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Draft Predatory Pricing Enforcement Guidelines

**NATIONAL COMPETITION LAW SECTION
CANADIAN BAR ASSOCIATION**

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PREFACE

The Canadian Bar Association is a national association representing 37,000 jurists, including lawyers, notaries, law teachers and students across Canada. The Association's primary objectives include improvement in the law and in the administration of justice.

This submission was prepared by the National Competition Law Section of the Canadian Bar Association, with assistance from the Legislation and Law Reform Directorate at the National Office. The submission has been reviewed by the Legislation and Law Reform Committee and approved as a public statement of the National Competition Law Section of the Canadian Bar Association.

Draft Predatory Pricing Enforcement Guidelines

I. INTRODUCTION

The National Competition Law Section of the Canadian Bar Association (the CBA Section) welcomes the opportunity to comment on the *Draft Predatory Pricing Enforcement Guidelines* (the Guidelines) issued by the Competition Bureau with respect to the Bureau's analysis of predation claims under the *Competition Act*. The CBA Section strongly supports the Bureau's continuing efforts to clarify its enforcement policy by publishing enforcement guidelines, information bulletins, speeches, press releases and other interpretative aids to the business community in Canada.

Overall, the CBA Section is generally supportive of the Guidelines and their overriding theme that it is important not to chill vigorous price competition. As such, the CBA Section agrees with many of the positions outlined in the Guidelines and commends the Bureau on its efforts. In this submission, we focus on those aspects of the Guidelines where the CBA Section has suggestions for improvement.

II. GENERAL COMMENTS

The Guidelines indicate that the Bureau has adopted three principal changes in its enforcement approach: (i) complaints of predatory conduct will be examined initially under the abuse of dominance provisions; (ii) the Bureau will use average avoidable cost instead of average variable cost and average total cost in its price-cost analysis; and (iii) price matching will be a reasonable business justification for pricing below avoidable costs.

A. Primary Focus on Section 79

The CBA Section strongly agrees that given the economic nature of a predatory conduct examination, it is appropriate to focus predation investigations under the civil abuse of dominance provisions. At the same time, the CBA Section believes that in essentially combining the discussion of the civil and criminal predation provisions into a single analytical framework, the Guidelines may diminish the stated objective of analyzing predation claims foremost under a substantial lessening of competition standard. In particular, infringement under paragraph 50(1)(c) may be possible merely on the basis of “eliminating a competitor” (irrespective of whether competition is substantially lessened) or conduct that is “designed to have that effect”. The CBA Section therefore recommends that the Guidelines clarify that eliminating a competitor is not a sufficient basis for the Bureau to conclude that there is predation unless competition is also substantially lessened. This approach is consistent with Bureau's own stated policy position that predatory pricing should be dealt with solely under the substantial lessening of competition standard of the abuse of dominance provisions.¹

B. Use of Avoidable Costs

While the Bureau's decision to use the average avoidable costs in the price/cost analysis under both section 79 and paragraph 50(1)(c) is a policy choice that may or may not be supported by future jurisprudence, the CBA Section welcomes guidance regarding the approach that will be used by the Bureau to analyze predation. At the same time, the Guidelines would benefit from more specific indications regarding how the Bureau proposes to apply the average avoidable cost test in practice, particularly given that the test was developed initially by the Bureau in the context of the airline industry and derives from airline specific regulations, rather than the more general abuse of dominance provisions. More detailed remarks on the use of avoidable costs are included below in the Specific Comments.

¹ Most recently, the Competition Bureau's January 11, 2008 submission to the Competition Policy Review Panel recommends that: “the criminal provisions on predatory pricing and price discrimination should be repealed so that these acts would be treated as reviewable practices under the civil provisions only”.

C. Price Matching Defence

The CBA Section welcomes the Bureau’s recognition that price matching is a reasonable business justification for pricing below avoidable costs and a defence to an allegation of predatory pricing.

D. Summarize Safe Harbour Concepts

In a number of places the Guidelines discuss concepts or conditions that are necessary for the Bureau to conclude that enforcement action is necessary with regard to claims of predatory conduct. It would be useful to summarize these “safe harbour” concepts, which should include (non-exhaustive list):

- pricing/revenue is not below average avoidable costs;
- the alleged predator is only matching prices;
- there is some other reasonable business justification for pricing below average avoidable costs (e.g., perishable inventory, store opening or introductory offers etc.); or
- the alleged predator has insufficient market power for recoupment (market share below safe harbour threshold or insufficient entry barriers).

III. SPECIFIC COMMENTS

A. Executive Summary – Definition of Predatory Pricing

Predatory pricing is defined at the outset of the Executive Summary (and the Preface) as a firm deliberately setting prices to incur losses “to eliminate a competitor, or otherwise inhibit competition in the expectation that the firm will subsequently be able to recoup its losses”.² The CBA Section recommends modifying this language to read: “to eliminate or discipline a competitor where the firm will subsequently be able to recoup its losses with the effect that competition will be substantially lessened.” We note in particular that successful predation requires the ability to recoup, not mere expectation of such by the alleged predator.

² Guidelines, p. ii.

B. Part 2.2.1 – Criteria for Criminal Enforcement

The Guidelines reserve criminal enforcement for situations where the predatory conduct is “egregious”.³ The Guidelines then provide two examples of egregious conduct: (i) enforcing or inviting participation in a cartel; and (ii) where the firm is already subject to a Competition Tribunal or court order or an undertaking forming part of an alternative case resolution.⁴ The CBA Section believes such criteria should be more narrowly confined to situations where the firm is subject to a previous criminal conviction, guilty plea or prohibition order relating to predatory pricing or is subject to an order under s.79 in relation to predation. As drafted, the criteria could include situations where the previous matter bears no relation to the current alleged predatory conduct, such as Tribunal orders relating to mergers or misleading advertising. Similarly, if the real concern is cartel behaviour, then the matter should be addressed directly under sections 45, 46 or 47 of the *Act*.

The CBA Section believes that if the Bureau intends to recommend resort to paragraph 50(1)(c) to address predation in some cases (which the CBA Section does not support), then the Guidelines should clarify that the Bureau will not, as a matter of enforcement discretion, refer a matter for prosecution under paragraph 50(1)(c) without evidence that competition will be substantially lessened. Where predation is truly egregious, it will substantially lessen competition and there is no need to resort to the additional “eliminating a competitor” branch of paragraph 50(1)(c). The Guidelines should state that the Bureau will not seek enforcement action in alleged predation matters other than where it has determined that competition will be lessened substantially. That would not preclude the use of criminal penalties, but it would ensure that, as a matter of discretion, there must be a proper determination of significant harm to the public interest in competition, as opposed to mere harm to individual competitors, before the Bureau would recommend criminal prosecution.

³ Guidelines, pp.5-7.

⁴ Guidelines, p.6.

C. Part 3.2 – Market Definition

Although footnote 21 of the Guidelines recognizes the potential “cellophane fallacy” problem regarding market definition in abuse of dominance cases, the text of the Guidelines refers to applying the hypothetical monopolist (SSNIP) test relative to “the price that would have prevailed in the absence of the alleged predatory conduct”.⁵ Because such a price may already be reflective of market power, the CBA Section believes that the Guidelines should clarify that the appropriate price level from which to apply the SSNIP test is the competitive level, although we acknowledge that such a level may be difficult to determine in practice.

D. Part 3.3 – Market Share

The Guidelines state: “With respect to predation, a firm that has a market share of less than 35 percent may have unilateral market power if it has a unique cost advantage or the ability to use strategic behaviour to build and entrench market power”.⁶ The CBA Section is concerned that this approach reflects discredited “entrenchment theory” and improperly penalizes a firm because it is more efficient. Predation law should not be concerned with the elimination of less efficient competitors. Moreover, 35 percent market share is well below market share levels that have been found to be of concern about market power in the jurisprudence. The CBA Section believes that a market share of at least 50 percent in a market should be required before further investigation regarding potential predation is warranted.⁷

The Guidelines also indicate that “the greater their market share is expected to be in the event that predation is successful, the more likely that the firm will have market power”.⁸ The CBA Section recommends deleting this statement, given the circularity of concluding that a firm will have market power on the basis that one expects that it will exercise market power (i.e., have the ability to expand market share following successful predation).

⁵ Guidelines, p.9.

⁶ Guidelines, footnote 27.

⁷ The Competition Tribunal has stated that no *prima facie* finding of dominance should arise with respect to a firm that has a market share of less than 50 percent. See *Canada (Director of Investigation and Research) v. Laidlaw Waste Systems Ltd.* (1992), 40 C.P.R. (3d) 289 (Competition Tribunal).

⁸ Guidelines, p.11.

The Guidelines refer to a threshold of 60% market share where the allegation of predatory conduct is based on joint abuse, consistent with the joint dominance market share threshold in the *Enforcement Guidelines on Abuse of Dominant Position*.⁹ Although the CBA Section generally supports safe harbour thresholds in guidelines, we believe that the Guidelines should acknowledge that while cases of single firm predation are likely to be rare, the chance of successful predation based on joint conduct is particularly remote, given considerations such as differing cost (and avoidable cost) structures and difficulty coordinating recoupment. As such, the Bureau’s general threshold of 60% for joint dominance may be particularly inappropriate in the context of predation. It is not surprising that aside from this reference to joint dominance, the Guidelines discuss predation almost exclusively in terms of single firm conduct.

E. Part 3.4 – Barriers to Entry

The Guidelines include as a barrier to entry switching costs associated with “the value consumers place on the long standing good reputation of a firm”.¹⁰ The CBA Section believes that good reputation in itself, absent other more tangible switching costs (e.g., contractual costs), should be viewed as the desirable outcome of successfully competing in the marketplace and, consequently, evidence of consumer preference, not market power.

The Guidelines also consider an incumbent’s “reputation for predation” as a barrier to entry.¹¹ In assessing such reputation for predation, the Bureau will consider, for example, whether the firm has “priced below cost . . . in the past”. However, absent a finding that an incumbent’s prior pricing was predatory, the CBA Section recommends caution in using past low pricing to infer barriers to entry and market power where the very issue being investigated is whether pricing is actually predatory. Moreover, several of the “market conditions” listed in “evaluating whether a firm has a reputation for predation” are not relevant to assessing the incumbent’s reputation. For example, the fact that a firm “competes against smaller rivals in more than one geographic or product market” or that

⁹ Guidelines, footnote 27.

¹⁰ Guidelines, p.12.

¹¹ Guidelines, pp.12-13.

“the financing of an entrant is reliant on outside sources” says nothing about whether the incumbent firm has a reputation for predation. In light of these various concerns, the CBA Section recommends deleting much of the text on reputation for predation in Part 3.4 and confining the discussion to considering prior pricing to be relevant only insofar as it has been found to be predatory.

The CBA Section also recommends deleting the reference to “market maturity” as a barrier to entry. Disincentive to enter a mature market because it offers less profit opportunity should not be construed as a barrier to entry and, in fact, may be more indicative of competitive pricing.

F. Part 3.5 – Profitability Criteria

This part of the Guidelines focuses initially, consistent with the Executive Summary, on whether a complainant’s business is, or is likely to become, “unprofitable”.¹² However, the text then refers to the different standard of whether the complainant's profitability “has been, or could be reduced”.¹³ The Guidelines should clarify that the mere reduction of the complainant’s profitability, absent a determination that it is incurring or is likely to incur losses, is not relevant to whether a firm is likely to exit a market and, therefore, whether competition is likely to be substantially lessened.

Footnote 31 suggests that a common way the Bureau assesses a complainant’s profitability and, in turn, whether it will likely be eliminated, is to focus on the accounting measure of earnings before interest, taxes, depreciation and amortization.¹⁴ While this may be a useful starting point, the CBA Section notes that if the complainant is covering its marginal costs (its average avoidable costs could be used as a proxy), that should be sufficient to conclude that it will not likely exit the market.

¹² Guidelines, p.13.

¹³ *Ibid.*

¹⁴ Guidelines, footnote 31.

G. Part 4 – Price/Cost Comparison

The Guidelines indicate that “when a firm sells at prices below its marginal costs, or an appropriate proxy thereof in order to harm a competitor, those prices can be said to be predatory.”¹⁵ This statement makes no reference to business justification, time frame or recoupment and is therefore inconsistent with the rest of the Guidelines. The CBA Section recommends modifying this statement to indicate that “when a firm sells at prices below its marginal costs, or an appropriate proxy thereof, for an appropriate period of time and without business justification in order to harm a competitor and has the ability to recoup the losses sustained by such conduct, those prices can be said to be predatory.”

H. Part 4 and 4.1 –Avoidable Costs

While the CBA Section appreciates the Bureau’s guidance that it will apply the average avoidable costs test for predation analysis under section 79 and paragraph 50(1)(c) of the *Act*, the CBA Section believes that the Guidelines would benefit from the Bureau indicating more tangibly how this test will be applied in practice. We have a number of comments.

The use of the avoidable costs test in the *Air Canada* case¹⁶ was mandated by airline-specific regulations. It is an open question whether the Competition Tribunal and Courts will adopt the avoidable costs test beyond the airline context and apply it generally under section 79 or paragraph 50(1)(c). For example, jurisprudence under paragraph 50(1)(c) has held that selling at prices above average variable cost of production does not constitute selling at unreasonably low prices.¹⁷ In determining whether prices are unreasonably low, it is also worth noting that the Bureau’s avoidable costs test in the *Air Canada* case did not focus on price, but rather compared aggregate revenues generated by flights to the avoidable costs of operating flights. Therefore, it would assist for the Guidelines to clarify whether the Bureau considers its avoidable costs test to be consistent with existing jurisprudence beyond the airline context and whether (and if so, to what extent) avoidable costs differ from variable costs.

¹⁵ Guidelines, p.14.

¹⁶ *Canada (Commissioner of Competition) v. Air Canada* (2003), 26 C.P.R. (4th) 476 (Competition Tribunal).

¹⁷ *R. v. Consumers Glass Co.* (1981), 33 O.R. (2d) 228.

The Guidelines indicate that, in addition to variable costs, avoidable costs will generally include: (i) “the non-sunk portion of product-specific fixed costs, otherwise known as quasi-fixed costs”; and (ii) “incremental fixed costs”.¹⁸ Quasi-fixed costs are included because “the firm either foregoes the opportunity cost of redeploying these input costs to an activity that would generate more revenues for the firm, or the firm would avoid these costs outright by not producing the product in question”.¹⁹ The Guidelines refer to “incremental fixed costs and sunk costs” in terms of “expanding capacity or redeploying assets to a relevant market”.²⁰

The CBA Section believes that the concepts of “quasi-fixed” and “incremental fixed” costs should either be more fully explained or removed, as we do not understand them to have a well defined economic meaning. It would also assist for the Guidelines to clarify whether these costs refer to anything other than redeployment and expansion situations. Moreover, it is unclear the extent to which these concepts differ from variable costs. For example, costs that can be avoided in a particular relevant market by redeploying assets more productively elsewhere (e.g., shifting aircraft to a more profitable route) could be viewed as variable with respect to the relevant market. Similarly, costs that can be avoided by not producing a product (or not expanding production) could be regarded as variable with respect to such incremental production decisions.

It may therefore assist for the Guidelines to characterize the average avoidable costs test more as a refinement on, rather than departure from, the average variable costs test.²¹

Nonetheless, insofar as focusing on avoidable costs allows one to better incorporate opportunity costs into the predation test, the CBA Section acknowledges that it may be a useful analytical framework.

¹⁸ Guidelines, p.16.

¹⁹ *Ibid.*

²⁰ *Ibid.*

²¹ In his seminal article on predation, William Baumol refers to average variable cost being “interpreted as average avoidable cost” - see William J. Baumol, “Predation and the Logic of the Average Variable Cost Test”, (1996) 39 *Journal of Law and Economics* 49.

The CBA Section also agrees that using average total cost is inappropriate as the test for predation, but for the more basic reason (rather than the allocation concerns referred to the Guidelines) that pricing that exceeds marginal costs and contributes to fixed costs (even where total costs are not covered) can be profit maximizing and therefore not predatory.

Finally, the CBA Section believes that the Guidelines understate the challenges associated with attempting to use the avoidable costs test. In our view, it would assist for the Guidelines to acknowledge that while using avoidable costs may aid in analyzing opportunity costs, such analysis can be very complicated in practice, as witnessed by the length and complexity of the *Air Canada* case, which itself dealt with only the price (revenue)/cost comparison portion of the overall abuse of dominance analysis.

I. Part 5.2 - Eliminating a Competitor

The CBA Section commends the Bureau for its recognition in Part 5.2 of the Guidelines that, if considering elimination of a competitor under the criminal predatory pricing provisions, it is important to have tangible evidence that the competitor has gone out of business or will clearly exit the market. Moreover, the Guidelines make the important observation that it is ultimately the exit of the competitive assets, not merely exit of a firm, which is most relevant.

Nonetheless, the implication of Part 5.2 is that in at least certain enforcement contexts, the Bureau will focus on elimination of a competitor as indicative of predation. It is true that the Guidelines reserve for criminal enforcement conduct that is particularly “egregious”. However, as noted above,²² the CBA Section believes that this should mean, at most, reserving criminal sanctions for egregious conduct, not employing the substantive test for predation from the criminal provisions. Indeed, where predation is truly egregious, it will substantially lessen competition such that there would be no need to resort to the “eliminating a competitor” branch of paragraph 50(1)(c). The Guidelines should clarify that while the Bureau may view criminal sanctions as appropriate for egregious cases of predation, the Bureau will not exercise its discretion to recommend seeking such sanctions

²² *Supra*, pp.4-5.

other than where it has determined that competition will be lessened substantially. In that regard, the CBA Section views as particularly problematic the indication in the Guidelines that the Bureau will be “more apt to pursue an investigation under the criminal predatory pricing provisions” where there is evidence that the competitor is a “maverick”.²³ There is no principled reason for departing from a proper assessment of whether competition is substantially prevented or lessened simply because a maverick is involved.

J. Part 6 – Remedies

The Guidelines’ discussion of remedies is generic – referring to the Bureau’s panoply of remedies in general, rather than for predation in particular. Given that one of the most challenging issues in cases of genuine predation is how to fashion an effective remedy while avoiding price regulation, the CBA Section believes that the Guidelines would benefit from a more predation-specific consideration of remedies.

IV. CONCLUSION

The CBA Section commends the Bureau for publishing the Guidelines and appreciates the opportunity to provide comments. We support the Bureau's efforts to educate the Canadian public and business community on the application of the *Act*. We hope that our comments will assist the Bureau in developing the final version of the Guidelines and would be pleased to discuss our comments with the Bureau or participate in further consultations

²³ Guidelines, p.22.