REVIEW OF McFETRIDGE AND WONG ON PREDATORY PRICING IN CANADA

by R.D. Anderson and S.D. Khosla*

In the lead article of the December, 1985 issue of the Canadian Bar Review, McFetridge and Wong undertake a comprehensive analysis of the treatment of predatory pricing in Canada.[1] The article examines in detail both legal and economic aspects of the issue. The article is presented in four parts. Part I provides a detailed analysis of the legislative history and case law respecting the interpretation of section 34(1)(c) of the Combines Investigation Act. Part II examines the economic approaches to predation, including its definition, the conditions in which it is likely to occur and the alternative rules that economists have suggested for its control. Parts I and II comprise two thirds of the article and provide a "state of the art" analysis of these aspects of predatory pricing.

Part III of the article applies various economic tests to the leading Canadian predatory pricing cases. Part IV comments on the extent to which such tests may be used within the terms of the Canadian law. The closing section of the article presents the authors' overall conclusions. In addition to the authors' well-known scholarship, the article reflects discussions in seminars at several Canadian universities. The following provides a synopsis of the article followed by a commentary.

SYNOPSIS

Part I of the article analyzes the three leading cases on the interpretation of section 34(1)(c): Producers Dairy (1966), Hoffmann-La Roche (1980) and Consumers Glass (1981).[2] The authors conclude that the judicial interpretation of the section is not yet settled. They emphasize that the judgments in the two recent cases take "distinct approaches" to the key issue of whether prices are unreasonably low. The judgment in Hoffman-La Roche sets forth a flexible framework for consideration of the issue, under which no specific level of prices is necessarily unreasonable. It suggests that the courts should consider all the circumstances of the case, and particularly: (i) the difference between prices and costs; (ii) the length of time during which the allegedly unreasonable prices are in effect; (iii) whether the price cutting is offensive or defensive; and (iv) any external or long run benefits accruing to the seller from the use of prices below cost.

The judgment in Consumers Glass takes a more focused approach, acquitting the accused firm on the basis that its prices remained above its average variable costs. However, the court's reasoning in that case is probably confined to situations of excess capacity. The judgments also leave somewhat ambiguous the interpretation of the additional element in predatory pricing cases of the effect or intent of substantially lessening competition or eliminating a competitor.

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*Bureau of Competition Policy, Ottawa. The views expressed are the authors' and not necessarily those of the Bureau.

Part II of the article provides a sophisticated analysis of the types of predation and the conditions in which they are likely to occur, synthesizing the implications of recent economic literature. It emphasizes the distinction between "classical" predatory pricing and "strategic entry deterrence". The former involves the use of low prices to drive existing competitors out of the market, while the latter concerns pre-emptive behaviour by existing firms to deter the entry or expansion of new rivals.[3] The authors note that section 34(1)(c) of the Combines Act is primarily concerned with classical predatory pricing and is not readily applicable to strategic entry deterrence.

The authors present a technical discussion of the nature and feasibility of both types of predation in terms of whether firms' costs are sunk (i.e., whether investments are irreversible). Strategic entry deterrence may be achieved by investing in greater than optimal plants, inventories, etc. The control of such conduct is problematic, since it is difficult to distinguish from pro-competitive behaviour. In the case of classical predatory pricing, the authors conclude that such conduct is likely to be futile whether or not costs are sunk. The reason is that attempts by predators to raise prices subsequent to a predatory campaign will trigger re-entry of existing or new competitors.

Part II also provides a comprehensive review of the various rules that economists have proposed for distinguishing predatory from non-predatory prices in specific cases. The authors place major emphasis on the Areeda-Turner proposal under which prices at or above short run marginal cost (or, where marginal cost data are unavailable, average variable cost) are considered lawful.[4] All prices below short run marginal cost (or average variable cost) are considered predatory, unless they are at or above average total cost. McFetridge and Wong would also require the alleged predator to have a large and stable market share. The authors do not favour the alternative two-tiered approach proposed by Joskow and Klevorick.[5] The latter proposal requires consideration of price-cost relationships only in situations where an examination of the structural characteristics of the market indicates that it is susceptible to predation.

Part III of the article attempts to apply the various economic tests to the three Canadian cases. It concludes that the defendant's behaviour in Producers Dairy would be considered predatory under the Areeda-Turner rule. Aspects of the accused firm's conduct in Hoffmann-La Roche would be considered predatory not only under Areeda-Turner but also under the more stringent test proposed by McGee, which would require prices below average variable costs and proof of predatory intent.[6] The defendant's behaviour in Consumers Glass would not be considered predatory under Areeda-Turner and most other economic tests.

Section IV of the article considers the extent to which the various economic tests may be utilized by the courts within the terms of the Canadian law. The authors point out that the answer to this question is "not obvious", since the language of section 34(1)(c) is more specific than the general U.S. monopolization provision for which the tests were designed. McFetridge and Wong nevertheless argue that several of the tests, particularly the Areeda-Turner rule, can be of assistance in applying the elements of the section.

In the concluding section of their article, McFetridge and Wong reiterate their preference for the Areeda-Turner test in the application of section 34(1)(c). They question, however, whether the prohibition of predatory pricing is necessary at all. In their view Hoffman-La Roche is the only unambiguous example of predatory pricing to come to light in Canada, but the losses in this case were borne primarily by the predator. They suggest that if the cases discussed in the article are the most glaring examples of predatory pricing to come to the government's attention, then the "inescapable conclusion" is that section 34(1)(c) is not needed.

COMMENTARY

McFetridge and Wong's article on predatory pricing is an important contribution to the discussion of competition policy issues in Canada. It provides a thorough analysis of the judicial interpretations of section 34(1)(c) of the Combines Investigation Act. It also provides a comprehensive review of the various economic tests that may be used to detect the occurrence of predatory pricing. The article will prove to be a useful reference for lawyers and economists dealing with the application of section 34(1)(c).

The article is, however, somewhat less comprehensive than its title suggests. For example, it does not examine section 34(1)(b) of the Act, a separate provision dealing with "geographic predatory pricing". The article also does not consider the issue of predatory pricing in the context of regulated industries. The threat of predation may be greater in regulated (or partially regulated) industries than under normal market conditions.[7] Predatory pricing in these industries is often dealt with under separate legislative provisions. For example, predatory pricing in the railway industry is dealt with under section 276 of the Railway Act, a less flexible provision than section 34(1)(c). Recent cases under this provision raise important legal and economic issues.[8]

Regarding their interpretation of the case law on section 34(1)(c), McFetridge and Wong seem to over-rate the apparent differences in approach in the leading cases. In our view, the judgment in Consumers Glass is not a "distinct approach" (as the authors suggest) but a special case of the flexible framework put forward in Hoffmann-La Roche. The latter emphasizes that the determination of whether prices are unreasonable should take account of all the circumstances of the case. The former merely holds that in the special circumstance of excess capacity, a price below average total cost (but above average variable cost) is not unreasonable. From this perspective, Consumers Glass reinforces rather than conflicts with the flexible framework established in Hoffmann-La Roche.

It is also important to note that the cases go to considerable length to recognize business justifications for price cutting. For example, the judgment in Hoffmann-La Roche would accommodate price cutting in situations of sales promotions, reasonable defensive retaliation and loss leading.[9] As noted, the judgment in Consumers Glass makes it clear that prices below average total cost will be considered natural in situations of excess capacity. These decisions go a long way to accommodate a core concern of many antitrust scholars: that the law against predation should leave broad scope for competitive price cutting.[10]

McFetridge and Wong's discussion of the various tests that economists have proposed for distinguishing predatory from non-predatory prices places considerable emphasis on the Areeda-Turner proposal. As noted, the latter involves focusing on price-cost relationships, with prices below average variable cost considered predatory. McFetridge and Wong believe that Areeda-Turner is the least costly of the possible tests in terms of enforcement costs.[11] This view is questionable. Analysis of price-cost relationships can be a difficult and time-consuming matter, particularly in the context of multi-product industries.[12]

In many cases, a two-stage structural and behavioural approach is likely to be the most efficient means of distinguishing predatory from non-predatory pricing. As McFetridge and Wong's analysis emphasizes, the possibility of successful predation can be ruled out in many markets on the grounds of ease of entry and exit. A low market share on the part of the alleged predator would also bear on the feasibility of successful predation. In such cases a preliminary analysis of the structural characteristics of the market - following the spirit of the proposal by Joskow and Klevorick - can avoid the need for analysis of price-cost relationships.

Recent cases before the U.S. Federal Trade Commission strongly support the usefulness of a two-stage structural and behavioural approach to the treatment of predatory pricing. In General Foods Corp., the Commission ruled out the possibility of successful predation on the basis of low entry barriers in the industry.[13] Similarly, in ITT Continental Baking, the Commission rejected the allegations of predatory pricing on the grounds of the low market share of the alleged predator, a low level of market concentration and a lack of entry barriers.[14] James C. Miller III, until recently Chairman of the Commission, believes this approach to be more efficient than the Areeda-Turner cost based standard.[15]

A broad structural and behavioural approach to predatory pricing cases is more consistent with the above-noted flexible judicial interpretation of the Canadian law than relying solely on an average variable cost standard. In his judgment in Hoffmann-La Roche, Mr. Justice Linden clearly rejected reliance on any single price-cost test. The judgments in both that case and Consumers Glass recognize that the evaluation of behaviour cannot be divorced from structural considerations. The Director of Investigation and Research under the Combines Act has recognized the need for consideration of both structural and behavioural factors in the evaluation of predatory pricing allegations.[16]

McFetridge and Wong conclude that section 34(1)(c) may not be necessary. They base this conclusion on the ground that Hoffmann-La Roche is the only unambiguous example of predatory pricing in Canada, and that the costs in this case were borne largely by the predator. This argument overlooks the likelihood that the law has successfully deterred other acts of predation.[17] In addition, the law serves an important social function in promoting fairness in business behaviour. Even Areeda and Turner, the authors of the test favoured by McFetridge and Wong, note "That predatory pricing seems highly unlikely does not necessarily mean that there should be no antitrust rules against it."[18] Thus,

while it is true that successful predation is often precluded by market responses, and it is important that the interpretation of section 34(1)(c) leaves broad scope for competitive price cutting, the authors' suggestion that the section is not needed goes too far.

NOTES

1. Donald G. McFetridge and Stanley Wong, "Predatory Pricing in Canada: The Law and the Economics." Canadian Bar Review, vol. 63, no. 4, December 1985, pp. 685-733.

2. R. v. The Producers Dairy Ltd., (1966), 50 C.P.R. (2d) 265 (Ont. C.A.); R.v. Hoffmann-La Roche Ltd., (1980), 109 D.L.R. (3d) 5 (Ont. H.C.), aff'd (1981), 125 D.L.R. (3d) 607 (Ont. C.A.); R.v. Consumers Glass Co. Ltd. and Portion Packaging Ltd., (1981), 124 D.L.R. (3d) 274 (Ont. H.C.).

3. A. Michael Spence, "Competition, Entry and Antitrust Policy," in S. Salop, ed. Strategy, Predation and Antitrust Analysis (Washington, D.C.: Federal Trade Commission, 1981), pp. 45-88.

4. Phillip Areeda and Donald F. Turner, "Predatory Pricing and Related Practices under Section 2 of the Sherman Act," Harvard Law Review, vol. 88, February 1975, pp. 697-733.

5. Paul L. Joskow and Alvin K. Klevorick, "A Framework for Analyzing Predatory Pricing Policy," Yale Law Journal, vol. 89, December 1979, pp. 213-270.

6. John S. McGee, "Predatory Pricing Revisited," Journal of Law and Economics, vol. XXIII, October 1980, pp. 289-329.

7. R.D. Anderson and S.D. Khosla, "Recent Developments in the Competition Policy Treatment of Predatory Pricing," Canadian Competition Policy Record, vol. 6, no. 3, September 1985, pp. 1-16, at 9-11.

8. See, e.g., Canadian Transport Commission, Railway Transport Committee, Order and Decision in the Matter of an Investigation into the Canadian National Railway Company's Newfoundland Container Rates, February 1986.

9. McFetridge and Wong, supra note 1, p. 700.

10. See, e.g., McGee, supra note 6; Robert Bork, The Antitrust Paradox (New York: Basic Books, 1978), pp. 144-155.

11. "In our view the Areeda-Turner test is the least costly of the tests in that it entails a low probability of convicting innocent behaviour and requires relatively little in the way of information gathering, interpretation and enforcement effort." McFetridge and Wong, supra note 1, p. 732.

12. Janusz A. Ordover and Robert D. Willig, "An Economic Definition of Predation: Pricing and Product Innovation," Yale Law Journal, vol. 91, no. 1, November 1981, pp. 8-53, at 20-21.

13. General Foods Corp., 3 Trade Reg. Rep. (CCH) 22,142 (April 6, 1984). In the U.S., the use of a combined structural and behavioural approach is facilitated by the jurisprudential requirement that there must be "a dangerous probability of successful monopolization" for a conviction under section 2 of the Sherman Act.

14. ITT Continental Baking Co., 2 Trade Reg. Rep. (CCH) 22,188 (July 25, 1984).

15. In describing the above-noted cases, Miller notes, "The Commission attempted to set out and employ an analytical approach that follows, in spirit at least, the two-tiered approach advanced by Joskow and Klevorick."...In this way. "the Commission was able to base its decision on the relatively certain evidence that predation could not be successful, and thus was able to avoid difficult and inherently uncertain analyses of price-cost relationships." James C. Miller III, "Predation: The Changing View in Economics and the Law," Journal of Law and Economics, vol. XXVIII, no. 2, May 1985, pp. 495-502, at 497 and 499.

16. "Each allegedly predatory pricing situation will be examined by the Director in light of the relevant facts....A price (below average total cost) will be considered in the light of its relationship to that cost standard or to variable cost, its duration, apparent purpose, whether aggressive or reactive, the market position of the parties, history of their behaviour and apparent long term consequences. The analysis will also take into consideration any indication that the alleged aggressor had used pricing selectively for disciplinary purposes, the extent to which that firm would be the beneficiary of the weakening or demise of the complainant, and whether barriers to entry were such that any firm driven out of the industry could not readily be replaced as a competitor." Director of Investigation and Research, Combines Investigation Act, Annual Report for the Year Ended March 31, 1982, p. 16.

17. Section 34 of the Combines Act, including the provisions dealing with predatory pricing and price discrimination, accounts for the largest proportion of activity under the Director's Program of Compliance. Business requests respecting this section accounted for 46% of total requests during the period 1960/61 to 1974/75. Paul K. Gorecki, The Administration and Enforcement of Competition Policy in Canada, 1960-1975 (Ottawa: Consumer and Corporate Affairs, 1979), Table 5-9, p. 219.

18. Areeda and Turner, supra note 4, p. 699.