

# Predatory Pricing

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2010

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**Predatory Pricing<sup>1</sup>**

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Forthcoming, Research Handbook on the Economics of Antitrust Law, edited  
by Einer Elhauge.

**Abstract**

Judge Breyer famously worried that aggressive prohibitions of predatory pricing throw away a bird in hand (low prices during the alleged predatory period) for a speculative bird in the bush (preventing higher prices thereafter). Here, I argue that there is no bird in hand because entry cannot be presumed. Moreover, it is plausibly commonplace that post-entry low prices or the threat of low prices has anticompetitive results by reducing entry and keeping prices high pre-entry and post-predation. I analyze three potential standards for identifying predatory pricing. Two are traditional but have been tangled together and must be distinguished. First, a price-cost test based on sacrifice theory requires that either price or cost be measured by what I describe as “inclusive” measures. A price-cost test to prevent the exclusion of equally efficient competitors, by contrast, requires that price and cost be measured by more traditional “exclusive” measures. Finally, I describe a Consumer Betterment Standard for monopolization and consider its application to predatory pricing. I explain finally how these three standards would affect the outcome of and focus of arguments in the American Airlines case, and argue that the Consumer Betterment Standard is a promising alternative to the more traditional tests.

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<sup>1</sup> I am grateful for many discussions with my coauthors Joseph Farrell and Louis Kaplow on this subject as well as Ralph Moore, Christopher Sagers, Steve Salop, Carl Shapiro, and Abe Wickelgren.

Antitrust aims to make markets more competitive, with the ultimate aim, of low consumer prices, or more generally high consumer welfare.<sup>2</sup> On these terms, predatory pricing may appear a paradox, because a predatory pricing claim asserts that a low price is anticompetitive.<sup>3</sup> Some put a point on the matter, saying that a predatory pricing claim asserts that a price is *too* low.

The so-called paradox is not a deep one, however, and is misleading, because while a rival complains of the low price, antitrust courts would ignore the complaint if there were not some convincing story that links the low price to a higher price; this higher price is the real policy concern guiding the law. Thus, the traditional story of predatory pricing has an incumbent or would-be monopolist driving an entrant or existing rival out of the market so that the incumbent can raise price in the absence of competition. The threat is not the low price but the high price. Edlin [2002] emphasizes instead the danger of an unnecessarily high pre-predatory, pre-entry price. He points out that banning the price cut can encourage the incumbent to charge low prices in the first place. Again, the threat is not the low price (entailed by the price cut), but the absence of an everyday low price “requiring” the cut.

Whatever the timing, the competition problem is a high price during a period without competition or with less intense competition. Predatory pricing claims are less a paradox than they are a challenge. The challenge for law and competition

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<sup>2</sup> Reiter v. Sonotone Corp., 442 U.S. 330, 342. See also “Statement of Commissioners Harbour, Leibowitz and Rosch on the Issuance of the Section 2 Report by the Department of Justice,” Federal Trade Commission, Sept, 2008, and Lande, R.H., Wealth Transfers as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged, 32 Hastings L. J. 67-106 (1982).

<sup>3</sup> See, e.g., Antitrust Paradox, Robert Bork (1978).

policy is to distinguish low prices or price cuts that raise average or “regular” prices from those that lower them. When this challenge proves frustrating or seems hopeless, the temptation is to abandon the venture and declare predatory pricing beyond the scope of competition law and policy.

Below, I begin by summarizing and critiquing prominent thinking about predatory pricing. Section 1 argues that Judge Breyer’s bird in hand is a fallacy. I explain in Section 2 that the strongest Chicago School skepticism of the existence of predatory pricing has weak theoretical foundations even in its wheelhouse (the case of symmetric costs and information). When information is asymmetric and/or when the monopoly has cost advantages, these foundations liquify as Section 3 explains. Following this theoretical discussion is an examination of the state of empirical knowledge in Section 4.

Sections 5.1 and 5.2 distinguish two strands of thought that courts and commentators have tangled into a thick knot: one is the sacrifice justification of price-cost tests; and the other is the equally efficient competitor justification. The two strands lead to distinct conceptions of the “appropriate” measure of cost. The sacrifice notion requires implementing an “inclusive” measure of cost or price; in contrast, the more common “exclusive” notion is appropriate (under certain assumptions, anyway) to prevent the exclusion of equally efficient competitors. I introduce and define inclusive and exclusive notions of cost and price in Section 5.1.

Section 5.3 introduces a new Consumer Betterment Standard for identifying exclusion in monopolization cases;<sup>4</sup> the standard proposes asking whether a monopoly's actions are likely to exclude from its market a competitor who would provide consumers a better deal than they get from the monopoly; Edlin [2002] is one specific implementation of that standard.<sup>5</sup> Applying that standard to the American Airlines case might have allowed the Department of Justice to win on the evidence they presented and would have provided a different avenue of proof more directly geared to consumer welfare. Although recoupment is not itself an element under such a standard, raising prices after a predatory episode may be an important part of a case.

Most of the discussion in this article focuses on markets with a monopoly or dominant firm; one section considers oligopoly.

## 1. Breyer's Bird in hand fallacy

One of the main reasons that noninterventionists argue that plaintiffs should jump a high hurdle to prove a predation case is the view that alleged predation generally involves unarguably competitive behavior (a good) whereas any consequent bads involve arguable and problematic claims. Judge Stephen Breyer

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<sup>4</sup> As far as I know, the standard is new but I fully expect that various historians of antitrust will soon inform me of its antecedents and I look forward to learning of them. Little in truth is new under the sun.

<sup>5</sup> The Consumer Betterment Standard for distinguishing anticompetitive from pro-competitive exclusion is inspired by my work with Joseph Farrell.

(now Justice Breyer) put a colorful point on the matter in *Barry Wright*.<sup>6</sup> He said there that to declare illegal an above cost price-cut would be to sacrifice a bird in hand (the price cut) for a speculative bird in the bush (preventing exit and a future price rise).<sup>7</sup> Breyer's "bird-in-hand" view has enormous gravitational pull and suggests that we must beware of interventionist policies.

The bird-in-hand view, however, is simply a fallacy. The important effects of court decisions and legal rules are prospective, which is to say the important effects are future effects on markets and potential cases.

The price cut only happens if and when there is entry and entry is not a bird in hand. Entry may never occur, and in fact a very permissive rule that allows aggressive price cuts post entry may make entry rare or delayed. If the entrant anticipates being outcompeted or predated post entry, why would it enter? Breyer's "bird in hand" presumes entry, and thus is just as speculative a proposition as the fear of high prices post exit.

The predatory pricing rule can affect the price before entry, the probability of entry, and pricing post entry if there is entry. In reality all effects are more like birds in the bush than birds in hand.

Some will be tempted to doubt this position and wonder how I can deny the fact of the real benefits that have actually occurred in the case under consideration from the price war that precipitated the instant court battle. How can these

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<sup>6</sup> *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227, 234 (1st Cir. 1983).

<sup>7</sup> Specifically, Breyer wrote " The antitrust laws very rarely reject such beneficial "birds in hand" for the sake of more speculative (future low-price) "birds in the bush".

consumer benefits not be a bird in hand? I concede that at the time of trial those gains are in fact real, but the trials results won't take them from consumers in any event. The relevant birds are all in prospective cases, not in the present case.

## 2. Is Predatory Pricing Common? If business folk think so, it is.

Robert Bork concluded that predatory pricing is “a phenomenon that probably does not exist.”<sup>8</sup> Professor Frank Easterbrook concurred in 1981, writing that predatory pricing is like “dragons” – everywhere in literature and nowhere in the world.<sup>9</sup> When I presented my 2002 paper at the University of Chicago,<sup>10</sup> it appeared to me that Judge Easterbrook had come to think that predatory pricing might be even rarer than that.<sup>11</sup>

Why so? Why did the Chicago School of Antitrust see predatory pricing as generally implausible, a claim that ultimately convinced the U.S. Supreme Court to write that “predatory pricing schemes are rarely tried, and even more rarely successful.”<sup>12</sup>

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<sup>8</sup> Antitrust Paradox, Robert Bork (1978) at 154.

<sup>9</sup> Easterbrook, F. (1981), Predatory Strategies and Counterstrategies, *University of Chicago Law Review*, 48 (2), 263-337. Jonathan Baker says that Chicago adherents either see predation as like a white tiger (if it exists at all) or a unicorn (if it does not). Baker, J. (1984). “Predatory Pricing after Brooke Group: An Economic Perspective” 62 *Antitrust Law Journal* 585.

<sup>10</sup> Edlin, A. (2002), Stopping Above-Cost Predatory Pricing, *The Yale Law Journal*, 111 (4), 941-991.

<sup>11</sup> Kenneth Elzinga and David Mills take a slightly more open view comparing successful price predation to an individual scoring over 65 points in a basketball game. Elzinga, K. and D. Mills (2001), Predatory Pricing and Strategic Theory, *Georgetown Law Journal*, 89 (8), 2475, at 2479.

<sup>12</sup> *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U. S. 574, 589.

Bork reasons thus:

*A firm contemplating predatory price warfare will perceive a series of obstacles that make the prospect of such a campaign exceedingly unattractive. The losses during the war will be proportionally higher for the predator than for the victim; merger law will make it all but impossible for the predator to purchase the victim, so the campaign will have to last until the victim's organization and assets are dissolved; ease of entry will be symmetrical with ease of exit; and anticipated monopoly revenues, being deferred, must be discounted at the current interest rate.*

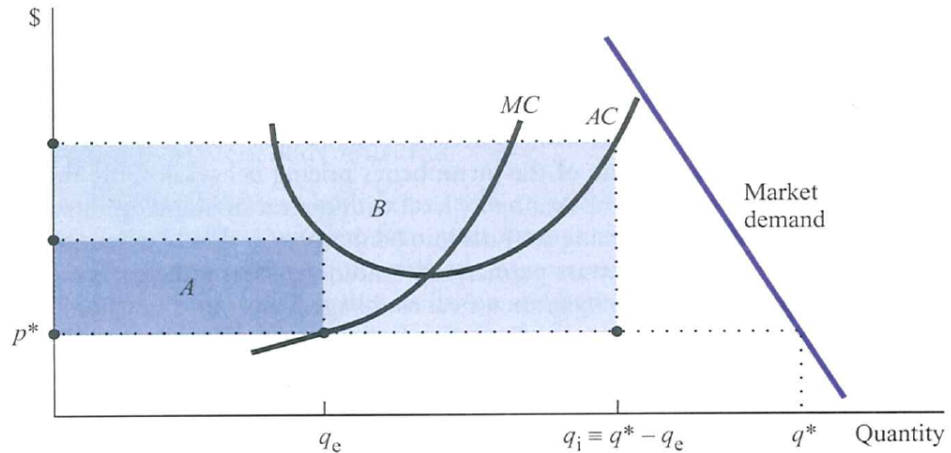
The beginning of the Chicago logic is the idea that the predator's losses during the predatory period will typically be large and larger than the prey. To understand this claim, consider the way the matter is taught to undergraduates in the leading industrial organization textbook written by Professors Dennis Carlton and Jeffrey Perloff.<sup>13</sup> See Figure 1, which is their Figure 11.1. Imagine a market that is big enough for two identical firms to produce at efficient scale as depicted in Figure 1. Can one firm oust the other through predatory pricing? Label the predator-incumbent "i" and the prey-entrant "e". The predation, of course, need not follow entry—it can simply be an effort to end an unsatisfactory sharing of the market.

Figure 1:

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<sup>13</sup> Modern Industrial Organization, 2005, Dennis Carlton and Jeffrey Perloff.





The entrant will presumably not consider exit so long as price exceeds the minimum of its average cost. In fact, it should only consider exit if price is below the minimum of its average avoidable costs (AAC), where “avoidable costs” are those that would be avoided by the exit. (As the time to exit expands, presumably more and more costs become avoidable by exit and AAC becomes closer to average total costs.) But in order to drive price to some level  $p^*$  below AAC, the entrant must expand output enough to keep the price at that level. After all at a price of  $p^*$  less than the minimum of AC, if the entrant stays in the market, the entrant will reduce its output to some  $q_e$  such that  $MC(q_e)=p^*$ . In order to keep price at  $p^*$ , the incumbent will need to increase its production to  $q_i=q^*-q_e$ . As shown in the figure, the losses for the entrant, the dark shaded area A, are considerably smaller than those for the incumbent, the shaded area B. In fact, even if rectangle A were taller than rectangle B, it must have smaller area because the area of rectangle B equals that of rectangle A plus the extra losses that the incumbent suffers on all units

between  $q_e$  and  $q_i$  (i.e., the area under MC and above  $p^*$  between  $q_e$  and  $q_i$ ).<sup>14</sup> So during the predatory period, in this example, anyway, the predator loses more per month than the prey.

In general, successful predation requires:

1. **Low prices;** price must be sufficiently low to tempt rivals to exit (generally below AAC) or otherwise to chastened them;
2. **Credibility;** the threat must be credible that the predator will keep prices low until rivals exit; and
3. **No re-entry;** re-entry or new competition must be sufficiently delayed that the predator can recoup its losses from predation.

Let's begin by focusing on requirements #1 and #2 and assuming for the time being that re-entry will not occur after an exit has been forced.

In order to satisfy condition #1, the market price must be driven below the prey's AAC. If the two firms have symmetric costs as in the example, and the predator's average costs rise with additional output as depicted in the figure, then the predator will lose more than the prey. As Bork, Carlton and Perloff and many others see the matter, this makes it implausible that the predator will continue such behavior.<sup>15</sup> And if it isn't plausible that the predator will continue, then the prey won't exit, and if the prey won't exit, the predator will never start, or at least rationally should never start.

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$$^{14} B = A + \int_{q_e}^{q_i} [MC(q) - p^*] dq.$$

<sup>15</sup> Carlton and Perloff conclude: "The reason that predatory pricing is unlikely to succeed where firms have identical costs is that the predatory firm suffers greater losses than its intended victim."

Their presumption seems sensible enough: If the predator is losing money by the boatload, shouldn't the prey expect that the predator will give up its foolishness before long? Particularly if the prey makes it clear that it will stick it out, by sticking it out! The logic has its appeal, but then consider that the prey is also losing money, albeit less. And, the predator too may make its own obstinance clear by sticking around.

In fact, in a game theoretic sense, there are (at least) two equilibria. In the no-predation equilibrium, the prey will persevere (perhaps rationalizing this decision on a comparison of relative losses), no matter how far the game continues, because he always expects that the predator will quit the next moment; the predator's corresponding strategy in this equilibrium is always to quit predation at the next moment no matter how long he has been in the market. If we restrict attention to any particular subgame, these two strategies restricted to the subgame constitute a Nash equilibrium. Hence, these two strategies are a subgame perfect equilibrium of the overall predation game.

But successful predation is also a subgame perfect equilibrium.<sup>16</sup> In that equilibrium, the predator expects the prey to drop out next period if predation continues and so at all points the predator wants to continue predation; correspondingly, the prey expects that the predator will continue indefinitely and so

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<sup>16</sup> This is demonstrated formally by Milgrom and Roberts [1982, Appendix A]. Milgrom, P. and J. Roberts (1982b), Predation, Reputation, and Entry Deterrence, *Journal of Economic Theory*, 27 (2), 280-312. The predation equilibrium can be eliminated if there is a known finite end to the game as in Selten, R. (1978), The Chain Store Paradox, *Theory and Decision*, 9 (2), 127-59, but this possibility is extremely unusual.

drops out quickly or immediately. These two strategies are just as consistent and sensible as the no-predation equilibrium.

Condition #3 is thought by many to be the real rub. After all, if the predator raises price, won't this simply invite entry? Maybe. But this "no re-entry" condition may not be so tough to satisfy. Condition #3 has a certain self-fulfilling character. If predation is known to be generally unsuccessful and implausible, then if by some stroke of luck, although rarely tried, predation is tried, and if although it rarely succeeds, by luck again it does succeed in inducing exit, the predatory strategy may still be unsuccessful taken as a whole. After all, for full success the predator must not just induce exit, but must also satisfy condition #3. And, if despite this success, entrants are not worried about further predation, the monopoly will be short-lived because the monopoly will invite entry as a vacuum invites gas.

But, suppose on the other hand that predation is a generally successful strategy. Then, entry (post-predation) would seem foolish as it will only be met with more predation. In this case, the period of monopoly rents will be long. And, if the recoupment period is long, this return will tend of course to justify a long and large investment in the predatory period, and if a large investment is justified, then a large investment won't even be necessary because the prey may get out early, realizing that it is unprofitable to wait the predator out. Now observe that if the prey gets out early, then the long post-entry period will not only be long, but contrary to Bork's suggestion also not be delayed, so the discounting that Bork worries about becomes relatively inconsequential.

There are two basic points to understand here. The first is that requirements #2 and #3 are not so very different and do not really compound the difficulties of successful predation, contrary to what many suppose.<sup>17</sup> Staying in a market is easier and cheaper than entering a market. Hence, if a firm in the market will and does exit in response to predation, no firm with similar cost structure will enter.

The plausibility of predation is much more self-fulfilling than often realized. Starting at the end and reasoning backward, if predation is a plausible strategy, then re-entry will be rare. The recoupment period will be long. It is then credible that the predator will continue its predation long enough to drive the prey out and hence the prey sees no advantage to staying in the market after it begins losing money with respect to AAC. If the prey will leave quickly and the recoupment period is long, then the predator will rationally persist. And if predation leads to quick exit and long recoupment without re-entry, then when firms consider re-entry this will be unattractive (because they will face predation). Hence, all the assumptions of plausibility are self-fulfilling.

There is a fair bit of stability to the equilibrium of a deep short price cut, followed by quick exit, and a long period without re-entry. Who but a madman, or a firm with extremely low costs, would enter such a market? And with the expectation of a quick exit and long recoupment period, a rational predator is

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<sup>17</sup> At the 70,000 foot level this is an instance of Stiglitz and Dasgupta's principle that "the more competitive ex post competition (competition is after entry) the less effective is the market discipline provided by potential competition." Stiglitz, JE and Partha Dasgupta, Potential Competition, Actual Competition, and Economic Welfare, *European Economic Review* 1988. 566-577.

willing to stick to its price cut despite large losses for a long time; after all, the predator in this equilibrium rationally believes that the prey is always hanging on by a thread and likely to leave shortly and without return. The unlikely event that the prey persists in the market for a long period may of course mean the predatory strategy turns out to be unprofitable *ex post*. But it does not mean that the predatory strategy is unprofitable *ex ante*. After all, this event is unlikely; in the extreme case, it is out of equilibrium and a zero probability event. And, it does not mean that continuing the predatory strategy is unprofitable in conditional expectation from any point in time; quite the contrary, the prey is expected by the predator to exit at any moment and the long period of recoupment is always expected to be very close. In the unlikely or out-of-equilibrium event that the prey persists for a long time in the market, it is only 20-20 hindsight that makes it appear that the predator's strategy was irrational because recoupment was so delayed.

This logic suggests that if predator and prey have consistent expectations, the Bork-Easterbrook view could be right, but it could also be completely wrong. What creates the expectations? Economics offers no solid theory to answer that question. In economic theory, expectations are "read" off the equilibrium; if there are multiple equilibria with different expectations, economics does not have a definite prediction of which will obtain. Possibly, financial constraints might play a role, as suggested long ago by Telser [1966] and more recently by Bolton and Scharfstein [1990] or by Bolton, Brodley and Riordan [2001].<sup>18</sup>

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<sup>18</sup> Telser, L. (1966), Cutthroat Competition and the Long Purse, *Journal of Law & Economics*, 9, 259-277. Bolton, P., J. Brodley and M. Riordan (2000), Predatory Pricing:

If the prey has capital constraints, one might think that it can't persist for long. Perhaps the predatory equilibrium is more likely then. It is tempting, then, to imagine that a predatory equilibrium will be more plausible when a large firm preys on a small firm. However, Bork points out that a predator who has 90% of the market may suffer more than 9 times the losses of prey who has only 10% of the market, particularly if the predator expands its output and losses and the prey contracts to minimize its losses. Possibly, then if both prey and predator have finite purses, the predator's will run out of money first and this may dictate the equilibrium through backward induction. With perfect capital markets, on the other hand losses once suffered are sunk and there is no necessary end to the predation game—only expectations bring it to an end. Thus, while many turn to imperfect capital markets to justify the plausibility of predation, depending on the nature of the imperfection, it might turn predation from plausible to implausible. If on the other hand the predator's purse comes from its involvement in other markets and not its involvement in the problematic one, then the difficulties of raising capital would weigh in favor of predation's plausibility.

Another weakness of the Bork-Easterbrook argument is that the loss analysis that is central to their argument may not be right even when production technologies are symmetric. They presume that the predator's losses become increasingly large as it increases output and the prey's decreasingly so as it

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Strategic Theory and Legal Policy, *Georgetown Law Journal*, 88 (8), 2239-2330. Bolton, P. and D. Scharfstein (1990), A Theory of Predation Based on Agency Problems in Financial Contracting, *The American Economic Review*, 80 (1), 93-106.

decreases output. What, though, if production is subject to increasing returns to scale? Then, the predator's average costs may fall as it increases output and the prey's costs may rise if it restricts output. For this reason the predator's losses if any may be smaller than the prey's.

We have seen that the home-run point about the relative losses of predator and prey is not such a home run despite its intuitive appeal. Whether predation is a successful strategy depends very much on whether predator and prey believe it is a successful strategy. Only if the Bork-Easterbrook skepticism is contagious (not just among courts and in academe but) among business people will predation be like dragons. If business people read Supreme Court opinions, perhaps the skepticism of Matsushita and Brooke Group would produce a world in which that skepticism were fully justified. Few, however, do.

### **3. Asymmetric Information and Asymmetric Fundamentals.**

Thus far, I have argued that predation is plausible even in the world of symmetric costs and symmetric information in which the Chicago attacks seem strongest. The main stream of literature on predation, however, took a different tact. The progress of Chicago School skepticism lead to a wave of critiques in the 1980s by many of the greatest names in economics such as Drew Fudenberg, David Kreps,



Paul Milgrom, John Roberts, Steven Salop, Jean Tirole, and Robert Wilson.<sup>19</sup> They pointed out that if firms have asymmetric fundamentals (e.g., cost of production or finance or discounting) and asymmetric information about these costs, then predation makes perfect sense in that a firm with high cost may cut price in an effort to convince entrants that it has low costs and that they should therefore exit.<sup>20</sup> It turns out that even without asymmetric information, asymmetric fundamentals by themselves, at least if they entail incumbent advantages, can make it more likely that incumbent price cuts are socially undesirable.

### 3.1. Asymmetric Information Models of Predation

Suppose that incumbents come in two types – low cost and high cost – and entrants or rivals cannot directly observe which is which. For the low-cost firms fighting entry is short-term optimal and for the high-cost firms accommodation is short-term optimal. Rivals lose money if they face a firm that fights, but otherwise make money. For the high-cost incumbents fighting is only optimal if it induces exit or deters further entry. Will the high-cost incumbents predate, thereby sacrificing short-run returns to induce exit or to discourage others from entry?

If information were symmetric and the game ended tomorrow, then incumbents would not predate today because regardless of what they do today,

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<sup>19</sup> Salop, SC, Strategic Entry Deterrence, *American Economic Review*, Vol. 69 p. 335 (1979). Milgrom, P. and J. Roberts (1982b), Predation, Reputation, and Entry Deterrence, *Journal of Economic Theory*, 27 (2), 280-312. Roberts, J. (1986), A Signaling Model of Predatory Pricing, *Oxford Economic Papers, New Series*, 38 (supp.), 75-93. Fudenberg, D. and J. Tirole (1986), A “Signal-Jamming” Theory of Predation, *The RAND Journal of Economics*, 17 (3), 366-376. Kreps, D. and R. Wilson (1982), Reputation and Imperfect Information, *Journal of Economic Theory*, 27 (2), 253-79.

<sup>20</sup> Ordoover and Saloner [1989] provide an excellent review of these asymmetric information models.

rivals know that tomorrow they will accommodate (Selten showed that a similar backward reasoning applies to games of arbitrary length as long as the parties know when they will end).<sup>21</sup> However, if rivals must infer the incumbents' costs from their behavior, then some of the high-cost firms will surely fight in any equilibrium. How do we know? Simple. If none did, so that all fighters have low cost, then by fighting even a high cost firm can make others believe it to be low cost, which by assumption will induce exit or deter entry. Thus the equilibrium involves some high-cost firms fighting even though they lose money in the short-run by doing so. If the game is long, then the proportion fighting can grow toward one. Fast reactions are, of course, equivalent to a long game with low discount rates, so when reactions can be fast, predation becomes very likely.

### 3.2. Asymmetric Fundamentals Models of Predation

Edlin [2002] has argued that even if information is symmetric, asymmetric fundamentals, like cost or product quality, allow an incumbent with advantages to predate on disadvantaged entrants and drive them from the market. Unlike the arguments in section 2, and like the arguments above, Edlin's [2002] arguments apply in both finite and infinite horizons.

Consider, as Edlin [2002] suggests, a monopoly incumbent charging a high price  $H$ . The monopoly is known to have low costs  $L$ . Will a potential rival with costs  $M$  between  $L$  and  $H$  enter the market? Not if the monopoly will respond with the price just under  $M$  (or equivalently beat whatever price the entrant charges).

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<sup>21</sup> Selten, R. (1978), The Chain Store Paradox, *Theory and Decision*, 9 (2), 127-59.

The capacity to cut price from H to M after entry allows the monopoly to charge H forever without fear of entry. Or, if the rival firm is already in the market, the monopoly can drive it from the market and raise price to H without fear of re-entry.

This straightforward competition problem is likely to be endemic. After all, it is common that an incumbent monopoly has cost or other advantages over rivals considering entry. If not for some advantage how else did the firm come to be or to retain a monopoly? (Well, predation is one possible answer, but surely advantages is another and indeed a complementary one). A monopoly may have lower costs due to fortuity, ingeniousness, or increasing returns. Its products could enjoy a quality advantage due to network externalities<sup>22</sup> or simply superior production; such quality advantages can roughly be thought of as cost advantages. At the very least, there is frequently a “switching cost” that buyers incur if they switch suppliers; such a cost will give the monopoly an advantage at keeping customers – at a minimum, if the entrant charges the same price as the monopoly it should expect very little if any business (even though in the “standard” model, it would get half the market).

In general, then, the canonical model of a monopoly and entrant should probably not have identical costs but assume at least that (most) potential entrants have higher costs or some other disadvantage. As a result, the incumbent may be able to force entrants to exit the market without incurring losses at all. Such “above-cost predation” may even be profit maximizing in the short run; it will be profit

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<sup>22</sup> Farrell, Joseph and Michael Katz [1986]. Competition or predation? Consumer coordination, strategic pricing and price floors in network markets. *Journal of Industrial Economics*, 53, 203-31.

maximizing in the short run if the firms have constant marginal costs and sell identical products.

Once one thinks of predation as including price matching or price beating by a monopoly that succeeds in significantly limiting entry, it becomes evident that such pricing patterns are roughly as common as entry in monopoly and nothing like dragons. Perhaps the Easterbrook-Bork vision of below-cost predation is like dragons (though the discussion in section 1 may lead one to doubt it); but above-cost predation of the Edlin [2002]-ilk is not.

There is a question in the minds of many (and of the courts) about whether above-cost pricing can be termed predatory at all, but if not, choose another word and call it “anticompetitive” above-cost pricing. As Professor Einer Elhauge points out, to *define* predation as entailing below-cost pricing rather than *arguing* that only below-cost pricing is worthy of concern is a cheap rhetorical ploy with no fundamental import.<sup>23</sup>

To sum up, even if one believes the expectational assumptions that make predation rare in the case of symmetric costs, symmetric information, decreasing returns to scale, and no switching costs, once one deviates from these assumptions, one moves from thinking that price cuts can sometimes be anticompetitive to thinking that they frequently can be.

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<sup>23</sup> Elhauge [2003] at 698-99 (Writing that “[o]ne unfortunate tendency has been to declare victory by definition---asserting that a “predatory” price must be below cost or that low above-cost prices involve ‘competition on the merits’”)

#### 4. The Empirical Evidence on Predatory Pricing.

What is the empirical evidence on predatory pricing? It depends a great deal of course on how we define predatory pricing. Thus, Elzinga (1970) did not find predatory pricing in the gunpowder trust, defining predatory pricing as below marginal-cost pricing. Yet, Zerbe and Mumford found it in 5 of 11 cases by including above marginal-cost pricing intended to drive a rival from business or to induce a rival to join a cartel.

Elzinga and Mills (2001) see no evidence of successful predation by General Foods in the 1970s to protect its Maxwell House coffee in the eastern United States from the incursion of Proctor & Gamble's Folgers coffee, which was the most popular brand in the West.<sup>24</sup> They emphasize in particular that the price cuts of General Foods did not in the end stop Folgers from moving east and becoming a national brand. Patrick Bolton, Joseph Brodley and Michael Riordan, on the other hand, argue that it is plausible that General Foods successfully engaged in test-market predation: success was measured by Folgers delaying its entry for 7-8 years; they suggest that this delay of competition in the East is an important harm to be considered.<sup>25</sup>

Most empirical studies are case studies that attempt to tease out of observed data what firms were trying to do and what they in fact did do. David Bunch and

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<sup>24</sup> See *In re General Foods*, 103 F.T.C. 204 and Kenneth G. Elzinga & David E. Mills, *Predatory Pricing and Strategic Theory*, 89 *Geo. L. J.* 2475 (2001).

<sup>25</sup> Bolton, P., J. Brodley and M. Riordan (2000), *Predatory Pricing: Strategic Theory and Legal Policy*, *Georgetown Law Journal*, 88 (8), 2239.

Robert Smiley take a different approach.<sup>26</sup> They survey managers and ask how frequently those in their industry engage in a variety of practices to deter entry. One striking finding is that limit pricing is the rarest of the surveyed strategies. Interestingly these authors do not survey firms about deterring future entry by predatory pricing in response to current entry (they do survey about “giving the impression through media” that entrants will be greeted with “especially rigorous” competition.) Capacity expansion tends to be used more when incumbents are larger and when the cost disadvantage to being small is greater, according to Bunch and Smiley.<sup>27</sup>

Burns (1986,1989) found that American Tobacco was able to purchase rivals at lower prices after predation as would be expected in a reputation model and contrary to McGee’s (1960) early arguments that merger was a substitute (and superior) strategy to predation. Scott Morton (1997) found that when newer or smaller entrants faced off with the British shipping conference they were more likely than larger firms to confront a price war and be driven from the market. This is consistent with Telser’s long purse theory. Genesove and Mullin (2006) have provided evidence of successful below-cost predation in the sugar industry in the early twentieth century. An excellent and extensive survey of the literature has been written by Bruce Kabayashi; a pithier survey is found in Kaplow and Shapiro.<sup>28</sup>

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<sup>26</sup> Bunch, David and Robert Smiley, 192, *Review of Economics and Statistics*, “What Deters Entry? Evidence on the Use of Strategic Entry Deterrents, 509-521.

<sup>27</sup> *Id.* at 517.

<sup>28</sup> Bruce Kobayashi, “The Law and Economics of Predatory Pricing” in *Antitrust Law and Economics*, ed. By Keith N. Hylton. Forthcoming Edward Elgar. Kaplow, Louis and Carl Shapiro,

Chris Sagers has surveyed all available information on airline price predation and concludes “that predation not only occurs in airline markets, but has been a key tool to preserve market power held by the surviving legacy carriers.”<sup>29</sup>

What is learned from this empirical evidence? Even if one takes a narrow view of predatory pricing and considers only below cost pricing as candidates for predation, the view that predation is as rare as dragons is not born of the empirical evidence. If you hold that view strongly as a prior,<sup>30</sup> then it is possible that papers such as Genesove and Mullin won’t sway you much. On the other hand, you shouldn’t expect to cite Koller (1971), McGee (1960, 1980) and Easterbrook (1981) as the Supreme Court did in its Matsushita ruling and convince someone that predation never occurs if that some one is predisposed to think predation possible.

If one expands ones view of predation to include cases where a monopoly drives out entrants and deters future entry to the detriment of consumers, then the frequency of predation surely goes up, but the empirical literature does not tell us how much.

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“Antitrust”, Handbook of Law and Economics, Volume 2, Edited by A. Mitchell Polinsky and Steven Shavell, 2007.

<sup>29</sup> “Rarely tried, and ...rarely successful:’ Theoretically impossible Price Predation Among the Airlines.” Christopher Sagers 74 J. Air L. & Com. 919 (2009).

<sup>30</sup> By a “prior,” I mean a belief held prior to reviewing the empirical evidence. Bayesian statisticians speak of this prior belief and the posterior belief resulting from updating the prior in light of the evidence.

## 5. Tests, Standards, and Rationales

I have argued that the Chicago School's skepticism about the existence of predatory pricing was unfounded,<sup>31</sup> particularly if one considers above-cost predation. Left unanswered is what if anything should be done? In particular, what should be the legal standard of illegal pricing? A good answer must pay due respect to administerability concerns.

The Supreme Court in the United States (at least in oligopoly markets) endorses a test of predatory pricing requiring proof that the predator prices below its cost and that it has either a reasonable prospect or probability of recouping the losses from so doing.<sup>32</sup> In contrast, the European Union has found abuse of dominance when above-cost price cuts were intended to drive rivals from the market.<sup>33</sup> The U.S. Supreme Court pays at least lip service to the idea that above cost price cuts can be undesirable but says they are "beyond the practical ability of a

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<sup>31</sup> Of course this skepticism itself has two strands: one is a theoretical contention that low prices harmful to competition is rare or nonexistent, and the other is that little can be done about it without doing more harm than good. So far, I have tackled only the theoretical claim.

<sup>32</sup> Most commentators assume that *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993) applies equally to oligopolies and monopolies. On the other hand, Edlin [2002] and later the court in *Lepage's*, 324 F.3d 141 (3<sup>rd</sup> Cir. 2003) argue that the *Brooke Group* precedent may not be applicable to monopolies. "[n]othing in the decision suggests that its discussion of the issue is applicable to a monopolist with its unconstrained market power." *Lepage's*, at 151.

<sup>33</sup> Key cases in this line include *AKZO, Compagnie Maritime (known as Cewal), and Irish Sugar*. Case C-62/86, *AKZO Chemie BV v. Commission*, 1991 E.C.R. I-3359 ¶¶ 70-73 (E.C.J. (holding that above variable cost but below total cost pricing is illegal if intended to eliminate a competitor). See also *Joined Cases T-24/93, T-25/93, T-26/93 & T-28/93, Compagnie Maritime Belge Transps. SA v. Commission*, 1996 E.C.R. II-1201 ¶¶ 138-153 (Ct. First Instance); *aff'd* by *Joined Cases C-395/96 P & C-396/96 P, Compagnie Maritime Belge Transps. SA v. Commission*, 2000 E.C.R. I-1365 ¶¶ 117-120 (E.C.J.) (European Court of Justice affirming that selective above-cost price cuts to meet an entrant were illegal when a firm with over 90% market share has purpose of eliminating entrant.) *Case T-228/97, Irish Sugar PLC v. Commission*, 1999 E.C.R. II-2969 ¶¶ 173-193 (Ct. First Instance), *aff'd* on other grounds, *C-497/99 P*, 2001 E.C.R. I-5333 (E.C.J.)



judicial tribunal to control without courting intolerable risks of chilling legitimate price-cutting.”<sup>34</sup>

The cost-based tests used in the U.S. present many implementation issues. Costs are notoriously difficult to measure, and once one begins measuring them, one immediately discovers that they come in many varieties: short-run marginal cost, long-run marginal cost, average variable cost, average avoidable cost, average incremental cost, and more. If the test for predation involves pricing below cost, what measure of cost is the right one to use? The U.S. Supreme Court has said that price should be compared with the *appropriate* level of cost, but declined to decide what measure was appropriate.<sup>35</sup>

One can't really consider what the appropriate level of cost is without explaining first why one is comparing price with cost to ferret out predation. Here I distinguished two cost-based rationales, and take each in turn: sacrifice rationales and excluding-equally-efficient-competitor rationales. Oddly, American courts say at various times that they are about either or both and don't seem to discern that they are different. After I discuss these two rationales and the test each implies, I introduce a Consumer Betterment Standard.

### 5.1. The Sacrifice Standard.

Sacrifice theories observe that if a price is below cost, this reflects a sacrifice, and sacrifice raises the question—“what for?” One possible answer is that the

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<sup>34</sup> Brooke Group, 509 U.S. at 223.

<sup>35</sup> Brooke Group, nt 1. (“... we again decline to resolve the conflict among the lower courts over the appropriate measure of cost.”)

sacrifice was suffered “to exclude competition,” and if this is the answer, then we have an antitrust problem. Under sacrifice theories of predation, the cost (and price) definition should be geared to identify sacrifice.

Areeda and Turner [1975] is the usual point of departure for sacrifice tests.<sup>36</sup> Their theory is premised on the observation that in perfectly competitive markets, price equals short-run marginal cost, and so if, and only if, prices are below that level, does the question “what for?” emerge. Thus, the AMR court writes, following *Advo* that “the ideal measure of cost would be marginal cost because ‘[a]s long as a firm’s prices exceeded its marginal cost, each additional sale decreases losses or increases profits.’”<sup>37</sup>

Others such as Ordover and Willig (1981) followed at least this much of the Areeda-Turner logic: if a firm undertakes actions that it would not undertake absent the effects of its action on reducing future competition, then the action is anticompetitive (but otherwise not). The Ordover-Willig definition urges that proving predation entails demonstrating first a short-run profit sacrifice and second that recouping the sacrifice is only possible due to reductions in competition. With some modification of rationale, this logic developed into the two-pronged Brooke Group test (prong #1,  $P < C$ ; prong #2, recoupment).<sup>38</sup>

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<sup>36</sup> Areeda, P. and D. Turner (1975), *Predatory Pricing and Related Practices under Section 2 of the Sherman Act*, *Harvard Law Review*, 88 (4), 697-733.

<sup>37</sup> *U.S. v. AMR* 335 F.3d 1109 at 1116, quoting *Advo*.

<sup>38</sup> Brooke Group cites Elzinga, Kenneth and David Mills, “Testing for Predation: Is Recoupment Feasible?” 34 *Antitrust Bulletin* 869 (Winter 1989); Hemphill, C. S. (2001), *The Role of Recoupment in Predatory Pricing Analyses*, *Stanford Law Review*, 53 (6), 1581-1612 (providing a particularly insightful analysis of recoupment).

What measures of cost and of price does a sacrifice theory suggest? Areeda and Turner, Ordover and Willig, and the courts in AMR and Advo advocate comparing price with marginal cost (MC) at least when possible. And, indeed output expansions when  $p < MC$  do involve a sacrifice.

But does  $P > MC$  imply lack of sacrifice? If MC were the dividing line between sacrifice and lack of sacrifice, then the test would be unbiased. However, contrary to the assumption of the AMR court and the Advo court,  $P > MC$  is quite consistent with sacrifice, as these terms are used in basic microeconomics texts. A price above marginal cost does not mean that an additional sale “decreases losses or increases profits”.<sup>39</sup>

Additional sales generally require lowering prices on all goods sold not just on the additional sales. As a result, marginal revenue – defined as the revenue from an additional sale – is almost always below price for firms that charge uniform prices. Only in idealized perfectly competitive markets can a firm increase output without lowering price, and such markets are pretty irrelevant to the contexts of antitrust (monopoly and market power). The more market power a firm has, all else equal, the greater will be the excess of price over marginal revenue.

Here are two simple ways to frame a price-cost comparison as a necessary and sufficient test of sacrifice which appears (sometimes) to be what the AMR court sought. Suppose that Dell sells one million computers each year for \$1,000 each, and pays \$900 to produce each computer. To sell 1,000,001 computers it must lower price by one cent to \$999.99. One cost of selling the extra computer is lowering

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<sup>39</sup> U.S. v. AMR 335 F. 3d 1109 at 1116 (Tenth Cir.). *Advo*, 51 F.3d at 1198.

price on one million computers by one cent each, which cost amounts to \$10,000 in lost revenue. As a result, even though the last computer sells for \$999.99 and this “price” exceeds the production cost of \$900, the sale involves an enormous sacrifice. Profits fall because

$$\$999.99 < \$10,900.$$

The real full cost of selling the extra computer is actually \$10,900. The Advo assertion holds true only if marginal cost includes the cost of losing \$10,000 of revenue on the first million computers.<sup>40</sup> Unlike the “production” measure of marginal cost, this “inclusive” definition of marginal cost can be compared to price to yield an unbiased measure of sacrifice. (I here introduce and utilize the terminology “inclusive” and “exclusive” which is inspired by the tax literature where prices are referred to as being tax-inclusive or tax-exclusive).

There is another way to think about the matter which is to reconceptualize price and not see price as \$999.99. Economists speak of marginal revenue (“MR”) which is the increment to revenue from the last sale. In this case, marginal revenue is negative. It is:

$$MR = \$999.99 - \$10,000 = -\$9,000.01$$

Extra output involves sacrifice if and only if  $MR < MC$ . Marginal revenue can be seen as an inclusive notion of price. It includes revenue effects. The alternative way to measure sacrifice is to talk about an inclusive notion of revenue that includes the lost revenue on inframarginal units, an inclusive notion of price can be compared to

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<sup>40</sup> This example is a variant of one in Phillip Areeda, Louis Kaplow and Aaron Edlin, *Antitrust Analysis: Problems, Text and Cases*, 6<sup>th</sup> ed. 2004, p. 478-79.

the exclusive production cost of \$900. In this example, as  $-9,000.01 < \$900.00$ ,  $MR < MC$ , and the output increase is unprofitable.

The Justice Department *implicitly* put forward these inclusive definitions of price (or maybe cost) in the AMR case.<sup>41</sup> AMR had added a number of planes to a route. The DOJ compared incremental revenue to incremental cost, where the “increment” was the additional flights. In a sense the price at which AMR was selling the extra flights was the amount by which its revenues increased (i.e., incremental revenue) rather than say the sum of ticket prices of passengers who travelled on the extra flights. There are at least two problems with simply counting the ticket prices on the extra flights: first, that would count revenue even if the only thing that happened was that passengers switched from existing American flights to the new ones, and second it would not account for the full impact (on existing flights) of any overall price decreases that American made to fill its expanded schedule of flights. With this inclusive definition of price as incremental revenue the DOJ proved a sacrifice. There is of course a strong sense in which the price at which American sold these extra flights equals the incremental revenue of adding them and not the revenues from tickets on the flights.

The district and appellate courts, however, did not accept these inclusive notions in AMR. The appellate court objected, using an example drawn from Elhauge, that the DOJ test “effectively treats foregone or ‘sacrificed’ profits as costs,

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<sup>41</sup> Oddly, the Department of Justice briefs in AMR were not straightforward in explaining the difference between inclusive and exclusive notions of price and cost. The briefs embrace Areeda-Turner who probably had in mind comparing exclusive measures of price and cost, but then proceeded to implement tests that used inclusive measures of one or the other.

and condemns activity that may have been profitable as predatory.”<sup>42</sup> The Elhauge example involves an airline that adds a flight with direct costs of \$500,000. Passengers on that flight purchase \$1,000,000 of tickets, but the revenue of the rest of the route falls by \$600,000 so that the net incremental revenue is \$400,000.<sup>43</sup> Adding the flight lowers profits by \$100,000 and involves a profit sacrifice. How then does the court come to view the added flight as profitable? It does so by comparing the \$1,000,000 exclusive price on the incremental capacity to its \$500,000 exclusive cost. Elhauge objects to the inclusive notions of cost or price saying “it is vital for analytical clarity to avoid using cost measures that effectively include forgone profits. Otherwise, one cannot keep predatory theories based on a failure to maximize short-term profits analytically distinct from theories based on pricing below costs.”<sup>44</sup>

Why though should one want to keep predatory theories based on profit sacrifice<sup>45</sup> analytically distinct from theories based on pricing below cost? One of the central rationales for price-cost tests is that pricing below cost indicates short-run profit sacrifice and sacrifice may indicate anticompetitive exclusionary activity. In defense of Elhauge here, his statement makes perfect sense if one views price-

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<sup>42</sup> US v AMR 335 F.3d 1109, 1118, particularly note 13.

<sup>43</sup> Elhauge [2003,694] or US v AMR 335 F.3d 1109, nt 13,

<sup>44</sup> Elhauge [2003,694].

<sup>45</sup> Here I have substituted the words “profit sacrifice” for Elhauge’s “failure to maximize short-run profits” because the latter may be a more inclusive term and because (to the extent that profit sacrifice and failure to maximize profits differ) profit sacrifice is the concept central to predation analysis. The Department of Justice distinguished between sacrifice theories and failure to maximize short-term profits theories by pointing out that its efforts to identify (large) profit sacrifices from adding incremental capacity in response to entry are different than obligating a firm to always maximize profits. The Department of Justice would not, for example, have argued that a firm that priced low in the first place before entry was unlawfully excluding competition because it failed to maximize short-run or long-run profits.

cost tests as the exclusive domain of equally-efficient-competitor standards rather than sacrifice standards. His point becomes one of truth in advertising, which is that price-cost tests do not measure profit-sacrifice so one should distinguish profit sacrifice tests from price-cost tests. My objection to that truth-in-advertising point is that for better or worse, price-cost tests have been adopted by courts at least in part to identify profit sacrifice and if price or cost is measured inclusively then the tests can do so admirably. What I think is clearly false advertising is to use exclusive measures of price and cost in an effort to measure sacrifice (to the extent that Elhauge is making this point, he and I are in complete agreement).

Additional output involves a sacrifice if and only if marginal revenue is less than marginal cost. Comparing exclusive notions of price to exclusive notions of marginal cost gives a free pass to sacrifices that are not too great. Counterproductively, bigger free passes are handed out to firms with greater market power because for them the wedge between marginal revenue and price is greater. In fact the free pass can be huge: in the example above, the goods were sold when the loss from so doing was ten times the price.

To the extent that one is trying to measure the intent to limit the competition from rivals --- and to the extent that short-term sacrifice is seen as a useful signal of such intent – comparing marginal revenue with marginal cost is a more accurate test of sacrifice than comparing exclusive notions of price with exclusive notions of marginal cost or price with average variable cost.

Saying that marginal (or incremental) cost should when possible be compared to marginal (or incremental) revenue to identify sacrifice, does not

transparently answer all questions of course. We briefly consider one other issue. Consider two-sided markets in which types A and types B are simultaneously served by a “market-maker” and the service consists of intermediation between A’s and B’s. Examples abound: a nightclub serves and matches men and women; credit card networks simultaneously serve customers and merchants; an academic journal serves readers and authors; in fact any distributor of goods or reseller can be thought to provide its distribution services both to suppliers and customers, who it is ultimately matching together.

Suppose the immediate cost of serving A is X and the market maker sells to A at  $p < X$ . Is the price below the “appropriate” measure of cost? Not necessarily. It sells below the exclusive cost, but not necessarily the inclusive cost. The inclusive cost is less than X because by serving A the market maker gets a higher price from B, or sells to more B’s. Such an adjustment seems necessary. (some readers should be careful before following me down this garden path, however, as I don’t see how they could consistently admit these adjustments and not admit the inclusive adjustments in AMR that Elhauge and the AMR courts eschew.) If the adjustment isn’t allowed on what grounds? In what fundamental sense can we say that X is the cost of serving A. The servicing of A can be viewed as an input to the service of B; perhaps A should be being paid and not paying. Is the processing of my credit card payments a service to me or to the merchant network of Visa who wants my business?

There are of course innumerable subtle issues involved in determining profit sacrifice. The main point here is that to measure profit sacrifice in an unbiased way using a price-cost test requires using either an inclusive notion of marginal or



incremental cost or an inclusive notion of price that amounts to marginal or incremental revenue.

## 5.2. Equally efficient competitor tests

A second strand of thinking asserts that we should only be concerned about price predation when such pricing excludes equally or more efficient competitors. To achieve this end with a price-cost test, “price” and “cost” should be defined with an eye to ensure as much as possible that prices above cost are too high to exclude equally efficient competitors, but that prices below cost threaten to do so.

Hence, Baumol and Posner come to favor an average variable cost test not as an approximation for marginal cost like the Areeda-Turner school, but rather as the *right* test. They recast it as an average avoidable cost test, where “avoidable costs” are those that would be avoided if the firm did not make the challenged increment of output—some would call this the average incremental cost test. (NB: If one challenges the last unit of output, this test converges to the Areeda-Turner marginal-cost test but with an exclusive measure of cost and price).

If a firm prices below average avoidable cost, then the firm may exclude a rival who could more efficiently produce the allegedly predatory increment of output. Prices above average avoidable cost can, they would argue, only exclude less efficient entrants because if an entrant were equally or more efficient in the

sense of having lower avoidable cost on the output increment, presumably that entrant could win the business when competing against a price above its cost.<sup>46</sup>

Thus the standard of Baumol and Posner is “the equally efficient competitor standard”.<sup>47</sup> Prices that exclude an equally or more efficient competitor are predatory. Prices that don’t are not. Elhauge argues for the equally efficient competitor standard for predatory pricing (but importantly not for other monopolization<sup>48</sup>) based on welfare effects, not as an axiom. Indeed, Elhauge concludes that “‘costs’ should be defined in whatever way satisfies the condition that an above-cost price could not deter or drive out an equally efficient firm.”<sup>49</sup> Thus if in some instance average avoidable cost did not do the trick, Elhauge would define “cost” as whatever cost measure did so.

The U.S. Supreme Court has at times embraced this focus on the relative efficiency of excluded firms, at least in dicta. For example, in *Brooke Group*, the court defines competition on the merits as excluding those who are less efficient and only those who are less efficient. This is certainly one view of “the merits”. It describes productive merits.

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<sup>46</sup> This proposition has an undeniable strength, though it is not as self evident in practice as it is in theory. In the typical theoretical model, an equally good product at a lower price captures the whole market. In practice, an entrant whose products are unknown may find itself selling little without (and sometimes even with) extraordinary marketing and sales expenses. There is a sense in which this entrant is less efficient in that its products won’t sell without these marketing and sales expenditures. Or, one might say that its products are not truly equally good because one aspect of a product is being known.

<sup>47</sup> Posner, R. (2002, 194-95), *Economic Analysis of Law*, 6th Ed., Aspen Publishers. Baumol, W. (1996), Predation and the Logic of the Average Variable Cost Test, *Journal of Law & Economics*, 39 (1), 49-72

<sup>48</sup> For example, Elhauge rejects the standard in the case of loyalty discounts: See, “Tying, Bundled Discounts, and the Death of the Single Monopoly Profit Theory, p. 67. Available at [http://www.law.harvard.edu/faculty/elhauge/pdf/Elhauge\\_629\\_Revised2.pdf](http://www.law.harvard.edu/faculty/elhauge/pdf/Elhauge_629_Revised2.pdf).

<sup>49</sup> At 689.

The average avoidable cost test raises many issues in application. Consider that American Airlines moves an aircraft from a profitable route in New York to add to its allegedly predatory campaign on the Dallas to Wichita route. Using the aircraft on the Wichita route is avoidable, but what is its cost? Is the lost net income on the New York route a cost? The purely economic answer is that it is. In fact, if consumers on the New York route lost consumer surplus one might argue that too should be counted in a true equally efficient competitor test. Remarkably, the court in *AMR* was unreceptive to seeing aircraft costs as includable in any fashion.<sup>50</sup> In contrast, even the defendant's expert in *Spirit v. Northwest* wanted to include the lost profits on other routes as the cost of an extra aircraft on the predatory route.<sup>51</sup>

Fixed costs present a vexing issue in predation cases. Costs that are truly fixed and so don't vary with the increment in question are not avoidable. That said, it is all too easy for a court or an economic expert to assume that a great many costs like rent (or aircraft ownership costs) are fixed particularly when a company's accountants label them as such. However, as businesses grow the amount of money that they spend on what accountants label as fixed costs grow as well, suggesting that these costs are not actually fixed in the long run.

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<sup>50</sup> *United States v. AMR Corp.* 335 F.3d 109 (10<sup>th</sup> Cir. 2003) at note 12 approving of the district court's conclusion that "VAUDNC-AC overstates short-run cost because it includes fixed, unavoidable aircraft-ownership costs."

<sup>51</sup> *Spirit v. Northwest* 431 F.3d 917, 942. To include only lost profits (and not lost consumer surplus) on the other route actually misses the point if one is asking about the total economic avoidable cost of shifting the extra airline to the predatory route. If on the other hand, one is trying to implement a sacrifice test, then these forgone profits are the relevant measure. Indeed, for similar reasons, if one is trying to identify sacrifice, then the foregone profits on the existing, (pre-expansionary) flights on the predatory route would also be relevant as discussed in section 5.1. Oddly, many would take the position as the defendant's expert in *Spirit* did that the relevant cost measure would include one forgone profit and yet not the other..

Are these costs fixed in the short run? They may be, at least in a sense. Thus, it is understandable that the district and appellate courts in AMR objected to including costs such as “dispatch, city ticket offices, certain station expenses, certain maintenance expenses, American’s flight academy, flight simulator maintenance, general sales and advertising.”<sup>52</sup> The court’s exclusion of these costs as unavoidable is plausible but not as compelling as the court thought. There are many hidden costs in the use of facilities, whether a city ticket office or a flight simulator. If facilities are crowded, there are crowding and waiting costs. If employees work harder than usual until new employees are hired, there may be a morale cost. One might argue that the reason new employees are hired or larger facilities are purchased is because those decisions are cheaper than the alternatives of continuing to bear crowding or morale costs.<sup>53</sup> Once one delves into the details, cost measurement becomes ever murkier.

### 5.3. Consumer Welfare Tests and Contestability Standards<sup>54</sup>

An alternative view of competition on the merits would focus not on the productive merits of a firm but on the merits of the offer it makes to customers. Thus, while Posner and Baumol see monopolization where a

*challenged practice is likely in the circumstances to exclude from the defendant’s market an equally or more efficient competitor; (Equally Efficient Competitor Standard)*<sup>55</sup>

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<sup>52</sup> U.S. v. AMR Corp. 335 F.3d 1109, 1117 (2003).

<sup>53</sup> I am grateful to my coauthor Joseph Farrell for teaching me this. We discuss it in “[The American Airlines Case: A Chance to Clarify Predation Policy](#),” Aaron Edlin and Joseph Farrell, in *The Antitrust Revolution*, Oxford University Press, 3rd ed. By John Kwoka and Lawrence White, 2003.

<sup>54</sup> This section draws on ongoing joint work with Joseph Farrell.

I propose seeing monopolization where a

*challenged practice is likely in the circumstances to exclude from the defendant's market a competitor who would provide consumers a better deal than they get from the monopoly. (Consumer Betterment Standard).<sup>56</sup>*

The Posner-Baumol standard focuses on production efficiency, asking: is a cheaper producer excluded from the market? The Consumer Betterment Standard focuses on consumer surplus, and flows fairly directly from the view espoused by the U.S. Supreme Court that antitrust is intended to protect consumer welfare.<sup>57</sup>

What are the differences at a theoretical level between these two definitions? Well, if a firm promised to sell forever at a price below its average avoidable cost, it would violate the Equally Efficient Competitor Standard but not the Consumer Betterment Standard, because this behavior is good for consumers. That example is unimportant in practice because no firm would do so.

To understand the bite of the Consumer Betterment Standard, consider the competition problem emphasized by Edlin [2002]. Suppose that an efficient incumbent sells at high prices and forestalls entry (from less efficient firms) because it "advertises" a credible threat (or makes a contractual promise) to cut prices post-entry to levels below the average costs of entrants but above its own avoidable

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<sup>55</sup> Quote is from Posner, R. (2002, 194-95), *Economic Analysis of Law*, 6th Ed., Aspen Publishers. Baumol, W. (1996), Predation and the Logic of the Average Variable Cost Test, *Journal of Law & Economics*, 39 (1), 49-72.

<sup>56</sup> I call this a Consumer Betterment Standard (as opposed to Consumer Welfare) because it is a process standard that indicates anticompetitive exclusion and need not require a final welfare analysis.

<sup>57</sup> Reiter v. Sonotone Corp., 442 U.S. 330, 342. See also "Statement of Commissioners Harbour, Leibowitz and Rosch on the Issuance of the Section 2 Report by the Department of Justice," Federal Trade Commission, Sept, 2008, and Lande, R.H., Wealth Transfers as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged, 32 *Hastings L. J.* 67-106 (1982).

costs. Such an incumbent monopolizes according to the Consumer Betterment Standard but not the Equally Efficient Competitor Standard.

Entrants in this example stand willing to provide consumers a better deal than the incumbent actually gives consumers, but entrants don't do so because the efficient incumbent would drive them from the market. Those worried solely about productive efficiency need not be concerned about productively-inefficient entrants, of course.

Edlin [2002] proposes protecting entrants who offer substantial consumer value vis-a-vis the incumbent offer, not out of concern for entrants but for consumers. The dual purpose is to encourage such entry and to encourage the incumbent to offer better deals pre-entry in order to forestall entry.

A refuge for those who favor the Equally Efficient Competitor standard is to say that the Edlin [2002] competition problem is theoretically possible but it can't be reliably identified. My answer is that in some cases such as AMR or Spirit Air, the problem can be identified and where it cannot, then perhaps the defendant should win.

Elhauge's main objection to Edlin [2002] was that limiting aggressive incumbent responses to entry could hurt consumers post-entry because it limits post-entry competition in cases where entry would occur regardless of antitrust protections. (i.e., in cases where the Edlin competition problem doesn't exist).

There are a few answers to Elhauge's main objection. First, it must be balanced against the benefits pre-entry of encouraging lower prices, and in cases where entry is very difficult, this benefit may be of utmost import. Second, courts

needn't offer protection to entrants who don't bring significant value to consumers with respect to the incumbent (Edlin [2002] suggests a benchmark of 20% lower prices for equivalent products to determine if the entrant offers significant value) and the higher the significant value hurdle is set, the smaller will be the losses from post-entry competition.

Elhauge's second objection to Edlin [2002] is that only inefficient entrants need the protection offered by defining predatory pricing according to consumer betterment, and such entrants have very little to offer in the end to consumers. Elhauge's idea is that even if such entrants offer consumers substantial short-run surplus, if one adopts a rule like in Edlin [2002] that an incumbent can't (for a time) match or beat the price of an entrant who does so, little is gained in the long run because once the bar on incumbent price reductions is lifted, the incumbent can drive the entrant from the market. Even hit and run entry, though, will provide benefits ex post and the monopoly will price lower ex ante to discourage such entry if that is its only tool to prevent it. Moreover, the disadvantages of an entrant may disappear with time, enabling it to provide long-term competition. Moreover, in situations with increasing returns, learning by doing, or switching costs, entrants offered protection may survive and promote long-run competition.

Elhauge, following Easterbrook [1981], would counter that in cases where long-run competition is viable, the entrant should be willing to borrow money to fund short-term losses, but I am skeptical of this retort. Who is to say that even if the entrant can and does borrow to finance low prices it will thereby get significant market share so that it ultimately achieves low costs? The incumbent is likely to

borrow (if that be necessary) to charge prices just as low or lower than the entrant to keep the entrant's market share low, especially in an environment with learning by doing, increasing returns to scale or network externalities. In many circumstances, incumbent advantages are sufficiently large that no borrowing would be needed.

The above arguments convince me that the Consumer Betterment Standard is promising.

## 6. An Application of the Three Standards: American Airlines

A concrete example may help to illustrate the three predatory pricing standards I have discussed and show one way that defining predation according to consumer betterment might work and be appealing. Consider the American Airlines case brought by the Department of Justice, a case discussed extensively by Edlin [2002], Edlin and Farrell [2003] and Elhauge [2002].<sup>58</sup> American reacted to entrants by overriding "its own capacity-planning models for each route" and increasing the number of flights on the route despite the fact that American's models suggested such increases would be unprofitable, by matching the entrant's prices, and "making more seats available at the new, lower prices".<sup>59</sup> The court found the pattern well illustrated by the DFW-Wichita route, where average prices

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<sup>58</sup> U.S. v. AMR 335 F.3d 1109.

<sup>59</sup> AMR at 1113.



were roughly \$100 pre-“predation”, dropped to \$60 during “predation,” rose to \$95 for the year after “predation,” and over \$100 thereafter.<sup>60</sup>

The question in the case was whether the quotation marks around “predation” should be removed. The appeals court wrote that “In each instance, American’s response produced the same result: the competing LCC failed to establish a presence, moved its operations or ceased its separate existence entirely. Once the [entrant] ceased or moved its operations, American generally resumed its prior marketing strategy, reducing flights and raising prices to levels roughly comparable to those prior to the period of low-fare competition.”<sup>61</sup>

The appeals court opinion seemed ambivalent about whether it was applying the equally efficient competitor standard or the sacrifice standard. At times one has the feeling that the court thinks they are the same, while at other times the court makes a sharp point to critique profit-maximization requirements.<sup>62</sup> In particular, it quoted *Advo* to the effect that “[a]s long as a firm's prices exceed its marginal cost, each additional sale decreases losses or increases profits”<sup>63</sup> an assertion that we have seen is false unless inclusive notions of price or marginal cost are used and the court did not allow the Department of Justice’s inclusive notions. That is, if the additional sale lowers

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<sup>60</sup> AMR at 1112.

<sup>61</sup> AMR at 1113.

<sup>62</sup> The Department of Justice tried to distinguish profit sacrifice tests from requiring profit maximization as follows. Under a profit sacrifice test for predatory pricing, it is predatory to make a large output expansion in response to entry when that expansion lowers profits beyond what the entry itself does. However, a failure to maximize profits in general, by for example charging prices that are lower than profit maximizing prior to entry or by charging prices above profit-maximizing levels is not predatory pricing.

<sup>63</sup> AMR at 1115.

profit margins on earlier sales, then a sale at a price above production cost can easily lower profits.

If the AMR case had been decided squarely using profit sacrifice, the Department of Justice should have won the case or at least gotten to the recoupment stage of proof. After all, the court found that American over-rode its own capacity model. In addition, the Department of Justice showed that the addition of extra flights (and the extra sales that were part of this strategy) caused overall profits to fall. The appeals court tried to say that the extra flights were still “profitable,” but this is really a statement that the ticket revenues of passengers on these flights exceeded the production cost of those flights, not an inclusive cost measure that included forgone revenues as passengers switched from the existing American flights to the new ones, or that included losses as fares fell on existing flights. The court explicitly jettisoned inclusive cost measures distinguishing “actual costs” from opportunity costs or “forgone or ‘sacrificed’ profits”.<sup>64</sup> In so doing, it is clear that the AMR Court ultimately applies the equally efficient competitor test, despite the confusing justifications of AVC tests as a proxy for MC and the court’s explanation that sales at prices above MC increase profits.

Under the equally efficient competitor test, the AMR opinion may be correctly decided. The DOJ was unable to show that a noninclusive measure of incremental revenues was less than a noninclusive measure of avoidable incremental cost. Although low-cost carriers (LCC’s) have lower costs of operating flights, American has the

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<sup>64</sup> In particular, the appellate court complained that “Test One effectively treats forgone or ‘sacrificed’ profits as costs, and condemns activity that may have been profitable as predatory.” AMR at 1119. The appellate court further wrote, quoting the district court, that “It is clear, therefore, that, in proffering Test One, the government has not ‘attempted to identify the actual costs associated with the capacity additions.’ AMR Corp., 140 F. Supp.2d at 1202.”

advantage of operating a hub and spoke system so that it can fill much of its plane with through-passengers which can justify the flight with very low prices for the direct-customers with whom it competes with LCC entrants.

How then might AMR be analyzed under the Consumer Betterment Standard? The key question is whether American's behavior is likely to exclude entrants who would otherwise provide consumers substantially better deals than American offers. What is the relevant benchmark deal that American provides? The \$100 pre-predation price? The \$60 predatory price? Or the final \$110 post-predation price? If entrants were likely to beat the \$60 price, nothing in American's behavior excludes them. But plausibly entrants willing to sell at \$60 or \$70 won't enter this market or markets like it because they will be driven out. They were driven out. The problem with American's behavior from a consumer welfare perspective is the likelihood that American can henceforth charge \$110 for a long time without substantial entry. The relevant benchmark "deal" from the vantage of consumer betterment is either the \$100 pre-predation price or the \$110 post-predation price. The question is whether entrants who would provide better deals than these prices (or if we followed Edlin [2002] substantially better deals) are likely to be excluded.

The inference of such exclusion would I think be plausible on the facts of AMR, but perhaps the evidence presented in AMR doesn't conclusively clinch the case. Suppose that in addition, the DOJ proved that there were five entrants who would definitely enter the market and charge prices of \$75 or below on the Dallas-Wichita route but these firms are unwilling to do so because they witnessed American's prior response and expect a similar response. In that case, the DOJ would have proved its case under a

Consumer Betterment Standard. And, of course, defining predation this way provides American the incentive to price low in the first instance to make its “deal better” and entry and predation cases harder. American might likewise price lower post-predation to make predation cases harder to bring because it will be harder to find these five would-be entrants. A Consumer Betterment Standard for adjudicating predatory pricing has the prospect of making consumers better off when facing a monopoly.

## 7. Oligopoly vs. Monopoly Predation

Most of our discussion has concerned cases of monopoly predation. Of course, plaintiffs will sometimes complain of predatory pricing in oligopoly industries. The economics in such industries of course are quite different. In fact, the skepticism of the Supreme Court in *Brooke Group* and *Matsushita* seems in many ways more warranted in light of the fact that both cases involved oligopolies.

A canonical story of predatory pricing in an oligopoly is that a maverick firm (Liggett in the case of *Brooke Group*) decides to increase its market share by undercutting the oligopoly pricing equilibrium.<sup>65</sup> Either all firms together or a few alone respond by engaging in a price war until this firm relents and raises its price.

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<sup>65</sup> This description is contested, as Elzinga and Wells view Liggett as the incumbent in the discount segment it pioneered and Brown and Williamson (the larger firm in the main market) as the entrant to the discount segment.

In oligopoly industries, raising prices after the predatory episode does not just require discouraging entry but discouraging competition from many competitors. In principle that is possible, of course, but it may require a degree of coordination that is impossible without explicit agreements.

Is an oligopoly price war following a maverick's price cut predatory? Does that depend upon whether its motivation is to encourage higher prices? One approach would be to say that this is essentially a cartel problem and the question is whether the firms have a price-fixing agreement, whether tacit or explicit. Under Section 1 of the Sherman Act, when the maverick agrees with its rivals to raise price (if indeed it does agree) and end the predatory episode, they have created an agreement in restraint of trade. The whole endeavor of predation may also be an aspect of an agreement to charge and maintain super competitive prices, and if this can be proven, then one has a price-fixing agreement.

Absent evidence of agreement, many would believe that the story is not a plausible one (rumor has it that the plaintiff in Brooke Group did not want to play the cartel card because it itself might wind up in trouble.) Absent evidence of a cartel agreement or some other mechanism to coordinate a price increase, the price rise, like that in Brooke Group is more likely explained by an increase in demand or a decrease in demand elasticity.

In Brooke Group the Court argued that Brown and Williamson only had 1/9<sup>th</sup> of the market and so most of the returns from its predation would

accrue to other firms.<sup>66</sup> This made the plaintiff's whole theory suspect to the Court. This much made sense.<sup>67</sup> On the other hand, this cartel-dependent observation undermines the Court's rationale for the recoupment requirement. The rationale offered in *Brooke Group* was that without recoupment, "predatory pricing produces lower aggregate prices in the market, and consumer welfare is enhanced." Even if that equivalence between recoupment and consumer injury held for a monopoly (and it holds only roughly at best) it is evidently far from holding if only one in nine high-priced purchases accrues to Brown and Williamson but consumers suffer with each one.

Given the economic differences between cartel situations and monopoly ones, it is odd that many courts in monopoly cases of predatory pricing in the U.S. feel bound by rules of predation that were codified in oligopoly cases like *Matsushita* and *Brooke Group*. This observation motivates the arguments of Edlin [2002] and later the court in *Lepage's* that oligopoly precedents should not apply in monopoly cases where anticompetitive pricing

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<sup>66</sup> Specifically, the court wrote: "In this case, for example, Brown & Williamson, with its 11-12% share of the cigarette market, would have had to generate around \$9 in supracompetitive profits for each \$1 invested in predation; the remaining \$8 would belong to its competitors who had taken no risk.

<sup>67</sup> It makes sense anyway, if one discounts as the Supreme Court did Brown and Williamson's internal assessments of what was at stake. See Adams, Walter, James Brock and Norman Orbst, "Is Predation Rational? Is it profitable?" *Review of Industrial Organization* 11: 753-758, 1996 (arguing that Brown and Williamson would have profited in expected value even if the predation had been fairly unlikely to succeed and that it in fact did succeed). But see Kenneth Elzinga and David Wells (disagreeing vehemently, and arguing that the documents relied on by Adams, Brock and Orbst were taken out of context and were unreliable). See finally, Adams, Walter, James W. Brock and Norman P. Orbst, "Is Predation Rational? Is it profitable?—A Reply" *Review of Industrial Organization* 11: 767-770, 1996.

practices seem much more plausible and problematic.<sup>68</sup> This point is consistent with the emphasis of Joskow and Klevorick on industrial structure as the first step of analysis in predatory pricing cases.<sup>69</sup>

## 8. Recoupment

Brooke Group makes clear that an essential element of a predation case is proving that losses can be recouped (at the least for oligopoly cases). Left unclear is what this means and why this element is required.

The Court writes that a reasonable jury might have concluded that Brown and Williamson priced below its cost<sup>70</sup> but that it could not reasonably have hoped to recoup the ensuing losses in an oligopoly industry where it sold only 12% of the output.<sup>71</sup>

Kenneth Elzinga and David Mills, who were economic experts in the case and whose academic writings the court cited regarding the importance of recoupment, describe predation as follows: “the predator prices at nonremunerative levels to drive rivals or an entrant from the market, or to coerce rivals to cede price leadership to the predator. In the second stage, the predator flexes its monopolistic

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<sup>68</sup> The Lepage court makes two distinctions. It argues that Brooke Group does not apply to monopolies and second that the plaintiff in Lepage did not allege predatory pricing. Lepage’s at 151.

<sup>69</sup> Paul L. Joskow & Alvin K. Klevorick, A Framework for Analyzing Predatory Pricing Policy, 89 *YALE L.J.* 213, 219-20 (1979).

<sup>70</sup> *Brooke Group v. Brown & Williamson*, 509 U.S. 209, 233.

<sup>71</sup> *Brooke Group v. Brown & Williamson*, 509 U.S. 209, 228.

muscles by charging supracompetitive prices and recouping the losses sustained during the initial stage.” It is straightforward to leap from this description to the two-prong test of Brooke Group.

But does the leap make sense? Some would argue that firms don’t ordinarily price at “nonremunerative” levels absent prospects of recoupment so that recoupment should be presumed. Why should a predator choose to suffer short-term losses if it does not expect to recoup them? Will a court’s expectations be more reasonable or accurate than the alleged predator? The Brooke Group Court does not address these questions, so one is left to wonder.

Whether we take the sacrifice view or the equally efficient competitor view of predatory pricing, the recoupment element may seem superfluous. On the other hand, if we adopt the consumer betterment standard for predation, then something close to recoupment may become important. The question under this standard is whether consumers typically pay higher prices than they might absent the predatory behavior. If the predator never raises prices this case will be hard to prove. If the predator quickly raises price after the predatory episode, we have a high-priced benchmark to refer to when asking: “Are rivals who would provide better deals than the incumbent likely to be excluded from the market?” The consumer betterment standard does not beg us to explicitly consider the predator’s rationality or the profitability of a predatory strategy, but like in a search for recoupment, high prices post predation will be relevant.



## 9. Conclusions

What can we conclude? U.S. predatory pricing law is built on two foundations. One is a shaky premise, which is that economic reasoning and experience predict that predatory pricing is rare if existent at all. Neither the theoretical nor empirical literature provides strong support for this premise. The other foundation is a healthy question: the question is what can be done about predatory pricing without overly discouraging desirable price competition. However, that question is often not put in sharp focus. Presumably, it is true, for example, that most price cuts are pro-competitive as Kaplow and Shapiro point out.<sup>72</sup> However, no antitrust proposals attack all price cuts, so that sample is irrelevant. Can we say that drastic price cuts by monopolies (who apparently could have priced much lower in the first place) are mostly pro-competitive, even when these price cuts destroy an entrant who has provided large surplus to consumers? Much less clear.

Here I introduce a Consumer Betterment Standard to test for monopoly exclusion as an alternative to the Equally Efficient Competitor Test. When applied to the American Airlines case, we see, that the result might have been different and more pro-consumer.

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<sup>72</sup> Specifically Kaplow and Shapiro write that “beneficial price cuts will vastly outnumber predatory ones, so heavy attention to false positives is nevertheless sensible.” Kaplow, Louis and Carl Shapiro, “Antitrust”, Handbook of Law and Economics, Volume 2, Edited by A. Mitchell Polinsky and Steven Shavell, 2007.