



Basics of Predatory Pricing

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Predatory pricing is the act of setting prices low in an attempt to eliminate the competition. It refers to the use of short-run price-cutting in an effort to exclude rivals on a basis other than efficiency in order to gain or protect market power. Predatory pricing, however, is a complex form of anticompetitive conduct. It requires the perpetrator to incur substantial losses or at least to forego present profits in the hope that those losses can be more than recouped in the future through the exercise of market power. Thus market conditions play a key role in determining whether price predation is a feasible tactic for a firm to employ. The predator must have a very substantial share of the market or at least the capacity to acquire such a share. In addition, entry conditions must be such that market power can be exercised for some period of time following a predatory episode in order to provide recoupment for the predator's "investment". To the extent that a predator mistakes market conditions his self-inflicted losses will not be regained and in this sense predation can be said to be self-detering

The traditional theory of predatory pricing is straightforward. The predator, already a dominant firm, sets its prices so low for a sufficient period of time that its competitors leave the market and others are deterred from entering. Assuming that the predator and its victims are equally efficient firms, this implies that the predator as well as its victims has incurred losses and that these losses are significant. For the predation to be rational, there must be some expectation that these present losses (or foregone profits), like any investment, will be made up by future gains. This in turn implies that the firm has some reasonable expectation of gaining exploitable market power following the predatory episode, and that profits of this later period will be sufficiently great to warrant incurring present losses or foregoing present profits. The theory also implies that some method exists for the predator to outlast its victim(s), whether through greater cash reserves, better financing or cross-subsidization from other markets or other products. In the short term, a price war can be beneficial for consumers because of the lower prices. In the long term, however, it is not beneficial as the company that wins a price war, effectively putting its competitor out of business, will have a monopoly where it can set whatever price it wants.

Tests to Determine Predatory Pricing

- **Areeda-Turner Test:** The Harvard law professors Areeda and Turner put forward the most influential test for analyzing allegations of predatory pricing which has widely been adopted by the US courts as a standard. "The test focuses on short-run costs and presumes prices to be predatory if they are below the short-run marginal costs of providing the product or service, unless it is higher than average total cost (ATC). Since marginal costs are difficult to determine, they are substituted with average variable cost (AVC) as a more practical proxy".
- **AVC & ATC Test :** Certain traditional tests such as the AVC (the non-fixed costs per unit of output) and ATC (the sum of all costs divided by output) have been criticized but are still in use because they are simple in application as compared to other costs tests. For example, AVC has been

advocated as a practical proxy for short run marginal cost, i.e. the change in cost incurred by producing one additional unit of output, which is argued to be the ideal cost measure but is unobtainable in practice. ATC, on the other hand, may be difficult to apply where there are important costs that are common across time periods and that can only be allocated arbitrarily. Several other jurisdictions consider and/or apply the average avoidable cost test, which focuses solely on the range of a firm's output that is alleged to be predatory in nature.

- **Structural Test :** This involves a two-tier approach where predatory pricing is alleged, the market structure is analyzed followed by an inquiry into the defendant's pricing conduct. In the first step, the market share of the alleged predator is analyzed to determine monopoly power, followed by an analysis of the entry barriers in the relevant market.
- **Recoupment Test :** This test assumes the occurrence of such pricing and test whether it is likely to succeed. Such a test aims to determine whether a company's predatory price action is likely to result in the elimination or deterrence of competition. And whether it can result in enough accumulation of supra-competitive profit for the recovery (recoupment) of losses sustained during the predatory attack. Predatory losses could be recovered by charging a price higher than the price that would have been charged in its absence.

Price wars are a fact of life-whether we're talking about the fast-paced world of "knowledge products," the marketing of Internet appliances, or the staid, traditional business of aluminum castings. If you are not in battle currently, you probably will be fairly soon, so it's never too early to prepare. Price wars are becoming more common because managers tend to view a price change as an easy, quick, and reversible action.

Defenses of Predatory Pricing

Legitimate business justifications (LBJ) are used as a defence against an alleged predatory pricing case. LBJ exists when behavior, which fails predatory pricing tests, is defended as justifiable because of special circumstances that render the conduct reasonable. A wide variety of circumstances constitute LBJ, which are discussed below.

- **Product introduction** Entry into a market or establishing a new brand does result in companies charging prices, which are at times below cost prices. Such pricing is rational when price does not remain below cost for long enough to harm competition, provided that promotional pricing does not occur regularly.
- **Loss leading** A company in order to allure its customers to buy additional products may price one or more of its product below cost. This is known as loss leader strategy. For example, a grocery store may offer orange juices at a lower price to lure the customers to enter the shop who are then likely to buy other higher margin items along with the orange juices.
- **Obsolete inventory** Sometimes pricing below cost is

necessary to clear out older products and make space for new products.

Legal remedies against Predatory pricing

Competition Law does not approve of such a pricing policy. Explanation (b) to Section 4 of the Competition Act defines "predatory price" as the sale of goods or provision of services, at a price which is below the cost, as may be determined by regulations, of production of the goods or provision of services, with a view to reducing competition or eliminating the competitors.

Dominant undertaking

The Competition Law provides that any conduct in a market by an undertaking, which amounts to the abuse of its dominant position, and which may affect trade in India is prohibited by the said Act and may be subjected to consequential penalties as prescribed by the Act.

Thus, there is a two-stage test:

- (1) whether an undertaking is dominant in a relevant market; and,
- (2) if so, whether it is abusing that dominant position. The prohibition is only on the abuse of the dominant position, not the position itself.

The Competition Commission set up under the Competition Act would find an undertaking's behavior an abuse after a detailed examination of the market concerned and the effects of the undertaking's conduct. An undertaking may be dominant if commands a substantial share of the market. The essence of dominance is the power to behave independently of competitive pressures.

Closer scrutiny of the judgements shows that India's competition law (Competition Act, 2002), which governs CCI's decisions, is itself deeply flawed. It's a typical case of the regulator being behind the curve. Because of loopholes in the law, many companies have been acquitted on technical grounds. In a glaring omission, the clause proscribing predatory pricing has been mentioned under Section 4, titled 'Abuse of dominant position'. This means that anyone indulging in it can only be found guilty when the player is already dominant in the concerned market. One of CCI's judgements is telling - "Since OP Group (Uber) doesn't seem to be dominant, there is no need to go into the examination of OP Group's conduct in such relevant market."

Note that the issue of predatory pricing has not even been touched upon because Uber isn't dominant yet. It seems the regulator is content to wait till these players occupy a dominant market share through cheating, after which it might be too late. Worse, CCI's decisions show that the sole determinant of dominance is market share. In most countries, as in India, outdated competition laws ignore critical factors such as the deep pockets that help companies acquire market dominance by undercutting bigger competitors through eye-popping losses. Both market share and deep pockets must be factored in while determining market dominance, so that beginners can have some leeway, but not to the extent of cheating.

Defying logic, CCI has held that app-based taxis and auto-rickshaws are different markets, which means the latter have no protection against predatory pricing. This omission can't even be blamed on the law, which duly states that products/services that are "perceived to be substitutable by consumer by reason of their basic characteristics, intended end-use, price etc." form part of the same market. The only thing that differentiates auto-rickshaws from taxis is their cheaper cost, although not when those are run by Ola and Uber. It's natural to choose air-conditioned cabs over autos, when the former's fares are cheaper. The autos, and related jobs, will come under

more fire as smartphones and cab companies proliferate. In the exceptional case where Ola is still being investigated, it was found to have a dominant market share in the concerned geography, Chennai. While CCI declined to rule against Ola, there was a strongly dissenting opinion given by one member. It said, "the behavior of the Opposite Party (Ola)... is a clear pointer to predatory intent since no other rational explanation can be attached to its behavior."

The Indian Telecom in the past 6 months has witnessed a turmoil, which was caused by a new entrant in the telecom market by the name of "Jio", a product of the conglomerate of Reliance Group of Industries. The services under the offer which was first launched as an "employee-only" offer (i.e. Unlimited Calling for life and Unlimited Data Benefit) were made open to the general public which this resulted in the torrent and surge of the masses to avail the proposed benefits. From what was already prognosticated not only did the move trigger profusion of clientele, but also instilled the rivals with a sense of fierce competition. This further resulted in multifold reduction in the prices of the services of all other leading service providers which then painted this insurgence of competition as an act of intentional sabotage. Though the allegations can't be discarded as foul cry, but the consumer centric market has welcomed the new entrant and the competition with open hands which further makes it difficult for others to form a basis of competition. Despite repeated denials by the Reliance Group of Industries about the "Predatory Pricing" & being a dominant player in the market, the conglomerate has surely affected the Indian telecom sector and the major players, left right and centre; it would be worth waiting to understand the course of events which follow.

Conclusion

Predatory pricing is a serious threat to competition and consumer welfare that requires serious scrutiny from competition agencies and courts across the globe. Caution needs to be exercised by competition agencies while analyzing predatory pricing cases, otherwise they may discourage welfare-enhancing competitive behavior. In the event of a competition authority is looking for evidence that an alleged predator intended to adopt a predatory pricing strategy, the following factors are to be considered to determine the intent:

- o That the below price cuts are targeted at rivals: In this case, for example, if a firm operates in several geographic markets but implements price cuts in only one of the markets in which it faces competition, then that behavior is consistent with predatory intent. However, if it decreases its prices in all the geographic market, then it suggests a more harmless reason for lower prices, and since the firm's costs have declined it is legitimately adjusting its prices to maximize profits.
- That attempts are made to acquire the target company: If the alleged predator had tried to acquire its rivals firms in the past, or is trying to do so while the alleged predation is on, then this may be the indication of a predatory intent. Having failed to acquire its rival firm, perhaps by a merger, it might do so using a predatory pricing strategy.
- Those moves are directed towards predatory intent: The other strategic moves like timing, duration and extent of price cuts by the alleged predator would help to establish predatory intent.

Thus if a predatory intent is established, tests need to be undertaken to determine predatory pricing allegations. The most practical and workable test would be the two-tier test that includes screening the market structure which would show that predatory pricing is likely to occur, including aspects of dominance and barriers to entry. Only cases in which affirmative findings are made should pass on the second test, i.e. the courts would then need to decide on a cost based test.