of the concept and how material the finding has been considered in a predatory practice investigation.

Within the context of clarifying the FCC's position on the matter, a Commissioner of the FCC has explained that "predatory pricing consists in a price reduction not based in costs with the purpose of eliminating a competitor and then being able to substantially increase prices above cost".¹⁹ No mention of recoupment was made.

An article published in the 1997 Annual Report, stated that recoupment is an element of predatory pricing²⁰ and explained that the market structure and barriers to entry must allow for recoupment of the costs incurred in the predatory campaign. The ability of obtaining supra-competitive profits, once the objective has been met, must be present.

Accordingly, the current letter of the law and its application reveal that the element of recoupment, so important in other jurisdictions,²¹ has received little –if any– attention under the Mexican competition regime. The Mexican approach seems to emulate the European version of the predation offence which does not incorporate the recoupment element but leaves the door open to doing so.²²

17 The Spanish word used is "*indebido*" which could also be translated as "inappropriate". I have chosen the word "illegitimate" in lieu of "inappropriate" because in my opinion it is better suited to convey the legislative intent of using "*indebido*", which is that rivals are driven out of the market by reasons that differ from sound competition/efficiency ones, namely predatory intent.

18 Chapter IV, Monopolistic Practices and other restrictions to competition (*Prácticas Monopólicas y otras restricciones a la competencia*). Section 2.5 (*Otras Prácticas Monopólicas Relativas*). Application of Section VII, Article 10, of the FLEC, at 72.

19 Dr. Pascual García Alba Iduñate, FUNDAMENTOS ECONÓMICOS DE LAS RESOLUCIONES DE LA COMISIÓN FEDERAL DE COMPETENCIA, Competition Report, Second Semester de 1996, pgs. 106-107.

20 Francisco Javier Soto Alvarez, LA DEPREDAÇÃO DE PRECIOS COMO PRÁCTICA MONOPÓLICA, Competition Report, 1997, pgs. 147-164. The factors are set forth in page 164.

21 Some U.S. courts require proof of recoupment as a key component of the offence of predation (e.g., *Matsushita v. Zenith Radio* (475 US 574 (1986)), *AA Poultry Farms Inc. v. Rose Acre Farms Inc.* (881 F 2d 1396 (1989), *Brooke Group v. Brown Williamson Tobacco* (509 US 209 (1993))).

22 In *AKSO v. Commission* (Case C-62/86 [1991] ECR I-3359, [1993] 5 CMLR 215) the European Court of Justice acknowledged the significance of recoupment (para. 71) but did not incorporate the same as part of the offence. The case involved the review of the European Commission's holding in *ECS/AKSO* (OJ [1985] L 374/1, [1986] 3 CMLR 273) that AKSO had abused its

III. ANALYSIS OF THE MEXICAN THEORY OF PREDATION

A. CONCLUSION

The Mexican version of predation is defective. The current legislative and administrative approach to the same is overbroad and discourages the type of healthy competitive process the statute was designed to encourage.

Predatory pricing has posed a policy dilemma on all jurisdictions that have addressed the issue; namely, whether a rule can be tailored which adequately addresses the predatory pricing problem without chilling legitimate price competition. The law must tread a fine line between condemning competitive responses by dominant firms, on the one hand, and sanctioning exclusionary behavior, on the other. Unfortunately, the Mexican answer trips in the same stones other jurisdictions have succumbed to and which have been criticized for decades.

In all fairness, the rule adopted reflects legislative prudence as well as confidence in the FCC's ability to detect anticompetitive conduct and weed out anti-competitive behavior from pro-competitive pricing. I believe such confidence is misplaced. Not for lack of ability of such governmental body, but because of the overall difficulty of correctly spotting such conduct without deterring pro-competitive conduct. I agree with Judge Posner's²³ and Bork's²⁴ suggestion in the sense that, although the conduct cannot be dismissed as irrational, given that the frequency of such conduct is questionable, the probability of mistake (because of difficulty of the problem), the consequences of the same (incorrectly classifying as predatory normal competitive behavior), and chilling effect on pro-competitive conduct, should argue in favor of a high standard.

A mitigating circumstance is that the pro-competitive/anti-competitive assessment the FCC carries out would seem to lessen the likelihood of an erroneous resolution by the FCC since, even though a firm's pricing policy could fit the predatory definition, it could always argue that the circumstances of the case result in an overall pro-competitive outcome and escape liability.

dominant position when it threatened ECS to withdraw from selling to the newly entered polymer industry or AZCO a Dutch firm with a dominant position in the benzoyl peroxide market would reduce its prices so as to harm it and later fulfilling its threat. Also, in *Tetra Pak II* (OJ [1992] L 72/1 [1992] 4 CMLR 551) the ECJ, in upholding that Tetra Pak was guilty of predatory pricing, refused to require proof of recoupment in the circumstances of the case since it believed it must be possible to penalize predatory pricing whenever there is risk that competitors will be eliminated. The case was a review of *Tetra Pak International SA v. Commission* [1996] ECR I-5951, [1997] 4 CMLR 662). (Richard Whish, COMPETITION LAW, Butterworths, Fourth Edition, 2001, pgs. 646-652.)

²³ Richard A. Posner, ANTITRUST LAW. AN ECONOMIC PERSPECTIVE, The University of Chicago Press, Chicago and London, 1976, at 186.

²⁴ Bork at 157.

In my opinion the law would have been well advised in using a higher threshold.

The problems of the theory of predation under Mexican law are that: (1) the price threshold for a sale to be deemed predatory is too low, making suspect many economically justified pricing; (2) the recoupment requirement is ignored, as a result, pricing which is most likely competitive or pricing policies which should be ignored *are* sanctioned; and (3) the cost characterization and allocation criteria of the FCC erroneously invites *ex post facto* second-guessing by the FCC of the firm's business and accounting decisions.

I will discuss the problems identified above in the order mentioned.

B. THE "BELOW-COST" PROBLEM

Most scholars and competition authorities agree that predatory pricing involves pricing below an appropriate measure of "cost" (with some additional factors). The issue lies in what is the appropriate measure of "cost".

The two measures adopted by the Mexican statute (average total cost for habitual sales and average variable cost for secular sales) are too low. As a result, economically justified pricing may become actionable. To counter such source of potential liability firms are forced to charge higher prices than their costs and the market structure allow for in order to avoid liability.

A glance at the theory of costs is necessary to understand the problems surrounding the definition of predatory pricing as well as the definition adopted by the Mexican competition laws.

1. *Types of Cost Measures*

As a general matter the cost of a product depends on the prices of production and the output level. Also, production processes may have properties, such as economies of scale or economies of scope, that influence the final cost of a product.

Diverse standards/types of measures of costs exist which will now be defined.

a. Total Cost

Total cost is the sum of fixed costs and variable costs: $C=F+VC$.²⁵

b. Variable Cost

Variable costs are costs that vary with changes of output. Typically, as output increases so does the need for raw materials, labor, electricity, etc. and so variable costs depend on the wages and prices that a firm must pay. It is usually illustrated as a function of output: $VC(q)$.²⁶

²⁵ Dennis W. Carlton, and Jeffrey M. Perloff, MODERN INDUSTRIAL ORGANIZATION, HarperCollins College Publishers, Second Edition, 1994, at 51.

²⁶ Carlton and Perloff at 51.

c. Marginal Cost/Incremental Cost

Marginal cost (also known as *incremental cost*) is the increment of total cost that results from producing an additional unit of output.²⁷

It generally refers to “short-run” marginal cost which is a function of variable costs since fixed costs, by definition, are costs unaffected by changes in output.

Short-run marginal cost usually decreases over low levels of output and increases as production approaches plant capacity. If variable costs are strictly proportional to output, marginal cost will equal average variable cost at all outputs. If not, marginal cost will be lower than average variable cost at some (usually low) outputs and higher at other (usually high) outputs. To state this otherwise, when per unit variable costs are falling, marginal cost is below variable cost; when per unit variable costs are rising, marginal cost is above variable cost.²⁸

It is important to distinguish between marginal cost and the various concepts of average cost, which shall now be defined.

d. Average Total Cost

Average Total Cost (“ATC” □ also known as *Average Cost* (“AC”) and *full cost*) is the result of dividing of *total cost* (the sum of fixed costs and variable costs) by output ($ATC=C(q)/q$).²⁹

Average total cost is higher than average variable cost at all outputs and will usually be below marginal cost at very high levels of output, when the plant is strained beyond efficient operating capacity.³⁰

Even though marginal cost is independent of fixed costs and average cost is not, it is *not* necessarily true that at any given output level marginal cost is less than average cost. The reason that marginal cost may exceed average cost is that marginal cost refers to *changes* in cost, not to levels.³¹

A firm which prices at least at ATC is completely profitable; it is able to cover and replace the fixed portion of its investment. Insofar as “cost” also includes a sufficient return to attract capital into the market, such a firm is also paying at least competitive dividends to its shareholders or reinvesting a like amount as well as paying the required debt service.³²

²⁷ Carlton and Perloff, pgs. 51-52.

²⁸ Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, at 320.

²⁹ Carlton and Perloff at 52.

³⁰ Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, at 321.

³¹ Carlton and Perloff at 52.

³² Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, at 394.

e. Average Variable Cost

Average Variable Cost (“AVC”) is the sum of all variable costs divided by output:
 $AVC=VC(q)/q$.³³

f. Average Fixed Cost

Average Fixed Cost (“AFC”) is fixed cost divided by output: $AFC =F/q$.³⁴

g. Fixed Costs

Fixed costs are those that do not vary with output.³⁵ The only way they can be avoided is by shutting-down.

h. Sunk Costs

Sunk costs are the portion of fixed costs that are not recoverable. As stated by Professors Carlton and Perloff, they are like spilled milk: once sunk they should not be worried about and should not affect subsequent decision-making.³⁶ They are bygones and, since they are past and irreversible outflows, should be ignored for purposes of taking financially accurate decisions so as to avoid the “sunk-cost fallacy”.³⁷

The following graph³⁸ and table³⁹ might assist in visualizing the different measures of costs and their relationships:

33 Carlton and Perloff at 52.

34 Idem.

35 Carlton and Perloff at 51.

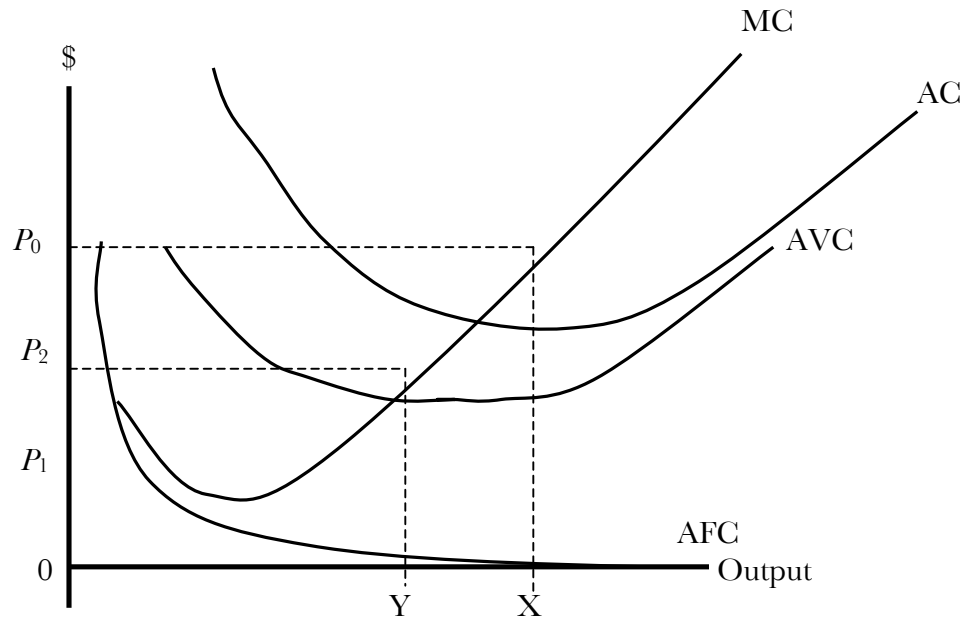
36 Also, Richard A. Brearley and Stewart C. Myers, PRINCIPLES OF CORPORATE FINANCE, McGraw Hill, 1996, at 115.

37 Idem.

38 Graph borrowed from Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, at 321.

39 Carlton and Perloff at 53.

Comparison of the Different Measures of Cost



Marginal cost (MC) is equal to average variable cost (AVC) when AVC is at a minimum and is equal to average cost (AC, or ATC) when AC is at a minimum.

Comparison of Different Measures of Cost

Output	Fixed Cost	Average Fixed Cost	Total Variable Cost	Average Variable Cost	Total Cost	Average Total Cost	Marginal Cost
0	100		0		100		
1	100	100	10	10	110	110	10
2	100	50	19	9.5	119	59.5	9
3	100	33.3	25	8.3	125	41.7	6
4	100	25	32	8.0	132	33	7
5	100	20	40	8.0	140	28	8
6	100	16.7	49	8.2	149	24.8	9
7	100	14.2	60	8.6	160	22.9	11
8	100	12.5	73	9.1	173	21.6	13
9	100	11.1	88	9.8	188	20.9	15
10	100	10	108	10.8	208	20.8	20

2. *Short-Run v. Long-Run*

In economic argot *short-run* is the time period during which a firm does not change its fixed-cost productive assets (e.g., an industrial plant) or they cannot be changed costlessly. In contrast, *long-run* relates to the time period over which all costs become variables and a firm can modify even its most “fixed” costs (e.g., selecting plant size); i.e., production factors can be varied costlessly.⁴⁰

The short-run/long-run characterization also bears relevance in the profit maximizing context since profit maximizing can also be distinguished according to time. The *short-run profit-maximizing price* will be the one set at the intersection of marginal cost and marginal revenue and will maximize monopoly profits in the immediate sale. Whereas *long-run profit-maximizing price* will be a lower price which deters entry by potential rivals or expansion by actual ones. By doing so a monopolist will trade away volume of immediate profits for a longer duration of monopoly profits.⁴¹

3. *Fixed v. Variable Costs*

The difference between fixed and variable is conceptual and no single period distinguishes them.

⁴⁰ Carlton and Perloff at 55.

⁴¹ Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, at 319.

Which costs are fixed and which are variable (and therefore marginal) is a function of the magnitude of the contemplated change in output and time.

Depending on the range of the output considered will the costs vary and a definite rule cannot be established. By way of example, other things remaining unaltered, as output reaches plant capacity costs usually diminish. As output surpasses the peak equilibrium point, costs tend to increase again. Hence, the influence output bears on costs is subject to a case by case analysis.

Also, full cost includes a reasonable return for the capital invested and estimating the reasonable costs of obtaining capital or the opportunity cost of using it is often intractable.⁴²

More costs become variable as time period increases. In the long run, all costs are variable⁴³ and almost no costs are variable in the very short run (e.g., the next few hours).

The above is complicated by the fact that, empirically, the durability of plant equipment varies even within a single firm.

As a result of the foregoing, and the important lesson to grasp for purposes of the topic being considered, is that *allocating costs among a firm's several product lines is arbitrary*.

The ATC and AVC standards may not always be appropriate. Some industries carry very high fixed costs with low variable costs. Take, for instance, the telecommunications industry where original infrastructure investment is enormous, but, once laid, the actual cost of a phone call is very low, almost as low as zero.⁴⁴

Economies of scale arise when average costs decline as output increases. Economies of scope occur where average costs are lower if two or more products are produced jointly: certain costs are common to a range of products.

4. Choosing the Best Measure of "Cost"

Having reviewed the laundry-list of measures Cost Theory provides, the question now becomes which is the most appropriate measure to fit the predatory pricing benchmark.

The answer should be determined by *what a rational businessperson would do in order to maximize profits*. The profit-maximizing or loss-minimizing output price for any firm is that where any increase in output would add more to costs than to revenues and any

⁴² Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, at 386.

⁴³ Hence, in the long run, long-run marginal cost and full cost will be the same when technology is constant.

⁴⁴ Richard Whish, COMPETITION LAW. Butterworths, United Kingdom, Fourth Edition, 2001, at 651.

decrease in output would reduce revenues more than costs.⁴⁵ Put otherwise, a firm, when deciding whether to increase or decrease output, will analyze the incremental effects on revenues and costs.

The question now is which cost measure achieves the goal described in the preceding paragraph. The answer is *marginal cost*.⁴⁶

The foregoing due to the simple fact that a rational firm, acting with the sole purpose of optimizing profits or minimizing losses, would not negate a sale at marginal cost insofar as it means more revenue to compensate for fixed overhead and, as explained before, sunk costs are like spilled milk, they should not alter subsequent decisions.

To illustrate the point, the following examples should prove helpful. Take the airline industry. Once fixed costs have been covered (e.g., the plane, fuel, crew, and so on) filling the remaining seats imposes very little additional costs (perhaps just the peanuts and paper ticket). Hence, selling such seats at below ATC or AVC is rational insofar as it provides for additional revenue. A rule condemning selling as explained would force the airline to inefficiently fly with the seats empty.⁴⁷

As another example take a bakery which marginal cost for an additional loaf of bread might be, say, 0.10¢ if it avoids factoring into the price the rent for the premises, cost of the oven, etc. (which would presumably have to be considered in the presence of an ATC standard), but just the flour and a small amount for labor (i.e., only marginal ingredients). Forcing the bakery to price above such price because it happens to be the only bakery in town (and, hence, for purposes of the example, I will assume it has market power) would only force consumers to pay a price higher than the one the bakery would have originally chosen.

Under a perfect competition scenario a firm maximizes profits (or minimizes losses) by producing the output at which marginal cost equals the market price.⁴⁸ The foregoing since it is a price “taker” and will therefore accept the price as given since any variations of its own output are too small to change market price.

45 Also, to determine which of the different cost categories is best suited to fit the concept of “below-cost” for purposes of the predatory price definition, it helps to ask what costs are relevant to a firm that seeks to maximize profits or minimize losses.

46 Because fixed costs do not vary with changes in output and are therefore irrelevant to a determination of the profit-maximizing or loss-minimizing output.

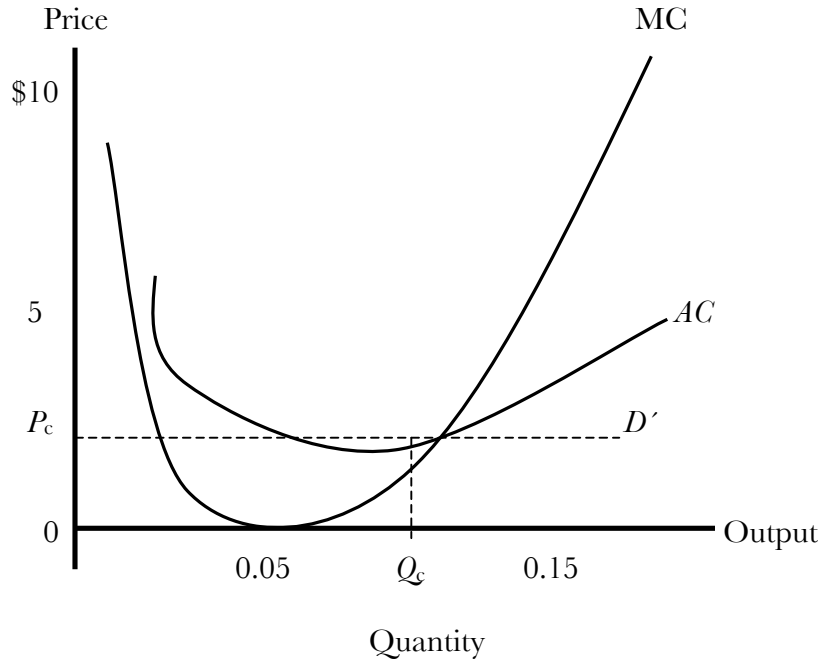
47 Of course many (even obvious) economic and pricing strategy arguments may be advanced against the result I may have apparently (yet unintendedly) suggested: selling a plane-fare at the cost of peanuts and paper ticket plus a slight spread to account for profit. I will not do so. They are obvious and irrelevant to the message I wish to convey.

48 Should the market-clearing price be below average variable cost at all levels of output, the firm can minimize losses by ceasing operations.

The beauty of the preceding situation is that under competitive conditions an efficient allocation of resources takes place since the market price will mirror what consumers are willing to pay for the last unit of output.

The following graph illustrates the profit-maximizing price for a competitive firm:⁴⁹

Description of Profit Maximizing Price of a Competitive Firm



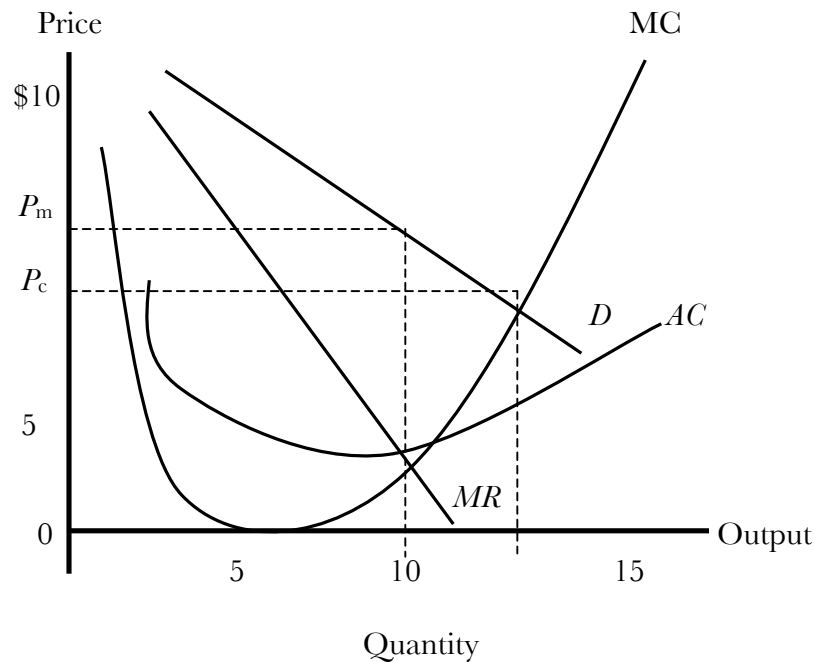
In contrast to the market outcome, a monopoly firm faces a downward sloping demand curve and any increase in output will reduce the market price. Therefore, any incremental revenue to the monopolist from producing an additional unit is the lower price received for such unit, minus revenue lost from selling all other units at the lower price. Accordingly, for the monopolist marginal revenue is always below *its* profit maximizing price. The output at which marginal cost equals marginal revenue will generate a price that exceeds marginal cost.

The monopolist's price is hence higher and output lower than the social optimum.

⁴⁹ Borrowed from Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, at 326.

The following graph faces the options of a monopolist:⁵⁰

Description of the Options of a Monopolist



Having argued in favor of the use of marginal cost as the appropriate “cost” benchmark, in all honesty I should point out that its use presents two serious problems:⁵¹ (i) the elements to be included in marginal cost are not always clear; and (ii) the incremental cost of making and selling the last unit is not readily derived from conventional business accounts showing no more than observed variable costs.

Although it would appear that I have argued myself into a corner, I find a solution to this conundrum in the suggestion made by Professors Areeda and Hovenkamp of using AVC as a surrogate for marginal cost.⁵²

The solution proposed for such problem by Professors Arreda and Hovenkamp is to exclude from variable (and hence marginal) costs the following: (a) capital costs (interest on debt and opportunity cost of share capital) attributable to investment in land, plant and equipment; (b) property and other taxes unaffected by output; and (c) depreciation on

⁵⁰ Idem.

⁵¹ Id. at 376.

⁵² Id. at 377.

plant (the life of which is little affected by use). According to Arreda and Hovenkamp inclusion of all other costs as marginal seems reasonable.⁵³

Using AVC as a (real life) proxy for the theoretical concept of ‘marginal cost’ would align theory with practice and provide for an adequate “cost” benchmark.

5. The Mexican Cost Benchmark

By choosing ATC for habitual sales and AVC for secular sales the FLEC Regulations forbid too much.

As stated before, pricing below such standards/benchmarks can be rational and profit maximizing (or loss minimizing). Yet by adopting such rule the FLEC Regulations have cast a shadow of suspicion on pricing which economic analysis justifies and puts a firm in the position of having to justify the pro-competitive results of its pricing policy. In my opinion, this is the wrong approach to the issue.

When in doubt, competition rules should be tilted in favor of *laissez-faire*; not in favor of intrusiveness.

The current rule is that prices under the referred standards by a firm with market power which have the effect of driving competitors out of the market will be considered predatory unless the pro-competitive consequences outweigh such result. I believe the onus should not be on the alleged predator. Granted. The possibility that a pricing policy below the referred thresholds will actually result in liability only materializes after a pro-competitive/anti-competitive assessment. However, the problem is not such outcome but rather that a firm that wishes to behave in a conservative manner will seek safe-harbors and, when pricing, it will need to price in a manner that reduces the benefits of economies of scale, efficiencies and competitive behavior. To make matters worse, the FCC will second-guess the cost characterization followed by a firm and *may* include historic costs into the equation. The result of this is not only that a firm will have to price above ATC or AVC, as the case may be, but will have to do an estimate of such thresholds which might be contrary to the *ex post facto* belief of the FCC. This combination spells inefficiencies and legal uncertainty for firms.

Also granted is the fact that the Mexican approach seeks to be prudent by being overinclusive and after following the pro/anti-competitive assessment it will be in a position to exercise its discretion and, depending on the circumstances of the case, decide whether it is appropriate to sanction or not.

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Even after considering such circumstances, I cannot agree with the approach taken. It does not persuasively rebut the predicament in which it puts firms which seek to price in a competitively-healthy and aggressive manner.

53 Idem.

The result of stating such a low cost-benchmark are: (i) it provides a safe harbor which lessens the benefits of efficiencies, economies of scale and healthy competitive behavior; and (ii) it attracts litigation. Such a high threshold coupled with the Monday-morning-quarterbacking the FCC will follow when faced with a competitor driven off the market will probably signify fines to firms which happen to have a dominant position in a market.

I believe the rule should have been drafted in the reverse manner. The threshold should have been marginal cost pricing, or equivalent proxies, such as the Areeda/Turner/Hovenkamp⁵⁴ average variable cost surrogate or the Posner⁵⁵ balance-sheet proxy.

The reasons for my position are twofold. First, and as I have already mentioned, I believe competition rules should follow an “exception approach”. That is, *a competition rule prohibiting certain behavior should be established only when it has clear and unambiguous social and economic reasons supporting it and the costs of implementation do not outweigh the benefits*. Second, the economic and legal theory of predatory pricing is still controversial⁵⁶ and the social costs

54 Idem.

55 Judge Posner proposes that sales below average accounting or balance-sheet cost is a tolerable proxy for predation and defendant would have to allocate its costs between the market in which it was allegedly predating and its other markets. (Posner, ANTITRUST LAW, at 190.)

56 A recent empirical study was made which concludes that the general skepticism regarding predation is justified. (John R. Lott, Jr. ARE PREDATORY COMMITMENTS CREDIBLE? WHO SHOULD THE COURTS BELIEVE? The University of Chicago Press, Chicago and London, 1999. Conclusion at 120.). Professor Lott argues in favor of the suspicion that, what some suspect to be predation, is nothing more than the “give-and-take” of normal competition (Lott at 16.). To come to such conclusion the following was analyzed: (a) Theoretical assumptions behind game theoretic models when applied by private firms (Lott finds that no evidence exists that the assumptions underlying several models of predation are empirically tenable. Quite on the contrary, the evidence justifies the court’s skepticism of game-theoretic models. (Lott at 59)); (b) The assumptions made by several economists’ models (e.g., Milgrom and Roberts (1982), Kreps and Wilson (1982), and Tirole (1990)); (c) Managerial preferences including managerial entrenchment (The argument that firms that supposedly engage in predation raise managerial compensation when short-run profits rise is difficult to reconcile with any notion of predation (Lott at 59). For managerial commitments to be credible, the firm’s contractual and non-contractual environment should make it difficult to remove them (otherwise they would be removed during the predation campaign for losses). Also, the incumbent’s management should be rewarded for increasing output as opposed to increasing short-term profits. Lott found no evidence that firms accused or convicted of predation obtained greater return to entrenching their managers. On the contrary, these firms were more likely to link management salaries to short-term profits. Such linkage between salaries and profits makes it more costly for a manager to sell output below cost as required by predation (Lott at 120). Significantly, none of the alleged predators in the 1963-1982 period were rewarded, there is little evidence supporting the notion that said management was more entrenched than other firms’. Moreover the alleged predators are more often large firms with managerial compensation schemes relying heavily on short-term profits. Such firms also tended to be located in states without antitakeover laws (Lott pgs. 59-60).); (d) Reputational models; including creating a reputation for toughness, and games where there are no last periods; (e) Reputational models regarding opponent’s perceptions of a predatory firm’s objectives; and (f) The asymmetrical information assumption in the sense that predatory firms are usually believed to have better access to informational advantages. Interestingly, Lott concludes that creating a

of an over-reaching rule and its erroneous implementation can be huge. Therefore, if the matter was to be regulated at all,⁵⁷ at least a *pro-laissez-faire* rule should have been adopted.

Since I have argued in favor of either the Areeda/Turner/Hovenkamp or the Posner approach, I will summarize the same.

a. Average Variable Cost as a Surrogate for Short-run Marginal Cost

Professors Areeda, Turner and Hovenkamp⁵⁸ believe short-run marginal cost to be the best cost frontier between predatory and non-predatory prices. Such concept consists of the added direct cost of producing an additional unit plus an amount equal to includable per unit use depreciation.⁵⁹ However, because it is very difficult to measure they propose that average variable cost be used as a surrogate. AVC is not identical to MC. When variable costs are declining, AVC is higher than MC. When variable costs are rising, AVC is below MC. However, if variable costs are constant in the relevant range, then in such range AVC and MC are equal.⁶⁰

MC will be less than AVC whenever unit variable cost declines as output expands. AVC will typically exceed marginal cost when a plant is operating below efficient use of

reputation to predate can be self-defeating to the extent that the secondary financial effects in the form of trading profits deriving from entry and competition by potential rivals will encourage entrance more than it will prevent it (Lott at 115). This because of the existence of rules which allow trades where one company takes a position in another on the basis of material and non-public information of the former (Lott at 126). Put simply, since executives of a potential rival are in an informational unique position they can make profits from trading in the predator's stock variation resulting from the before and after entry fluctuation. They can do so because they can count on the reputed predator from engaging in such conduct, and because the Securities laws prevent trading in one's own firm's securities but not other firm's securities. (See in general, Chapter Five of Lott).

57 Which is not a necessary answer. For instance, Judge Bork believes that a rule against predatory price cutting will probably do more harm than good (Bork at 386). I am more persuaded by judge Posner's pragmatic view that such rule should exist but should not be so stringent (Posner at 190).

58 Their position is expounded in Phillip Areeda and Donald Turner, PREDATORY PRICING AND RELATED PRACTICES UNDER SECTION 2 OF THE SHERMAN ACT, 88 Harvard Law Review 697, (1975); and Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, at 378.

59 Areeda and Hovenkamp. ANTITRUST LAW, Vol. III, at 378.

60 Pausing to reflect on this assertion is warranted. To illustrate the relation between AVC and MC the following example should prove useful. Suppose that as persons are walking in a room, they are being weighed by two individuals. The first writes down its weight and adds it to the weight of the persons that entered the room before her. The second person computes the average weight. As the fourth person walks into the room it turns out that the average weight is 200 pounds. A fifth ("marginal") person walks in and weights 220 pounds. The average weight will increase to 204. Alternatively, imagine such fifth individual had weighed 120 pounds. The average will decrease to 184. However, if the fifth individual had weighed 200 pounds, the average weight would have remained unchanged. As long as average weight remains constant at 200 pounds as people walk into the room, the "marginal" rate will remain at 200 pounds. (This example was inspired by a similar one in Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, at 379.)

capacity. This makes predation easier to show in excess capacity conditions. In this region, AVC is correct in principle and not only as a proxy of MC. Under these conditions a firm that sells at a price below AVC is not minimizing losses, it would be cheaper to simply shut down.⁶¹

Capacity also plays an important role in the accuracy of using marginal cost and the AVC surrogate. When capacity is excess (which is any output lower than the competitive level of production $\leq Q_c$), some of the firm's prices may seem lower than AVC and nevertheless be competitive. Particularly when: (i) the firm has some ability to price discriminate; and (ii) a firm has the opportunity to make a low price sale out of the unused capacity.⁶²

Areeda and Hovenkamp sustain the view that no price equal to or exceeding properly defined marginal or incremental cost should ever be deemed predatory or unlawful.⁶³ Although non-predatory justifications exist for pricing below AVC,⁶⁴ Areeda and Hovenkamp conclude that prices below average variable cost are ordinarily irrational since they are neither profit maximizing nor loss minimizing. Therefore, when certain structural requirements are met, said prices carry a strong presumption of unlawfulness and can be condemned without evidence of intent.⁶⁵

61 Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, at 381.

62 Under excess capacity a price can be above marginal cost and lower than ATC. By contrast, at outputs above Q_c , any price above marginal cost would also be above ATC. (Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, at 394.)

63 Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, at 367. Moreover, some prices below marginal cost are economically justified and hence should be lawful those that are unambiguously above the defendant's ATC and hence fully profitable. As a rule of thumb, prices below marginal cost will involve a predatory or exclusionary practice which is unlawful when certain structural conditions are met. The exception to this rule is when below-marginal-cost price is equal to or higher than average total cost. This would be a rare situation since production would be wasteful whether or not it exceeded average cost. Hence, this scenario is likely to seldom occur. However, without the defense unwarranted suits would be galloping. Also, prices above ATC are fairly easy demonstrable in contrast to marginal cost, which is extremely hard to prove. Hence, prices above ATC should be regarded as a safe harbor. Inframarginal cost pricing above ATC occurs when the monopolist exceeds the level at which its average total costs are minimized because marginal cost rises above average total cost only at high levels of output. Marginal cost is below average cost when the monopolist possesses excess capacity. Only then will the monopolist's marginal cost price deprive equally efficient rivals—actual or potential—of “normal” returns on their capital (Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, at 369.). A price equal to or exceeding the monopolist's AC cannot ruin equally efficient rivals or entrants.

64 Namely: (i) shutting down imposes collateral costs higher than cost of continuing production below AVC; and (ii) a firm may be starting up and anticipating reaching production levels that will bring its price to remunerative levels.

65 Areeda and Hovenkamp. ANTITRUST LAW. Vol. III, at 363. The only exceptions are: (i) meeting competition; (ii) when the cost of shutting down and restarting are even higher; (iii) prices below cost as a result of time lags or information failures which, although the firm intended to set at above AVC, result in a different outcome. For instance, trying to service clients which need to know prices for a period of time well in advance of all information being available and then the

Bork criticizes the Areeda/Turner AVC test on the grounds that true AVC costs cannot be reconstructed adequately from business records in a firm of any complexity. Areeda and Turner seem to discuss plant-level costs which, although themselves troublesome, do not equate to the entire firm costs, which, especially in a multiproduct plant or multiplant firm, become extremely difficult to estimate and allocate. Hence, there is a high probability that the costs that the law uses are mistaken and the harassment by government authorities and plaintiffs will harm consumers by inducing non-competitive price behavior.⁶⁶

Judge Posner criticizes the Areeda/Turner/Hovenkamp sales below short-run marginal cost rule since they reason that for short-run marginal cost to be lower than long-run marginal cost means that the market has excess capacity, in which case market price should be set equal to short-run marginal cost in order to discourage the replacement of productive capacity as it wears out and so eventually eliminate the excess. In Judge Posner's opinion such reasoning, while orthodox, overlooks the fact that most firms have some reserve capacity either deliberately—in order to meet unexpected peaks in demand—or unavoidably—because of lumpiness of assets. In either event, short-run marginal cost will be lower than long-run marginal cost until that unused capacity is taken up by the expansion in output.⁶⁷ In the short-run marginal cost does not include interest, rent, depreciation, and other overhead items because they do not vary in the short-run with the amount of output. Nonetheless, they are part of the long-run marginal cost of production which is why a firm's short-run marginal cost of production is lower than its long-run marginal cost.⁶⁸

b. The Balance Sheet Cost Proxy

Judge Posner proposes as a definition of predatory pricing the *pricing at a level calculated to exclude from the market an equally or more efficient competitor*, and states that only two practices fit the definition:⁶⁹

firm having to stick to such prices; (iv) miscalculations of demand which force the disposal of products at distress prices, particularly when the product cannot be inventoried for long periods; and (v) prices used for promotional purposes. (Areeda and Hovenkamp, ANTITRUST LAW, Vol. III at 364 and 375.)

⁶⁶ Bork at 154.

⁶⁷ Richard A. Posner, ANTITRUST LAW, University of Chicago Press, Chicago, London, second edition, 2001, at 218. The reader should note that I am now citing from the second edition of Judge Posner's book. In the first edition of his book (Posner, ANTITRUST LAW, at 191.) Judge Posner stated that short-run marginal cost is lower than long-run marginal cost even when there is no excess capacity. The assertion that short run marginal cost is *always* below long-run marginal cost seemed wrong as a matter of economics. It appears to have been corrected in the new edition of Judge Posner's eminent book.

⁶⁸ *Id.*, pgs. 191-192.

⁶⁹ *Id.* at 188.

- i). Selling below short-run marginal cost: Because no reason exists consistent with efficiency for selling a good at a price lower than the cost that the seller incurs by the sale.⁷⁰
- ii). Selling below long-run marginal cost with the intent to exclude a competitor: long-run marginal costs are those which must be recovered to stay in business for an indefinite future. If a firm's revenues do not cover these costs it will eventually be driven out of business.⁷¹

Judge Posner proposes that sales below average accounting or balance-sheet cost is a tolerable proxy for predation and defendant would have to allocate its costs between the market in which it was allegedly predating and its other markets.⁷²

6. Following in the European Steps

As a final note, the Mexican ATC and AVC approach resembles the current European take on predation. In *AKZO v. Commission*,⁷³ the following rule was adopted:⁷⁴

- Above ATC: A dominant firm charging prices above ATC will not be guilty of predation.
- Prices between ATC and AVC: A dominant firm selling at less than ATC but above AVC will be guilty of predation where such pricing policy is done as a part of eliminating a competitor.
- Prices Below ATC: A dominant firm selling at less than AVC will be presumed to be acting abusively. The presumption is rebuttable where an objective justification exists for below-cost selling.

70 Even though a sale under such measure of cost can only have the purpose and (if persisted in) likely effect of excluding an equally, or more, efficient rival; measurement problems make such definition difficult to apply. A firm may be offering goods at a price below cost (maybe at a zero price) as a method of sales promotion. In these circumstances Judge Posner proposes that the *real* sales price must be calculated by including future revenues generated by the sale other than anticipated revenues from monopoly pricing. A qualification is applicable. A firm might dispose of some of its output below cost in one market in order to limit its output and thus increase prices and profits in another market where it has market power. (Posner, ANTITRUST LAW, at 189.)

71 However, selling below long-run marginal cost is only suggestive and not conclusive evidence of inefficient pricing. A firm may charge below such prices without exclusionary intent but, e.g., to make a cost-minimizing exit from the market. (Posner, ANTITRUST LAW, at 189.)

72 Posner, ANTITRUST LAW, at 190.

73 Case C-62/86 [1991] ECR I-3359, [1993] 5 CMLR 215.

74 Whish at 649.

C. THE RECOUPMENT PROBLEM

I have stated (§III.A) that the second problem with the Mexican approach to predation is the recoupment issue.

Other jurisdictions require for the predation claim that plaintiff demonstrate that recoupment was possible.⁷⁵ The reason for the foregoing can be summarized as follows. First, pretty much all markets are contested; hence, absent some structural factor that will allow post-predation recoupment (such as a barrier to entry⁷⁶) a predator which, after the predation campaign, sought to price supra-competitively to recoup the costs incurred in the same will attract competition and with it the necessary lowering of the prices to competitive levels which, by definition, disallow the recoupment of the predation investment.⁷⁷ Therefore, assuming rationality, no firm would make the investment on predation absent some indicia that it would obtain a return⁷⁸ from such investment.

Second, absent recoupment, the pricing below-cost will constitute nothing more than a gift to consumers. Whether or not such gift hurts competitors is irrelevant for competition law purposes which is concerned with *competition* not *competitors*. Accordingly, such gift is unactionable under competition laws.

Finally, a rational firm makes an investment only after calculating that the anticipated payoff seems to be worth the costs and risk. Investing in predation is no different. Hence, the *ex ante* assessment the firm must undertake in regards to the financial feasibility of predation must factor:⁷⁹ (a) the cost of predation; (b) the returns from recoupment; and (c) the time value of the predation investment and the risk of failure or detection and prosecution. Accordingly, by requiring proof of recoupment competition authorities ensure that neither competitive nor irrational behavior be forbidden or sanctioned. In the absence of the possibility to recoup, chances are that the challenged pricing will be competitive more than predatory. Should be not be the case, in the absence of recoupment no competition injury will ensue and the practice will be self-defeating. Therefore, competition law need not worry about the same.

To the extent Mexican competition authorities fail to factor the recoupment ingredient in their predatory pricing stew, they disregard all the factors such requirement seeks to

⁷⁵ In the U.S. some courts require that “a plaintiff must demonstrate that there is a likelihood [1] that the predatory scheme alleged would cause a rise in prices above a competitive level [2] that would be sufficient to compensate for the amounts expended on the predation, including the time value of the money invested in it.” (Brooke □ 509 U.S. at 225).

⁷⁶ Which must be very high to ensure a monopoly.

⁷⁷ Predation by a rational firm must be understood as a (risky) investment in a future monopoly.

⁷⁸ The return on the “predation investment” refers to monopoly prices which are sufficiently high and sufficiently long to payoff for the investment.

⁷⁹ Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, at 279.

fulfill; namely, not punishing pricing which is likely to be competitive; and avoid sanctioning self-defeating or irrational practices.

D. THE COST-ALLOCATION AND CHARACTERIZATION PROBLEM

I have stated⁸⁰ that the third problem with the Mexican approach to predation is the cost-allocation and cost-characterization criteria followed by the FCC.

I have summarized⁸¹ the FCC's approach to the cost characterization and allocation issue raised by predatory pricing. The FCC has issued accounting criteria as to what it considers part of the "cost" definition. The criteria relate to the following matters: (1) costs which should be included in the definition of "cost" for predatory pricing purposes; (2) the allocation of indirect costs; (3) the relevance on "cost" of other expenditures; and (4) parallel accounting.

I shall comment on each and then address certain additional characterization problems.

1. *Relevant Costs*

The FCC has stated that, as part of the definition of "cost" for the predatory pricing benchmarks included in the FLEC Regulations, should an investigation occur, it will consider "historic costs" and not merely the costs used by the investigated entity.

No explanation as to what it meant by historic "costs" was provided. I understand such concept to mean fixed and sunk costs. If this is the case, I believe the FCC's inclusion of such concepts will be contrary to Cost Theory, the practice followed by firms and sound financial theory.

With regards to fixed costs, allocating the same in the manner it deems fit to put a price tag on a product will be contrary to the notion that it is reasonable for a firm to charge a price equal to marginal cost and ignore fixed costs for the simple reason that it means more revenue.

As per sunk costs, the FCC's position appears to be contrary to the financial theory lesson that rational decision making[□] including pricing[□] should ignore sunk cost to the extent that they are bygones and like spilled milk and, hence, should be avoided in making proper business decisions.⁸²

80 Section III.A, supra.

81 Section II.B.2 of this Chapter.

82 "*FORGET SUNK COSTS. Sunk costs are like spilled milk: They are past and irreversible outflows. Because sunk costs are bygones, they cannot be affected by the decision to accept or reject the project, and so they should be ignored.*" Quoted from Brearley and Myers, PRINCIPLES OF CORPORATE FINANCE, at 115.)

2. Indirect cost allocation

In addition to internal accounting criteria followed by the firm, the FCC will favor an allocation of indirect costs by the proportion that the product in question has with respect of total sales costs. The foregoing to the extent that it believes that allocation of indirect costs by returns of total sales tends to hide predatory practices.⁸³

The problem posed by the FCC's approach is that it results in Monday-morning quarterbacking by a party which is not the best situated to do the applicable cost allocation and characterization.⁸⁴ In doing so the FCC second-guesses business decisions taken by firms which *are* the best situated to decide on such matter. To make matters worse, in the cited case the firm had allocated its costs pursuant to generally accepted accounting principles.⁸⁵

I cannot agree with such approach. The allocation of a cost by firms is usually arbitrary and, in my opinion, to the extent the manner it chooses to do so is congruent with any business rationale or a generally accepted accounting principle, the FCC would be well advised in restricting its *ex post facto* questioning of the firm's accounting decisions.

Moreover, a firm's past accounting practices should provide an adequate basis for allocation. If a firm provides evidence that the same accounting practices were followed during periods other than those of the alleged predatory campaign, I believe the same would be good evidence that the allocation of the costs in question is not manipulated but rather consistent with its belief of the best manner to do so.⁸⁶

3. Relevance on Cost of other expenditures

With respect to excluding other cost concepts from the accounting such as publicity/advertising or the chemical composition of a product, the FCC will evaluate and order expert studies in order to determine its feasibility. The FCC may use the independent studies provided by the investigated firm should it deem them trustworthy.

83 Annual Report 1995-1996, at 64. This point was restated in the second phase of the Bubble Gum War which involved an *ex officio* investigation (Competition Report, 1997, pgs. 73-74). The FCC restated that the allocation of costs should be made between sales costs noting that it did not intend to disqualify other generally acceptable accounting methods nor does it imply an opinion as to their technical accurateness; however, it did note the "incongruence" of allocating indirect costs in terms of sales shares, price per product and prices unrelated to the sum of costs and profits.

84 The party best suited in allocating costs is the firm involved. No matter how economically-literate the antitrust personnel are (and Mexico's is!) nothing beats the hands-on knowledge refined by the day-to-day decisions involved by managing the firm.

85 I have to avow a bit of bias. I was involved in the cited case as part of the team of attorneys who represented the defendant in the bubble gum war. I disclose the foregoing so that the reader may assess the opinions presented as she deems adequate.

86 Interestingly, in the bubble gum war case the FCC refused to take into account such factor.

With regard to this decision, I express my agreement with the approach. It is congruent with the opinion expressed in the last paragraph of the preceding section. Deference should be given by the FCC to a firm's allocation of a cost or expenditure which is congruent with some GAAP or business rationale. Should the issue become how to allocate the same, an expert opinion is the best route to follow.

4. Parallel accounting

The FCC noted the convenience of following a parallel accounting to the normal one using the allocation criteria. When assessing the existence of possible predatory pricing, the FCC will only except from the general rule cases where special reasons exist to determine that other means of allocation are more appropriate for the type of expenses.⁸⁷

The opinion expressed before as to the deference by the FCC to firm's accounting decisions applies here. In addition, I believe it an absurd idea to require parallel accounting. It will unnecessarily and wastefully increase costs.

5. Additional Cost characterization problems

The issue of cost characterization and allocation is magnified by the existence of diverse types of expenditures which present policy issues. They will now be briefly commented upon.

a. Promotional Expenditures

A *promotional price* is a temporary low price designed to induce patronage with the expectation that the customer will continue purchasing the product in the future at a higher price. The promotional price may be below cost and is readily illustrated by a seller who gives a product away for free to would-be customers. If the promotional price succeeds, it increases sales to the point that its output is efficient and profitable.⁸⁸

Promotional pricing by firms lacking power in the promoted product poses no competition threats. It facilitates entry and serves the purpose of informing consumers of its existence giving consumers a better buy during the promotion period and allowing it to judge (and reject) the competing good. In this sense, it is preferable to advertising.

Although the promotion may divert demand from better products or more efficient producers, the diversion should only last for the time necessary for them to reject the inferior quality product.⁸⁹

⁸⁷ The FCC may be consulted for cases in which the assessment could be different from that obtained from sales costs.

⁸⁸ Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, pgs. 446-447.

⁸⁹ Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, at 447.

When the firm has market power in the promoted product, the defense disappears. The promotion injures competition by diminishing it instead of intensifying it.

b. Advertising

Advertising relates directly to immediate output and in cases where advertising is appropriate at all it almost certainly becomes one of the incremental costs of predation.⁹⁰ Without clear evidence of the extent and measurability of the long-run effects, advertising should be classified as variable. Accordingly, it is incorrect to believe that all advertising expenses might be fixed costs, as some courts have said.⁹¹

c. “Excessive” Promotional Spending

It is said that a firm may undertake advertising campaigns or provide special services/conveniences to customers with no price increase. Such expenditures obviously increase the firm’s costs and may impose high burdens on small rivals to maintain their market share. If the additional promotional expenditures raise AVC above price, then the promotional spending could be deemed predatory.⁹²

d. Loss Leaders

A “loss leader” is a good that is priced aggressively so as to attract customers in the hope that they will purchase other goods as well. By definition, the loss leader would be below any measure of cost.

A loss leader may not qualify as a promotional price since the seller may not be a new firm or the aggressively priced product may not be a new one, and loss leader pricing strategy may be used for an indefinite duration too long to be regarded as promotional.

Assuming that the incremental revenue impact of the aggressive pricing is positive, loss leader pricing is not predatory.⁹³

e. Multiple Product Firms and Products with Differential Returns

When a firm produces multiple products and earns different returns, measuring the appropriate price-cost ratio is extremely complicated.

A businessperson, acting competitively, in determining a price always begins with the set of assets it has and then considers whether the incremental revenues will be sufficient to cover incremental costs, all suitably discounted for risk and time. That a new grouping of

⁹⁰ Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, at 390.

⁹¹ *U.S. Phillips Corp. v. Windmere Corp.*, 861 F2d 695, 703-704 (Fed. Cir. 1988), cert. Denied, 490 U.S. 1068 (1989).

⁹² Phillip Areeda and Donald Turner, PREDATORY PRICING AND RELATED PRACTICES UNDER SECTION 2 OF THE SHERMAN ACT, 88 Harvard Law Review, 697, 1995; in Terry Calvani and John Siegfried, ECONOMIC ANALYSIS AND ANTITRUST LAW, Little Brown, Boston and Toronto, Second Edition, 1988, at 206.

⁹³ Areeda and Hovenkamp, ANTITRUST LAW, Vol. III, at 424.

sales is incrementally profitable, following the preceedingly explained process, should not be regarded as “below cost” or predatory simply because it appears to be below cost when averaged with other costs that have already been paid.⁹⁴

Four problems may arise:⁹⁵

- a) “Subsidizing” lower returns in the predated market with higher returns from a different product or geographic market.
- b) The determination of the appropriate return when the firm produces different groupings of sales in the same plant or facility, but predation is alleged to exist only in one. This problem comes in two types: (i) different products produced in the same plant; and (ii) same product sold to different groupings of customers.
- c) Measuring variable costs when the firm produces multiple products in the same plant and some have certain variable costs in common; and
- d) The effects of predation in one product on the monopolist’s substitute products.

f. Predatory Investment

If it is appropriate to condemn a firm for predatory pricing it would appear equally appropriate to condemn a firm for adding new facilities when it anticipates that the revenue to be obtained from them over their useful life will not cover all costs, including a normal rate of return.⁹⁶

Areeda and Hovenkamp conclude that competition law should ignore alleged predatory investment in a monopolized product for the following two reasons:⁹⁷

- i) Building and perpetuating excess capacity is extremely costly and the risk that it will fail to deter new entry or expansion of rivals is significant. Hence, it should be regarded as the exception rather than the rule. Most of the cases that will appear to involve instances of excessive investment will most likely be miscalculations or cost savings.
- ii) The practical difficulties of attempting to distinguish between innocent and predatory expansion are much more severe than those of evaluating short-run pricing.

94 Id. at 412.

95 Idem.

96 Id. at 454.

97 Id. at 455.

IV. PREDATION IN PRACTICE: *POST SCRIPTUM*

On the question of whether predatory pricing should be regulated or sanctioned at all, a recent experience has had a profound impact on my understanding (and, hence, stance) of the topic.

I must confess that my initial studying and thinking on the matter at some point led me to believe that perhaps the whole theory should be scrapped since it seemed to me that the actual taking place of the phenomena was questionable and, hence, intervention was dangerous. However, recently, a businessperson I am acquainted with confessed to me his intent to engage in a predatory campaign against an illegitimate⁹⁸ rival. His reasons for doing so were (a) he wanted to run the rival from the market; and (b) he claimed he could justify before management *any* investment provided it could obtain a return in a reasonable period of time, and he believed that within one fiscal year he could recoup the investment on the predatory campaign because of the profitability of the enterprise.

This experience, which came sometime after the writing of this study, made me reevaluate and question all of my (frankly) theoretical knowledge on the matter.

Curiously, upon doing so, I have come to the same, albeit reinforced, conclusion: *the standards under Mexican law are simply too overbroad and dangerous*. However, the doubt I originally had as to whether the phenomenon should *ever* be regulated at all has been dissipated. Experience has shown that the practice *does* need to be regulated and sanctioned.

Hence, once more, and upon reconsideration of the matter, I pledge allegiance to the view⁹⁹ that, although the conduct cannot be dismissed as irrational, the following circumstances militate in favor of a high standard: (a) the likelihood of occurrence of such conduct is questionable; (b) the probability of mistake (because of difficulty of the problem); (c) the consequences of the same (incorrectly classifying as predatory normal competitive behavior); and (d) the chilling effect on pro-competitive conduct.

⁹⁸ I characterize the rival as “illegitimate” inasmuch as it was composed of personnel who left the company with industrial and trade secrets/formulas and was using them to compete —with assets and inventory stolen from said business person’s company!— against the latter. The reaction was motivated by the frustration stemming from finding out how difficult in practice it is to prove that a theft of industrial secrets had taken place, particularly because of the stringent requirements under Mexican law to do so. I advised him against such course of action. That I know of, the practice never took place.

⁹⁹ Advocated by Judge Posner (ANTITRUST LAW, pgs. 186-190) and Judge Bork (ANTITRUST PARADOX, at 157).