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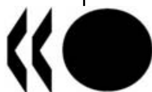

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DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
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ROUNDTABLE ON RESALE BELOW COST LAWS AND REGULATIONS

-- Note by the United States --

This note is submitted by the Delegation of the United States FOR DISCUSSION at its forthcoming meeting to be held on 19-20 October 2005.

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1. Introduction

1. In the United States, there is no federal law that broadly prohibits below-cost sales ("BCS"). A majority of U.S. states, however, have some type of BCS laws, which prohibit retailers from setting prices below a statutorily mandated level of cost. The primary concern with these laws is that they deter firms from lowering their prices, and thus deprive consumers of the benefits of competition. BCS laws may apply generally to all retail sales or may apply only to sales of specific items, such as milk, alcohol, gasoline, or tobacco. Most BCS laws define cost in a way that includes both fixed and variable costs. Although many of these laws require a plaintiff to show that the defendant's pricing had an adverse effect on "competition," most courts interpreting BCS laws have found that evidence of sales being diverted from a competitor to the price-cutting defendant satisfies this adverse effect requirement. Accordingly, a plaintiff can prevail under BCS laws even if there is no proof of harm to competition. This contrasts with courts' treatment of predatory pricing claims under federal antitrust laws, where plaintiffs must show that the defendant's price-cutting is likely to harm consumers.

2. Because there is no necessary relationship between liability under BCS laws and effects on consumer welfare, BCS laws almost certainly condemn competitive conduct. Enforcement of BCS laws varies among states, but recent court cases and press reports suggest that they are likely to constrain firms' pricing decisions in some places. To the extent that firms adjust their behaviour to avoid liability, BCS laws are likely to deter firms from cutting their prices below the statutory minimum. Because these price cuts are unlikely to threaten competition, consumers are worse off.

3. There are relatively few empirical studies of the effects of BCS laws. There is no consensus among the studies that have been conducted of how BCS laws affect market outcomes. Some early studies that focus on industry structure as opposed to market outcome variables, such as price or margins, find contradictory results with regard to the relationship between BCS laws and market concentration or the presence of small businesses. More recent studies of gasoline-specific BCS laws also arrive at mixed results. Although some studies find that BCS laws are associated with higher gasoline prices, others have found no effect or evidence that BCS laws are associated with lower long-run gasoline prices. The inability to control for the vigour of enforcement of a state's BCS law – and thus whether the BCS law is a binding constraint on pricing decisions – may be partially responsible for these varied results.

4. This paper provides an overview of state BCS laws and how they are likely to affect competition. It also discusses relevant empirical work and competition advocacy by the Federal Trade Commission involving BCS laws.

2. State Below-Cost Sales Laws

5. While federal antitrust law prohibits predatory pricing, there is no specific federal prohibition on below-cost sales. There are two types of state BCS laws – laws of general application that apply to all retail merchandise; and laws that apply only to the sales of specific products, such as gasoline, cigarettes, alcoholic beverages, or milk. Twenty-five states currently have general BCS laws and thirty-one states have laws that cover the sale of specific items (see Table 1).

6. BCS laws make it illegal for a retailer to sell below some statutorily defined measure of cost with the intent to injure competition. State laws define cost differently, but most rely on a measure that includes both fixed and variable costs. For example, Alabama's Motor Fuel Marketing Act ("AMFMA"), which is typical, defines "cost" to include the lesser of "the invoice or replacement cost of the motor fuel . . . less all trade discounts except customary discounts for cash," plus applicable taxes and fees and "the cost of doing business."[1] The cost of motor fuel is defined as the lower of "(i) the invoice cost of the motor fuel .

. . or (ii) the lowest replacement cost of motor fuel . . . within five days prior to the date of sale, in the quantity last purchased."[2] The Act defines the "cost of doing business" to include:

> labour (including salaries of executives and officers), rent (which rent must be no less than fair market value based on current use), interest on borrowed capital, depreciation, selling cost, maintenance of equipment, transportation or freight cost, losses due to breakage or damage; credit card fees, or other charges; credit losses, all types of licenses, taxes, insurance, and advertising.[3]

7. Other states define cost to include a minimum mark-up over incurred costs. For example, for cigarettes, alcoholic beverages, and gasoline, Wisconsin's Unfair Sales Act defines "cost to retailer" as invoice or replacement cost plus a mark-up ranging from 3 percent to 9.18 percent, depending on the product and type of seller involved in the transaction.[4]

8. Many BCS laws allow plaintiffs to present evidence of below-cost sales to satisfy the "intent" element of the violation as well.[5] Some BCS statutes require that the defendant's conduct have an adverse effect on competition[6] or allow a fact finder to infer intent to injure competition from evidence of actual effect.[7] BCS laws, however, typically define harm to competition with regard to how a defendant's below-cost sales affect its competitors.

9. For example, although Alabama's Motor Fuel Marketing Act makes it illegal to sell gasoline below cost "where the effect is to injure competition," judicial interpretation of the statute has made it clear that evidence that the below-cost sales in question caused one competitor to lose business will suffice.[8] Likewise, the Tenth Circuit has held that evidence that the defendant's sales increased while its competitor's sales decreased satisfies the requirement that a below-cost sale must "substantially lessen competition" to violate the Oklahoma Unfair Sales Act.[9]

10. Some courts, however, have attempted to bring state BCS laws into closer harmony with predatory pricing jurisprudence by requiring plaintiffs to show likely harm to competition. For example, in *Wal-Mart Stores, Inc. v. American Drugs, Inc.*, the Supreme Court of Arkansas overturned a Chancery Court finding that Wal-Mart had violated the Arkansas Unfair Practices Act ("AUPA") by selling certain health and beauty products below cost.[10] The court noted that Wal-Mart's "loss-leader strategy . . . is readily justifiable as a tool to gain a competitive edge," and that as opposed to threatening competition, Wal-Mart's pricing "simply enhanced competition in the area" and accordingly prevented the plaintiffs from "making the profits that they once did."[11] The court concluded that "[a] competitor that has been injured by legitimate competitive pricing . . . should not be permitted to use the [AUPA] as a fountain for recouping its losses."[12]

11. Most BCS laws allow for various defences to a *prima facie* case. Wisconsin's Unfair Sales Act is representative, providing that the prohibition against below-cost sales "shall not apply" to sales when:

1. merchandise is sold in bona fide clearance sales;
2. perishable merchandise must be sold promptly in order to forestall loss;
3. merchandise is imperfect or damaged or is being discontinued;
4. merchandise is sold upon the final liquidation of any business;
5. merchandise is sold for charitable purposes or to relief agencies;

6. merchandise is sold on contract to departments of the government or governmental institutions;

7. the price of merchandise is made in good faith to meet an existing price of a competitor and is based on evidence in the possession of the retailer … in the form of an advertisement, proof of sale or receipted purchase, price survey or other business record maintained by the retailer . . . in the ordinary course of trade or the usual conduct of business;

- Merchandise is sold by any officer acting under the order or direction of any court.

- Motor vehicle fuel is sold by a person to a wholesaler of motor vehicle fuel, who may sell the motor vehicle fuel at either retail or wholesale.[13]

12. General BCS laws explicitly are concerned with "fair" treatment of businesses and consumers rather than the protection of consumer welfare. Enacted earlier in the century, against the backdrop of the Depression, most states passed general BCS laws to protect small businesses from "unfair" competition from chain stores. Thus, by contrast with the current view of the goals of competition law, states designed BCS laws specifically to protect small competitors from larger rivals. An additional goal behind BCS laws was to protect consumers from being deceived by retailers that use loss-leaders to lure customers into their stores and then charge the unwary customers "unfairly" high prices for other goods.[14] For example, Wisconsin's Unfair Sales Act, enacted in 1939, states that:

> The practice of selling certain items of merchandise below cost in order to attract patronage is generally a form of deceptive advertising and an unfair method of competition in commerce. Such practice causes commercial dislocations, misleads the consumer, works back against the farmer, directly burdens and obstructs commerce, and diverts business from dealers who maintain a fair price policy.[15]

13. Similarly, in 1959 the U.S. Supreme Court said the following about loss leaders while commenting on the constitutionality of the Oklahoma Unfair Sales Act:

> One of the chief aims of state laws prohibiting sales below cost was to put an end to "loss leaders" selling. The selling of selected goods at a loss in order to lure customers into the store is deemed not only a destructive means of competition; it also plays on the gullibility of customers by leading them to expect what generally is not true, namely, that a store which offers such an amazing bargain is full of other such bargains.[16]

14. Clearly, this statement runs counter to the Supreme Court's current view that because "low prices benefit consumers regardless of how those prices are set," below-cost sales "are of no moment to the antitrust laws if competition is not injured."[17]

15. BCS laws that specifically concern gasoline generally are of a more recent vintage, and may have been enacted as a way to protect small independent station owners from vertically integrated refiners and other high-volume competitors, such as warehouse clubs.[18] Increased competition from these new business models has caused a steady erosion in the number of gasoline stations – especially small independent stations – in the U.S. since the 1970s.[19] Some modern proponents of gasoline BCS laws try to connect the protection of small businesses to increased consumer welfare by arguing that prohibitions on below-cost sales by multi-product retailers and vertically integrated refiners is likely to make entry more probable, and thus lead to more competitors and lower prices.[20]

3. Competitive Impact of BCS Laws

16. The primary concern with BCS laws is that they will deter firms from lowering their prices, thus depriving consumers of the benefits of competition. In the U.S., below-cost pricing that is likely to harm competition is addressed by Section 2 of the Sherman Act[21] and the Robinson-Patman Act.[22] To maximize the likelihood that only pricing behaviour that is likely to harm competition is subject to antitrust challenge, the U.S. Supreme Court has imposed a heavy burden on plaintiffs trying to make a predatory-pricing claim. In states with BCS laws, however, the bar for plaintiff is set much lower; firms risk liability for cutting prices below the statutorily defined measure of cost, even when their actions have no possibility of harming competition.

3.1 Predatory Pricing Under US Antitrust Law

17. All legal rules have costs associated with falsely convicting the innocent ("type-I errors") and letting the culpable go free ("type-II errors"). The expected cost of error associated with a particular rule has two components: the probability of committing an error and the cost that making an error imposes on society. When legal rules have high type-I error rates, legal conduct that is erroneously being condemned is deterred, and the more valuable the deterred conduct, the larger the social cost.

18. In the context of antitrust law, a rule with a high type-I error rate deters firms from engaging in procompetitive conduct. It is widely recognized that competition provides consumers with tremendous benefits in terms of lower prices, better quality, and greater variety.[23] Accordingly, legal rules that reduce firms' incentives to compete impose costs upon consumers.

19. The Supreme Court's jurisprudence under Section 2 of the Sherman Act, which is concerned with unilateral conduct, shows a keen awareness of type-I error costs.[24] This concern has been most pronounced in predatory pricing jurisprudence, where the conduct under scrutiny – lowering prices – is the hallmark of competition; a legal rule that condemns price-cutting too easily is likely to deter firms from competing on price as vigorously as they otherwise would, to the detriment of consumers. In *Matsushita Electric Industries Co. v. Zenith Radio*, for example, the Court observed that "cutting prices in order to increase business often is the very essence of competition," and stated that "mistaken inferences" in cases involving generally procompetitive conduct, "are especially costly, because they chill the very conduct the antitrust laws are designed to protect."[25] In its most recent decision concerning predatory pricing, *Brooke Group Ltd. v. Brown & Williamson Tobacco Co.*, the Court again expressed concern with the error costs associated with legal rules that attempt to distinguish predatory pricing from procompetitive price-cutting: "[T]he costs of an erroneous finding of liability are high. The mechanism by which a firm engages in predatory pricing – lowering prices – is the same mechanism by which a firm stimulates competition."[26]

20. To minimize error costs, the Supreme Court set out a two-part test to detect price-cutting that is likely to harm consumers. First, a necessary (but not sufficient) condition for pricing to be unlawful is that the low prices must be "below an appropriate measure of [the defendant's] cost for the purpose of eliminating competitors in the short run and reducing competition in the long run."[27] Although the Court has not stated what the measure of cost should be, prominent antitrust scholars and several federal circuit courts have concluded that the price-cutter's marginal costs, or a close proxy such as average variable costs, should be the criterion.[28] This rule prevents firms from facing antitrust scrutiny for prices that, even though below cost, are likely to make business sense regardless of any strategic effect they may have on rivals.

21. Second, even if prices are below appropriate costs, courts examine whether the defendant is likely to be able to recoup its investment through future supracompetitive pricing.[29] The rationale is that