



BUREAU OF COMPETITION

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FEDERAL TRADE COMMISSION
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Cheyenne, Wyoming 82002

Dear Ms. Woodhouse:

I am writing in response to your letter of September 17, in which you described your interest in updating the Wyoming statute that governs below-cost sales. The staff of the Federal Trade Commission appreciates this opportunity to give you some information about our own statutes and also to comment more generally about this subject.¹

We believe that every state should be circumspect in enacting prohibitions against below-cost pricing. Statutory prohibitions against pricing below cost can chill price competition that would be beneficial to consumers, due to the difficulty of distinguishing between below-cost pricing and vigorous competition. Moreover, after having reviewed many allegations of such conduct, we believe that firms will rarely engage in genuine below-cost pricing, because they typically know that they cannot count on a later period of monopoly power during which they can raise prices above their costs and recoup their earlier losses.

The remainder of this letter is divided into two sections. In the first I set out some general thoughts about the difficulties of applying predatory pricing laws without harming consumers in the process, and propose an interpretive rule that you may want to consider in administering any statute in this area. In the second section I address the specific questions that you asked about our experiences with our own predatory pricing statutes.

¹ This letter sets out the views of the FTC's Bureau of Competition, Consumer Protection, and Economics, and not necessarily those of the Commission itself or of any individual Commissioner. The Commission, however, with Commissioners Bailey and Strenio dissenting, has voted to authorize us to submit these comments to you.

I. General comments on below-cost pricing

The theory of below-cost or predatory pricing is that a firm could price its products below the actual costs of producing them, for a prolonged period of time, and could eventually drive its less well financed rivals from the market. The original firm would then be in a monopoly position and would seem to be able to raise prices, perhaps high enough to make up all the initial losses and still show an overall profit on the venture.

We believe, however, that predatory pricing is difficult to accomplish and is therefore quite rare. At least two obstacles stand in its path. First, the predator must absorb relatively large losses, since, as it acquires an ever-larger market share, it must bear per-unit losses on an ever-larger number of units. This means that the predator's financial losses will be much larger than those of its putative victims. Second, the predator cannot count on having a period of monopoly power within which to recoup these losses. When the predator begins to raise prices, the market will become attractive and firms will once more enter in response to the new profitability of the industry. This competitive response may be lessened if the predator can raise prices in a piecemeal or hidden way, or if the market is protected by barriers to the entry of new firms. In the absence of significant problems of this sort, however, we can expect that entry will in fact occur rather rapidly, and that it will ensure that prices do not remain above competitive levels.

These views are consistent with the Supreme Court's recent opinions in two cases involving predatory pricing, Matsushita Electric v. Zenith Radio Corp., 106 S. Ct. 1348 (1986), and Cargill v. Monfort, 107 S. Ct. 484 (1986). These decisions contain the Court's first discussion of the issue since 1967² and reflect the substantial developments in the legal and economic analysis of predatory pricing that have occurred in the past two decades. The Matsushita case involved allegations that Japanese television manufacturers had engaged in a complicated conspiracy to raise prices in their home market and use the profits to subsidize predatory pricing here. A motion for summary judgment raised the question of whether there were any genuine issues of fact for trial. Concluding that predation was unlikely on the facts alleged, the Supreme Court observed that "there is a consensus among commentators that predatory pricing schemes are rarely tried, and even more

² See Utah Pie Co. v. Continental Baking Co., 386 U.S. 685 (1967).

rarely successful." 106 S. Ct. at 1357-58. The Cargill case raised similar issues. There a meat-packing company had challenged a merger between two of its competitors, alleging that this would give the merged firm the financial resources to engage in predatory pricing. Although relying on technical grounds to reverse a ruling for the plaintiff, the Court indicated more generally that the mere possibility of such harm, without any more specific evidence, was too speculative to support an injunction against the merger. The Court said that "[c]laims of threatened injury from predatory pricing must, of course, be evaluated with care," and that "the obstacles to the successful execution of a strategy of predatory pricing are manifold, and . . . the disincentives to engage in such a strategy are accordingly numerous." 107 S. Ct. at 495 n.17.³

Underlying these decisions is a belief that the success of any predatory pricing effort is inherently uncertain:

[T]he short-run loss [from predatory pricing] is definite, but the long-run gain depends on successfully neutralizing the competition. Moreover, it is not enough simply to achieve monopoly power, as monopoly pricing may breed quick entry by new competitors eager to share in the excess profits. The success of any predatory scheme depends on maintaining monopoly power for long enough both to recoup the predator's losses and to harvest some additional gain.

Matsushita, 106 S. Ct. at 1357-58.

³ In Cargill the Court stated: "Predatory pricing may be defined as pricing below an appropriate measure of cost for the purpose of eliminating competitors in the short run and reducing competition in the long run." 107 S. Ct. at 493 (footnote omitted). Accord, Matsushita, 106 S. Ct. at 1355 n.8. The Court found it unnecessary to consider "whether above-cost pricing coupled with predatory intent is ever sufficient to state a claim of predation." Cargill, 107 S. Ct. at 493 n.12. Commentators and courts continue to differ on the exact measure of cost to be used in defining below cost pricing. Id. To some extent the definition of the cost benchmark will determine the incidence of predation. The divergent technical positions on the cost question, however, do not undermine the consensus that predation, however defined, occurs infrequently.

Several factors contribute to the uncertainty of outcome. One is the need for entry barriers, as the Matsushita Court discussed. Entry barriers are essential if a predatory scheme is to work, yet, in our open economy, a market generally is not insulated from competition long enough to permit recoupment of the initial losses. Another problem for the rational predator is that future profits must be discounted. By dropping prices below cost the predator forgoes profits in current dollars, whereas any recoupment will necessarily be in discounted future dollars. Still another source of uncertainty is the fact that recoupment may be affected by intervening changes in business, technological, or regulatory conditions. Accordingly, we believe that predatory pricing statutes address a rare problem.

In addition, we believe that such statutes may be affirmatively harmful to consumers. If the statutory definition of the offense is overbroad (making it too easy to prove) or if the offense is so vaguely defined that erroneous public and private applications of the statute are probable, businesses may be deterred from vigorous but legitimate price competition. Deterrence from competition is a particular problem because firms have an incentive to complain about the successful competitive efforts of their rivals, however proper those efforts may be.

These risks can be seen in the mix of complaints that are brought to the Commission. During one recent five-month sample period we received nineteen complaints of predatory pricing. Commission attorneys followed up on all of these by calling the complainants to request additional and more specific information. In fourteen of the nineteen cases the complainants had no data to support their charge; they simply "felt" that their competitors were pricing too low. In most of these cases it appeared more probable to our investigators that the alleged predators were achieving operational efficiencies that would legitimately allow them to charge lower prices. In support of this they observed that most of the industries had low entry barriers, which would tend to rule out a strategy of predatory pricing.

To screen out those cases in which predatory pricing is unlikely, we consider the structural characteristics of the market before reaching questions of costs and prices. This initial inquiry focuses on whether a market is so structured and so sufficiently protected by entry barriers that predation is a realistic possibility. The Commission has followed this

approach in its own most recent predatory pricing cases.⁴ In dismissing the charges in these cases, the Commission found it unnecessary to reach a detailed examination of evidence relating to either intent or conduct. Rather, the Commission observed in each case that the market structure and the vigor of current competition precluded any dangerous probability that below cost pricing, if it had occurred, could have led to sustained monopoly power.

This phased approach permits careful evaluation of predatory pricing complaints, yet also reduces the resources necessary to assess them, because market information typically is more available and less ambiguous than evidence regarding an individual firm's cost levels or intent to monopolize. In addition, reliance on market evidence limits the risk that a law enforcement investigation might chill legitimate price competition. By using such evidence to weed out improbable predatory pricing claims, competitive firms are not subjected to intrusive and potentially expensive inquiries into their motives, cost structures, and business plans.

II. Specific questions

Our answers to your specific questions are as follows:

1. Do you have a selling below cost statute or "discrimination" statute?

No statute enforced by the Commission prohibits below-cost pricing directly. Section 2 of the Clayton Act, as amended by the Robinson-Patman Act, 15 U.S.C. § 13, prohibits discrimination in price between different purchasers of commodities of like grade and quality under certain conditions. Section 2 of the Sherman Act, 15 U.S.C. § 2, prohibits monopolization and attempts to monopolize. The Commission has

⁴ International Telephone & Telegraph Corporation, 104 F.T.C. 280 (1984) ("ITT"); General Foods Corp., 103 F.T.C. 204 (1984) ("General Foods"). In ITT, the Commission determined that sales "at prices that equal or exceed average variable cost should be strongly, often conclusively, presumed to be legal." 104 F.T.C. at 403. The Commission also concluded that sales "at prices below average variable cost for a significant period of time should be rebuttably presumed to be anticompetitive." Id. at 404. Finally, the Commission determined that sales "at prices that equal or exceed average total cost should be conclusively presumed to be legitimate." Id. In ITT and General Foods, Commissioner Bailey disagreed with the Commission's definition of predation.

no authority to bring actions under the Sherman Act directly, but Sherman Act standards can be applied to actions brought under Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45.

2. Please send a copy of your law.

Copies of the statutes cited above are attached.

3. If you do not have a sales below cost statute, how does your state deal with problems in this area?

Not applicable.

4. Do you consider your statute effective?

We believe that the statutes cited above provide effective means of challenging predatory pricing.

5. How workable is your statutory definition of "cost?"

"Cost" is not defined in the statutes enforced by the Commission, and the definition of the term remains unresolved. See, e.g., Matsushita, 106 S. Ct. at 1355, nn. 8 & 9.

6. How is your law enforced (attorney general, county attorney, administrative agency, private action)?

Section 5 of the FTC Act is enforced by the Commission. The Sherman Act is enforced by the Department of Justice and by the Federal Trade Commission through Section 5 of the FTC Act. The Robinson-Patman Act is enforced by both the Commission and the Department of Justice. In addition, private actions may be brought under the Sherman Act and the Robinson-Patman Act. State attorneys general may also bring suit as *parens patriae*. 15 U.S.C. § 15c.

7. How effective are the private remedies in your statute?

A plaintiff in a private action who proves injury to his business or property may recover treble damages. 15 U.S.C. § 15.

8. What are the penalties for selling below cost?

The Commission is empowered to issue cease-and-desist orders. A court may award injunctive relief as well as damages.

9. How many actions has your office filed in the past 5 years for sales below cost?

a) Number of criminal actions?

Not within our jurisdiction.

b) Number of civil actions for injunction?

The Commission filed no such actions in this period. It decided two such cases, ITT and General Foods, cited above in footnote 4.

c) Number of civil actions to revoke a corporate charter?

Not within our jurisdiction.

d) Description and number of other actions?

Our remedies are limited to issuing cease-and-desist orders.

10. Who investigates complaints under your below cost sales act?

The predatory pricing complaints that appear to warrant investigation are studied by the agency's own staff. The primary responsibility for antitrust matters lies with our Bureau of Competition.

11. What type of staff does the agency have to investigate these cases? What is the budget for this agency?

Investigatory teams include both economists and lawyers, with paralegal assistance sometimes available as well. The total budget of the FTC is \$69.7 million, with \$31.4 million of that designated for all antitrust matters. We do not have a separate line item in the budget for predatory pricing matters.

12. How many attorneys in your office are assigned to enforcing below cost sales statutes?

Attorneys are assigned to monitor particular industries rather than to enforce certain statutes. Therefore, there are no attorneys specifically designated for predatory pricing matters.

13. Has the constitutionality of your law been upheld?

Yes. See Atlas Bldg. Products v. Diamond Block & Gravel, 269 F.2d 950 (10th Cir. 1959), cert. denied, 363 U.S. 843

(1960) (Robinson Patman Act § 2(a)); Sears, Roebuck & Co., 258 F. 307 (7th Cir. 1919) (FTC Act); Standard Oil v. United States, 221 U.S. 1 (1911) (Sherman Act).

14. Are there any rules or regulations promulgated pursuant to this statute?

There are none dealing specifically with the issue of below-cost pricing.

Conclusion

The Commission staff believes that predatory pricing statutes, while not intrinsically without merit, can do more harm than good. We therefore recommend that they be drafted and applied with care. In particular, we believe that revisions intended to make the law stricter and enforcement actions easier to bring should be carefully considered. We also recommend that any analysis of a predatory pricing claim begin with a threshold inquiry into market structure.

Thank you again for the opportunity to comment on these issues. We hope you find our observations helpful. Please don't hesitate to get back in touch if we can give you any further information. In particular, we would be happy to comment, at your request, on any specific legislative proposal that you might draft.

Sincerely yours,



Jeffrey I. Zuckerman
Director