Non-Technical Summary

Predatory pricing, the adoption of a pricing policy that is ultimately beneficial because it induces exit of a competitor, has received considerable attention from economists in recent years. The main focus has been to elucidate why predation can be a successful and sensible strategy in the presence of imperfect information. In contrast to the growing economic literature on predatory pricing, there is limited case law in Europe and the US. In European competition law the core case that defines predation is the AKZO Chemie BV versus the Commission case contested in the 1980s. This case identifies a lower cost threshold, average variable cost, below which prices are deemed predatory, and an upper cost threshold, average total cost, above which prices are usually deemed to be non-predatory. Between these two thresholds, prices are not deemed predatory unless part of a plan to exclude. More recently the European Commission have explicitly sought to change the test for predation and this has been echoed and extended in the guidelines to the UK's 1998 Competition Act. The changes have arisen in the context of a telecommunications but the Commission are clear that they view these changes as relevant in a broader context and certainly within network industries.

The Commission identify incremental cost as the relevant lower threshold in the presence of common costs, which is a natural extension of the Akzo judgement, but explicitly adopt a longer time period to define the incremental cost than that implicit in the 'average variable cost' rule. The guidelines in the UK Competition Act identify an even longer time frame than the Commission's. The Commission's move to incremental cost has remained silent on the upper threshold. This paper outlines the problem and assesses the alternatives, in particular the use of combinatorial tests as suggested in the guidelines to the 1998 Competition Act. The stated intention to apply the combinatorial test within the Competition Act identifies clear problems that may arise from the concurrent application of the Competition Act by the Office of Fair Trading and sector specific regulators. In the same notice that outlines the new stance on predation, the Commission also outline in some detail how a price squeeze should be treated as a form of abusive pricing. This is discussed in some detail here and in

particular how it interrelates to the question of what should be the appropriate test of discrimination to apply in conjunction with a price squeeze test.

The paper suggests that the use of incremental cost for a lower threshold predation test makes complete sense but this leaves open the issue of an appropriate upper threshold. Thresholds of average long run incremental cost, average long run stand alone cost and average fully allocated total cost have been discussed and it is suggested that the former is most sensible but that in some cases this may not be a good bright line test but rather a looser test with some element of rule of reason applying for some prices in this region. It is argued that significant problems arise with the use of combinatorial tests as the upper threshold where common costs span some products where a company is dominant and others where it is not. It is suggested that combinatorial tests are not suited to this situation since they were developed through the desire to improve regulatory price setting rather than for competition law per se. A crude solution that allows combinatorial tests to be preserved in the regulated context is suggested. It is argued that the problem of employing combinatorial tests in the Competition Act is an example of a general problem that has arisen with abusive pricing in the context of the concurrent application of the Act, i.e., it provides regulators with the temptation to engage in regulatory overspill.

The paper then considers the role of the price squeeze and emphasises the distinction between a price squeeze and the explicit policy of raising rivals costs. It is argued that the interpretation of discriminatory pricing in the context of a price squeeze is important and that a blanket rule that assumes that all input prices are tied together across price squeeze tests will be extremely restrictive. Application of price squeeze tests where a company has several retail products and several upstream inputs requires a market by market application of discrimination.