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UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
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May 15, 1989

Office of the Regional Director

The Honorable William R. Ratliff
Economic Development Committee
Texas State Senate
P.O. Box 12068
Capitol Building
Austin, Texas 78711

Dear Mr. Ratliff:

We are pleased to respond to your invitation to comment on Texas Senate Bill 974, which would ban certain forms of below cost pricing.[1] Specifically, the proposed legislation would ban below cost sales made by a retailer or wholesaler with the intent of injuring competitors or competition. The bill defines "below cost" to mean below the seller's invoice purchase price (minus discounts but plus freight and other charges).

We believe that careful consideration should be given to the costs of prohibitions aimed at anticompetitive below cost pricing (normally characterized in the antitrust literature as predatory pricing). Due to the difficulty of distinguishing between the below cost pricing targeted by the proposed legislation and vigorous competition, statutory prohibitions against pricing below cost can chill price competition that would benefit consumers. Moreover, after having reviewed many allegations of such conduct, we believe that firms will rarely engage in genuine predatory 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. In determining whether to enact the bill, the legislature may wish to consider the likely anticompetitive effect of this bill and the relatively small countervailing benefits to consumers.

<u>Interest and Experience of the Federal Trade Commission</u>

The Federal Trade Commission ("FTC") is an independent regulatory agency responsible for protecting competition and

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1 These comments are the views of the staff of the Dallas Regional Office and the Bureau of Competition of the Federal Trade Commission. They are not necessarily the views of the Commission or any individual Commissioner.

safeguarding the interests of consumers. Section 5 of the Federal Trade Commission Act[2] prohibits unfair methods of competition and unfair or deceptive acts or practices. Through investigations of alleged violations of this statute, the staff of the FTC has gained experience in analyzing the effects of various trade restraints and the costs and benefits of these restraints to consumers. Upon request by federal, state and local governmental bodies, the FTC staff regularly assesses the competitive impact of legislative and regulatory proposals in order to identify provisions that may benefit consumers by promoting competition and reducing prices, and provisions that may harm consumers by impairing competition or increasing costs without offering offsetting benefits.

In recent years, the Commission's staff has had extensive experience with the issue of predatory pricing. The staff has conducted a number of investigations of alleged predation. Two of these investigations have led to antitrust enforcement proceedings.[3] The Commission's staff has also submitted comments to a state legislature and a state agency concerning other proposed predatory pricing bills.[4]

Description of S.B. 974

Section 1 of S.B. 974 would add a new Chapter 19, entitled "Unfair Sales," to the Texas Business and Commerce Code.[5] Section 19.03(a) of the bill would, *inter alia*, prohibit retailers and wholesalers from selling tangible personal property at prices below cost

> with the intent to induce the purchase of other merchandise, unfairly divert trade from a competitor or

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2 15 U.S.C. § 45.

3 International Telephone & Telegraph Corporation, 104 F.T.C. 280 (1984) ("ITT"); General Foods Corp., 103 F.T.C. 204 (1984) ("General Foods").

4 Letter from Jeffrey I. Zuckerman, Director, Bureau of Competition, Federal Trade Commission, to Senator Gene Thayer, Chairman, Business and Industry Committee, Montana State Senate (March 10, 1989); letter from Jeffrey I. Zuckerman, Director, Bureau of Competition, Federal Trade Commission, to Gay Woodhouse, Senior Assistant Attorney General, State of Wyoming (December 11, 1987).

5 Tex. Rev. Civ. Stat. (Business & Commerce Code) §§ 19.01-19.08. In this letter, the particular provisions of the bill will be referred to by their Chapter 19 citation, as they are set out in the bill.

otherwise injure a competitor, impair or prevent fair competition or injure the public welfare, or if the advertisement, offer, or sale tends to deceive a purchaser or prospective purchaser, substantially lessen competition, unreasonably restrain trade, or create a monopoly in a line of commerce.[6]

"Cost to the retailer" is defined as "the invoice cost of the merchandise or the replacement cost, whichever is lower . . .," less most trade discounts, plus other specified costs of doing business, such as taxes and transportation costs.[7] "Cost to the wholesaler" is defined similarly. A showing that a retailer or wholesaler advertised, offered or sold merchandise at a price "below cost" would be prima facie evidence of an intent to injure competition or competitors.[8]

Section 19.03(b) of the bill would make a violation of the statute a misdemeanor. Sections 19.04 and 19.05 would authorize private actions for injunctions and damages to remedy any violations.[9]

Predatory Pricing Generally

The theory of predatory pricing suggests that a firm could price its products below the actual costs of producing or obtaining them, for a prolonged period of time, and drive its less well financed rivals from the market. A firm would have the incentive to pursue this strategy if it could achieve a monopoly position, thereby enabling it to raise prices high enough to recoup its initial losses.

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6 Section 19.08(a) specifies exceptions for unusual circumstances, such as business liquidation sales, clearance sales, or sales to aid charitable causes. However, Section 19.08(b) may be interpreted to provide that if a retailer or wholesaler purchases goods at such a sale, he may not pass his savings on to the consumers because he must use "replacement cost" in the "ordinary channels of trade" to establish his cost for such products.

7 Section 19.01(1) of the bill.

8 S.B. 974, Section 19.07.

9 Section 19.04 allows a suit for an injunction by a "person injured by a . . . threatened violation of this Act." (Emphasis added.) In addition, under this section, a party need not show irreparable injury or unavailability of other remedies in order to obtain an injunction.

We believe, however, that successful completion of this strategy is difficult, and the strategy is therefore quite rarely undertaken. 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 market is protected by barriers to the entry of new firms.[10] 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., 475 U.S. 574 (1986), and Cargill v. Montfort, 479 U.S. 104 (1986). These decisions contain the Court's first discussion of the issue since 1967[11] 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 rarely successful." 475 U.S. at 589. 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

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[10] The competitive response might also be lessened if outside firms were deprived of the information needed to make informed entry decisions. For example, a predator might cultivate a reputation for irrational pricing behavior, and thereby deter entry by increasing the market uncertainties that an entrant must face. See J. Tirole, Theory of Industrial Organization pp. 372-77 (1988). Although this outcome is logically possible, there is thus far no consensus that it actually occurs to any significant extent.

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

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." 479 U.S. at 121 n.17.[12]

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 <u>maintaining</u> monopoly power for long enough both to recoup the predator's losses and to harvest some additional gain.

<u>Matsushita</u>, 475 U.S. at 589.

Several factors contribute to the uncertainty of outcome. One is the need for entry barriers, as the <u>Matsushita</u> 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.

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[12] In <u>Cargill</u> 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." 479 U.S. at 117 (footnote omitted). <u>Accord</u> <u>Matsushita</u>, 475 U.S. at 584 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." <u>Cargill</u>, 479 U.S. at 117-18 n.12. Commentators and courts continue to differ on the exact measure of cost to be used in defining predatory pricing. <u>Id.</u> 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.

Still another source of uncertainty is the fact that recoupment may be affected by intervening changes in business, technological, regulatory, or demand 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.[13] 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 five-month sample period in the mid-1980's 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 rational strategy of predatory pricing.

To screen out those cases in which predatory pricing is unlikely, we consider the structural characteristics of the market (such as the number of firms in the market, their individual market shares, and the barriers to entry into the market by individual firms). Our findings may obviate reaching questions of costs and prices. This initial inquiry focuses on whether a market is so structured and so protected by entry

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[13] The Supreme Court specifically recognized this potential problem when it stated:

> Moreover, the mechanism by which a firm engages in predatory pricing -- lowering prices -- is the same mechanism by which a firm stimulates competition; because "cutting prices in order to increase business often is the very essence of competition . . . mistaken inferences . . . are especially costly, because they chill the very conduct the antitrust laws are designed to protect." [Matsushita, 475 U.S. at 594.]

Cargill, 479 U.S. at 121-22, n.17.

barriers that predation is a realistic possibility. The Commission has followed this approach in its own most recent predatory pricing cases.[14] 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 structure and entry barrier 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. After all, a firm may engage in allegedly below cost pricing for a time for a number of legitimate purposes (such as to liquidate inventory, for promotional reasons to enter a market, in response to competition, etc.). Because we use such evidence to weed out improbable predatory pricing claims, legitimately competitive firms are not subjected to intrusive and potentially expensive inquiries into their motives, cost structures, and business plans.

Effect of S.B. 974 on Competition

As discussed in the previous section, a below cost pricing statute can be written and applied to prohibit activities that do not harm or threaten to harm competition. S.B. 974 appears to be such a statute. The bill appears likely to chill price competition, to the detriment of consumers.

Section 19.07 of the bill provides that evidence of a sale or the offering for sale at a price below the cost of the retailer or wholesaler would be prima facie evidence of intent to injure competition. Since Section 19.03(a) of the bill would make it illegal to engage in below cost pricing with an "intent" to injure competition or a competitor, these provisions taken

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14 ITT, supra note 3; General Foods, supra note 3. 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.

together may in certain circumstances permit a competitor to prove a violation of the law upon a mere showing of sales made "below cost." As discussed in the previous section, such a result may injure rather than benefit consumers by deterring merchants from engaging in vigorous price competition.

Other provisions of the bill may also discourage merchants from lowering prices to consumers. Section 19.03(a) would prohibit below cost sales "with the intent to induce the purchase of other merchandise." This provision seems designed to prevent the use of "loss leaders," a competitive device commonly used by retailers to encourage consumers to shop in their stores. This is troublesome because loss leaders can benefit consumers in several ways. Loss leaders can convey cash discounts and induce consumers to try new products. Frequently loss leaders are used as a competitive device to facilitate the entry of new competitors into a market or the introduction of new products. Since loss leaders are a familiar promotional technique, these goals can be accomplished without misleading consumers as to the prices prevailing elsewhere in the store. In addition, if Section 19.08(b) is interpreted to prevent merchants who have purchased goods at costs considerably lower than usual (due to bankruptcy, closeout or other such sales) from passing these savings on to consumers, consumers will not receive any benefit from the merchant's lower than usual cost.

For all these reasons we believe that the net effects of S.B. 974 will be harmful to consumers.

Existing State and Federal Laws

We do not believe new legislation on this subject is necessary. There are existing federal and state laws that can be used to prevent or redress injury resulting from true predatory pricing on the rare occasions when it occurs. (Of course, we think predatory pricing should be thwarted on those rare occasions that it takes place.) Predatory conduct in wholesale and retail marketing is already subject to the Sherman Act, the Clayton Act, the Federal Trade Commission Act, and, at the state level, the Texas Free Enterprise and Antitrust Act.[15] These statutes address possible anticompetitive practices more effectively than would legislation more specifically regulating

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15 Tex. Rev. Civ. Stat. (Texas Business & Commerce Code) §§ 15.01-15.05. 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 the Commission. 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.

below cost selling. The existing antitrust laws deter firms from engaging in predatory behavior, but, at the same time, allow them to engage in price competition that is beneficial to consumers. In contrast, the price regulation envisioned by S.B. 974 may deny firms the flexibility to adjust their prices in response to changing market conditions.

Conclusion

For the reasons stated above, we believe that S.B. 974, if enacted, would tend to insulate wholesale and retail marketers of tangible personal property from price competition. The result would likely be that Texas consumers would end up paying higher prices for goods.

We appreciate the opportunity to comment on S.B. 974. Please feel free to contact us if we can be of further assistance.

Sincerely,

Thomas B. Carter
Director
Dallas Regional Office