Predatory Pricing After Boral

By Christopher J. Pleatsikas

INTRODUCTION

“… predatory price cuts are particularly hard to distinguish from vigorous competition.”

Price competition has long been one of the two most obvious manifestations of the benefits conferred by the competitive process (the other being innovation). For this reason, the concept of predatory pricing has long been a difficult problem in the law and economics of antitrust. If prices are low enough they can undermine competition under some circumstances. However, low prices may also result from legitimate, albeit sometimes aggressive, competitive behaviour. If so, they can be of substantial benefit to consumers and, thus, should be encouraged. Therefore, the courts and policy makers must take care to develop standards for differentiating between pro-competitive and anticompetitive price cuts.

The Boral case in Australia has certainly raised the profile of predatory pricing for lawyers, jurists and economists. Beginning with the original court decision, the decision by the Full Court of the Federal Court, and culminating in the recent decision by the High Court, the case has been marked by controversy and sharp divergences in the views and reasoning expressed by the different Courts that have issued decisions on the case. Economists also have expressed divergent views and opinions on both the case in particular and the concept more generally.

Like the Matsushita decision and, especially, the Brooke Group decision in the United States, the High Court’s decision in the Boral case is a turning point that is likely to substantially change the character of predatory pricing claims that follow. With this in mind, the objectives of this paper are, first, to provide some background on economic concept of predatory pricing, second, to develop an economic analysis of the decisions by the Full Court of the Federal Court and,

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1 This paper was presented to the Trade Practices Law Conference in Sydney, Australia, May 2003. I would like to thank Michael Akemann for his comments.
6 I will refer to all of these decisions as the Boral decision, differentiating among them by denoting the court venue of each.
7 Matsushita Electric Industrial Company v Zenith Radio Corporation 475 US 574 (1986). In this case Zenith alleged that Japanese manufacturers of television sets had engaged in a two-decade-long effort to price these products in a predatory manner in order to eliminate non-Japanese producers from the marketplace. The court, in deciding to dismiss the case, determined that engaging in predatory pricing over a 20-year period was inherently irrational, because the present value of the losses would certainly overwhelm any potential expected gains. The court also expressed scepticism that entry barriers were sufficiently high to permit recoupment, even if the Japanese manufacturers had succeeded in driving others from the market.
8 Brooke Group v Brown and Williamson Tobacco 509 US 209 (1993). This case concerned allegations by Brooke (also known as Liggett) of predatory pricing for generic, low-priced cigarettes. Brooke, at that time a very small player in the United States cigarette industry, had been the first to introduce this product into the market and had quickly added to its share of sales. A competitor, Brown & Williamson, had countered with a similar product at an even lower price point. In its decision the United States Supreme Court stated that both below-cost pricing and a reasonable likelihood of recoupment were required to sustain allegations of predatory pricing. In this case the court determined that, while Brown & Williamson’s prices may have been below at least some measures of cost (although the court did not opine on the appropriate measure for such costs), there was no likelihood of recoupment.
particularly, the High Court in Boral and, third, to identify the implications of the High Court’s decision on future predatory pricing claims in Australia. As to the last objective, in my opinion the High Court’s decision will substantially undercut the ability of applicant’s to utilise more traditional theories of predation and will result in a shift to more strategic theories in any attempts to demonstrate that pricing by respondents is predatory.

This paper is organised as follows. First, the basic economic concept of predatory pricing is identified. In addition, a few key economic concepts that are important to understanding predatory pricing are set forth. Second, significant developments in the economic theory of predation are reviewed. Third, the Boral decisions by the Full Court of the Federal Court and High Court are reviewed. Fourth, the implications of the High Court’s recent decision in light of the economic theory of predation are evaluated. Finally, I provide comments on the form that predatory pricing claims are likely to take in the near term in response to this decision.

PREDATORY PRICING AS AN ECONOMIC CONCEPT

Perhaps surprising, given the controversy engendered by both legal and economic analysis, the theoretical concept of predatory pricing is relatively straightforward in economics. Economists typically define predatory pricing as pricing below some measure of cost to undermine competition in order to raise price to supra-competitive levels so that the losses incurred from the initial low prices can be recouped. It is supracompetitive prices that cause harm to consumers (thereby raising antitrust concern).

Seen in this light it should be clear that recoupment is central to the concept. Absent an expectation of recoupment (i.e., through supracompetitive prices), consumers generally gain from low prices, and there is no anticompetitive harm.

At the same time, the mere fact that prices are low – even below some measures of cost – cannot by itself constitute predation even if it results in some exit from the industry (or results in some parties deciding not to enter). Such prices may be profit-maximising in the long run for a whole host of pro-competitive reasons – e.g., building relationships with owners of key complementary assets or developing one’s own complementary assets. Furthermore, because not all entry or exit is efficient, instances of exit or failure of entrants (or failure to enter) may not be indicative of anticompetitive conduct.

Thus, the simple screen of harm to competitors is not sufficient to determine whether pricing is predatory. Harm to competitors is often a necessary (and natural)

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2 While, traditionally, economists considered that recoupment would occur in the future, more recently economists have accepted the possibility that multi-market predators could, at least in theory, recoup some of their predation losses during the period of predation.
3 Of course, a requirement that recoupment actually occur before anticompetitive concerns may be raised is too strict. Such a rule would result in antitrust policy that could act only after competition had already been harmed. For this reason, the ex ante expectation of recoupment is the important factor in distinguishing behaviour that ought to be precluded on competition grounds (because it may cause economic harm) from behaviour that should not.
4 Examples of the latter include forward pricing, where the firm “invests” in order to gain the experience required to lower manufacturing costs in the long run, and promotional activities, where the firm “invests” in order to broaden or deepen the market potential of a product.
consequence of competitive behaviour. As the High Court in *Queensland Wire Industries Pty Ltd v Broken Hill Co Pty Ltd* noted:

> Competition by its very nature is deliberate and ruthless. Competitors jockey for sales, the more effective competitors injuring the less effective by taking sales away. Competitors almost always try to “injure” each other in this way. This competition has never been a tort … and these injuries are the inevitable consequence of the competition sec. 46 is designed to foster. 13

Recognising this, courts, economists and policy makers have accepted that the purpose of competition policy is to protect and promote competition, not competitors. This general guide helps to distinguish predatory pricing from aggressive but competitive behaviour, which should be encouraged as a matter of public policy because it enhances economic efficiency and provides benefits to consumers.

The specific means by which recoupment must be accomplished according to economic theory is via supracompetitive prices. In order to understand the meaning of supracompetitive prices, it is necessary to understand the economic concepts of competition and market power. These are discussed briefly here.

Supracompetitive prices can only be established by the application of a significant degree of market power. 14 “Market power” refers to the ability of a firm (or a group of firms) to exercise discretion over price. By a “significant degree” of market power I mean power that is either largely or totally unconstrained by competition. In this sense, I intend that my economic terminology is generally consistent with the legal standard generally used in antitrust analysis.

> “Competition” is a fundamental concept in economics. The concept is rooted in the notion of rivalry between economic entities in their efforts to gain and retain customers. Competition takes place within a market. To examine competition in a market, economists often employ the concept of a “relevant market”. While normally applied in the context of antitrust analysis, the “relevant market” concept has broader applicability to the analysis of competition. A relevant market is defined generally to include all products that impose competitive constraints on the ability of a single firm (or a group of firms) profitably to raise the price of a particular good or service (or sets of particular goods or services) above some benchmark level for a significant period of time.

Competition in a market is not an economic abstraction but rather a continuous vying for customers driven by the profit motive and entrepreneurial incentives. In competitive markets, firms have strong incentives to offer products and services that satisfy consumers’ preferences and ensure efficient production and responsive innovation. 15

Economists often utilise structural descriptions of the relevant market (e.g., monopoly or oligopoly) to gauge the extent of likely competition within the market and the ability of a single firm (or a group of firms) to exercise market power. For example, in a classic monopoly market, there is only one seller, often with significant discretion over price. By contrast, in a perfectly competitive market, there

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13 *Queensland Wire Industries Pty Ltd v The Broken Hill Pty Ltd* (1989) 167 CLR 177, 191 (citation within quote omitted).

14 Use of this terminology is deliberate in that I am aware that there are legal tests (e.g., in Australia and the United States) that are defined by the terms “substantial market power” and “monopoly power”, respectively.

are many sellers, all lacking the ability to influence price through their actions and thus lacking market power. In the real world, almost every firm has some degree, however small, of market power. Between the extremes of perfect competition and monopoly, there are various types of imperfectly competitive markets. These include “oligopolistic markets” (relatively few firms selling identical or differentiated products) and “monopolistically competitive markets” (containing many sellers of differentiated products). In such markets, firms can often (at least in the short-run and sometimes in the long run) earn profits that exceed “normal” levels. Economists define a “normal” level of profits as a return on assets just sufficient to warrant the replacement of economic assets employed by the firm, taking into account the risk associated with these assets. Firms generally strive to earn profits that exceed such levels.

Economists generally consider a market to be competitive if it is at least “workably competitive” (sometimes known as “effectively competitive”). This benchmark is commonly used for gauging firm behaviour in an antitrust context. In a workably competitive market some (or even all) market participants may have some market power, but no market participant has a “significant degree” of market power. In a workably competitive market, at any specific point in time, prices can deviate from underlying costs and the deployed technologies can deviate from the most efficient ones currently available. However, in such markets, economic forces drive the market, albeit not instantly, towards competitive prices, outputs and costs.

By contrast, a firm that has a “significant degree” of market power is able to price without regard (or substantially without regard) to (actual or potential) competition and/or can act in a manner that would exclude equally or more efficient competitors from the market. There are pricing constraints operating even on a monopolist, of course. The phrase ‘without regard to competition’ usually means that a firm can profitably price significantly above the competitive level for a significant period of time. It is therefore important to distinguish between market power (sometimes referred to as “economic” market power) – which merely implies that a firm has some discretion over its prices, product quality and service – and a “significant degree” of market power (usually referred to in an antitrust context as “monopoly” power or a “substantial degree of market power”).

With this background, one can distinguish between supracompetitive prices and other prices. Supracompetitive prices are not merely prices that are higher than those that may have prevailed at some other point in time. Because workably competitive markets can encompass markets with different structures, there is no one level of prices that can be viewed as “competitive.” Indeed, in most such markets, prices will vary over time depending on economic conditions and the state of competition. Thus, at some times prices will be higher than at other times.

16 The characteristics of the perfectly competitive market model are set forth in more detail, e.g., in Carlton D and Perloff J, Modern Industrial Organization, 3rd Edition, Addison-Wesley, New York, 2000, p.56ff. These include, inter alia, homogeneous goods and services, perfect information, price taking (i.e., any deviation from market price is unprofitable), free entry and exit, and the absence of scale and scope economies.
18 Note that the term “monopoly” has two meanings in economics. A classic “monopoly market” has just one seller. In antitrust analysis, however, the term “monopoly power” is also used more broadly to describe a situation where a firm, or group of firms, wields substantial market power.
Supracompetitive prices are distinguished from competitive prices in that the former are sustained by a “significant degree” of market power. Thus, a firm alleged to have engaged in predatory pricing must either possess a “significant degree” of market power or have a reasonable expectation that it will obtain it (perhaps, but not necessarily, through its predatory action).

DEVELOPMENTS IN ECONOMIC THEORY

While predatory pricing has been the subject of economic and legal inquiry at least since the creation of Standard Oil in the 1870s and 1880s, in 1967 the Utah Pie decision was instrumental in injecting renewed vigour into the economic analysis of the concept. This analysis has focused on two related topics – development of empirical tests to distinguish predatory pricing from pro-competitive price reductions, and evaluation of the theory of predation, particularly investigating the conditions under which such behaviour might rationally be undertaken. While it is not the purpose of this paper to review this literature in detail, it is useful to review some of the most important developments.

Three basic types of empirical tests have been suggested by economists to determine whether predatory pricing has occurred. These can be roughly categorised as cost-based measures, evaluations of intent, and strategic analyses.

Among the cost-based tests, Areeda and Turner were highly influential in the years following the Utah Pie decision. They believed that any price that exceeded short-run marginal costs should be viewed as presumptively not anticompetitive. Further, recognising that marginal cost was inherently difficult to measure, they suggested the use of average variable cost (AVC) as a workable proxy for marginal cost. While AVC has been criticised by some economists as a misleading proxy, more recently Baumol has noted that AVC may, in fact, be superior to marginal cost, because AVC more closely corresponds to measures used by firms in making certain business decisions.

The other significant cost-based measure that has been suggested is long-run incremental cost (LRIC). However, there has been comparatively little economic support for LRIC as an appropriate cost filter for examining predatory pricing claims, mainly because economists have long recognised that, in the short run, it is generally rational for firms to produce at any price above their short-run marginal costs.

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19 Utah Pie Company v Continental Baking Company 386 U.S. 685 (1967). The Utah Pie Company was engaged in competition in the Salt Lake City region with three national firms to supply frozen dessert pies. It is generally accepted that Utah Pie’s products were initially priced lower than its competitors’ products. Price competition ensued and all three national firms lowered their prices dramatically in this region. The United States Supreme Court found that these national competitors had charged less than average total costs (but apparently had not charged less than average variable costs) in the region where they competed against Utah Pie. In addition, they had charged less in that region than they charged elsewhere in the United States. Throughout the period, Utah Pie held the largest share of regional sales for these products. The decision was subsequently sharply criticised by most economists.

20 Procompetitive price reductions would be pro-consumer as well, although it is at least theoretically possible that price reductions could be competitively neutral while still being pro-consumer.

21 For a more in-depth analysis see, for example, Ordover J and Saloner G, “Predation, Monopolization, and Antitrust” in Schmalensee R and Willig R (eds), Handbook of Industrial Organization, Volume 1, Ch 9 (North Holland, 1998).

22 See Areeda P and Turner D, “Predatory Pricing and Related Practices under Section 2 of the Sherman Act,” (1975) 88 Harvard Law Review 697. They did note that there were some instances (such as promotional pricing) where prices could be set below marginal costs without anticompetitive effect.

costs. It may even be rational, in the short-run (e.g., with high exit and/or entry costs) to accept a price below short-run marginal costs.

Intent-based tests for predatory pricing have no independent theoretical foundation in economics. Despite this, some economists have suggested use of evidence on “intent” – which is inherently subjective in virtually all cases – in combination with pricing below LRIC as a test to determine whether predatory pricing claims can be demonstrated. Such tests have little to recommend them from an economic perspective.

Finally, so-called strategic tests have also been suggested. The objective of these tests is to evaluate the strategic objectives of the alleged predator in order to distinguish anticompetitive behaviour from pro-competitive (or competitively neutral) activities. For example, Williamson and Baumol suggested analysing behaviour concerning output decisions and pricing, respectively. Ordover and Willig suggested an even more general type of strategic test. The basic test they developed is quite strict in that it could deem as “anticompetitive” business conduct that would pass scrutiny under other tests. Specifically, they proposed that the incumbent’s response to an entrant be deemed anticompetitive if the challenged response would be unprofitable without exit of the rival, but would be profitable with exit, taking into account additional profits the incumbent would earn after the rival’s demise. Moreover, for the challenged conduct to be predatory, according to this definition, some other response would have to be more profitable if the entrant did not in fact exit the relevant market (or markets).

One problem with these strategic tests is that they are difficult to utilise in a manner that would avoid errors in enforcement. Either they are sufficiently vague or complex in application (e.g., Ordover/Willig) that it is difficult to distinguish predatory pricing from competitive pricing or they are sufficiently rigid (e.g., Baumol and Williamson) that they risk providing excessive incentives to inefficient market participants. Thus, attempts to apply them generally encounter similar types of informational and interpretational disputes that encumber debates about intent.

In recognition of these problems, some economists have used game-theoretic approaches in an effort to further develop the theory of predation and to identify more specifically the conditions under which predatory pricing could be successful (and, therefore, economically rational). The proponents of this approach maintain “[s]tatic theory is ill-equipped to handle inherently dynamic strategic interactions like predatory pricing.”

31 For example, the test could be, and has been, applied to product innovations and capacity expansions by dominant firms. Under some tests of predatory/exclusionary conduct such behaviour may be regarded as being outside of the purview of competition policy.
32 The authors have stated that the test is sufficiently general to apply in circumstances where the rival does not exit but is competitively “disciplined” in some manner. This test is broadly similar to other tests that have been proposed to distinguish predation from pro-competitive conduct. For example, according to Baumol, n 15, at 26 (n 50), “any reduction in price, or any other decision, should be judged non-predatory if and only if it is profitable for the incumbent on the assumption either that the entrant is there to stay indefinitely or that the probability that the entrant will withdraw is fixed”. Similarly, Bolton P, Brodley J, and Riordan M write that “a predatory price is a price that is profit-maximizing only because of its exclusionary or other anticompetitive effects”; see their article, “Predatory Pricing: Strategic Theory and Legal Policy” (2000) 88(8) Georgetown Law Journal 2239.
Several routes of predation have been suggested including so-called “signal-jamming” theories (e.g., test market predation and financial market predation) and sunk-cost commitment predation (incurring a sunk-cost prior to the entry or expansion of a competitor to deter investment by that competitor). Proponents of these theories contend that no informational advantages are required to explain rational, predatory behaviour through these means, although informational incompleteness and relatively high costs to ameliorate the incompleteness as well as certain other market imperfections may well be required.31

In addition, two other strategic theories of predatory pricing have been proposed that do rely on informational advantages — reputation and signalling. Reputational models of predatory pricing posit that, under some circumstances, incumbents can effectively deter entry by developing a “reputation” for cutting prices to predatory levels when entry occurs or is credibly threatened.32 Signalling models of predatory pricing attempt to explain exit-inducing conduct using similar methods.33 In both such models the predator employs some informational advantage to induce existing rivals to exit and/or potential rivals not to enter, because they believe the predator possesses a sustainable cost advantage.

These models have been developed in an attempt to specify conditions under which recoupment would be more plausible and/or feasible (i.e., economically rational). Thus, in part, they are a response to a view held by many economists (including, but not confined to, adherents of the so-called “Chicago School” theories) that, under traditional theories of predatory pricing, recoupment is very unlikely and, as a result, is not an economically rational ex ante expectation in the vast majority of circumstances.

However, there has been considerable disagreement among economists concerning the applicability (and plausibility) of strategic theories of predation to real-world circumstances. For example, there has been considerable controversy as to the likelihood that significant informational advantages can be sustained for any significant period of time, given the many sources of information potentially available to market participants and the fact that competitors may well be able to deploy informational advantages of their own in some circumstances.34 It is also important to note that these theories (and other “strategic” theories of predatory pricing) do not exclude consideration of recoupment. Rather these theories merely posit recoupment through conventional (i.e., subsequent supra-competitive pricing) or alternative (e.g., targeted predation in selected markets by a multi-market monopolist that recoups in the “non-targeted” markets) means. Thus, recoupment remains a fundamental element of all economic theories of predatory pricing.

One of the most serious problems that proponents of such strategic theories face in gaining more widespread support for the plausibility of such theories (at least in some circumstances)35 is that there is relatively little substantial empirical

31 E.g., ibid., p. 2500.
35 Note that many such proponents still do not contend that predatory pricing is common, so their views on the applicability of such theories relative to those who tend to discount such theories is really more a matter of degree. E.g., see Bolton P, Brodley J and Riordan M, op. cit. (2001), p. 2504.
evidence to support their views at this time. This problem is particularly acute in the airline industry, which is often cited as a primary example of an industry where strategic theories are applicable. However, informational advantages are unlikely to confer significant advantage in this industry, since cost structures are so well studied and detailed knowledge of them (even for specific carriers and routes) is relatively widespread. Furthermore, entry (some of it quite successful) continues to be relatively common, even against established carriers at (or near) their hubs. In addition, this entry occurs in the face of strategies employed by incumbent carriers that are well-known and must be anticipated by entrants. The recent American Airlines decision in the United States was a substantial setback to proponents of strategic predation theories, although the case is on appeal and could yet provide fodder for them.

The focus on airlines has, however, highlighted three interesting issues in the debate about predatory pricing and the objectives of antitrust policy. First, while the focus of the economic debate over antitrust policy has generally been on preventing firms from taking action that causes the exit or failure to enter by an equally (or more) efficient competitor, some proponents of strategic predatory pricing theories have noted that, in some circumstances, even less efficient competitors can confer benefits on consumers (e.g., where they cause firms with market power to reduce prices). Some economists counter (particularly in reference to the airline industry) that the lower prices that result do not necessarily benefit consumers if they undermine broader efforts by multi-market firms that face substantial common costs to develop more efficient price structures.

Second, because it is so difficult to demonstrate that certain airline fares are “below cost” (e.g., given that marginal costs may be so low and that price discrimination is so widespread), some economists have contended that “above cost” pricing can sometimes be predatory, particularly because such prices can allegedly deny consumers the potential benefits from entry by less efficient, but still low-price, competitors. While clearly a minority view, absent definitive guidance on the correct measures of cost from either economists or the courts, some Applicants will have a strong self-interest in employing such views.

Third, many proponents of strategic theories see no distinction between the use of price and the use of capacity as instruments of predation. Thus, again using the airline industry to illustrate the point, predation is often accomplished, in their view, by simultaneously reducing price and increasing capacity in an effort to prevent entry and/or cause exit of competitors. As noted above, the problem proponents must explain is why entry continues to occur despite the fact entrants

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36 I.e., matching entrant fares for selected seats on selected routes while simultaneously increasing capacity.
37 United States v AMR Corp 140 F Supp 2d 1141 (D Kan 2001). The case concerned the behaviour of American Airlines at the Dallas-Fort Worth Airport (DFW), one of its main hub airports in the United States. American has long dominated passenger traffic at this airport, but has been challenged on some routes by smaller, low-price, startup airlines. In virtually every case where this occurred, American responded by increasing capacity and matching the promotional fares offered by the entrants (although the matched fares were generally offered on proportionally fewer of American’s seats than for its entrant rivals). Further, in many cases where entrants subsequently exited from routes, American responded by reducing capacity (through lower flight frequency) and increasing fares. The court, in granting summary judgment in American’s favour (i.e., in dismissing the case), was sharply critical of virtually all aspects of the plaintiff’s case and generally affirmed the emphasis on demonstrating the rationality of recoupment as a central part of proving any predatory pricing allegations. However, the court may have employed too narrow a view for market definition in formulating its decision.
must expect that they will face such strategies. Indeed, entrants must expect to succeed even in the face of simultaneous capacity increases and price cuts by incumbents or they would not enter.

FULL COURT OF THE FEDERAL COURT DECISION IN AUSTRALIA

The Boral decision by the Full Court of the Federal Court in Australia illustrated sharp differences between its views on predatory pricing and the fundamental economic principles that relate to that concept. The Full Court of the Federal Court reversed a decision by the trial court and held that Boral had engaged in predatory pricing in breach of ss 46 of the Trade Practices Act 1974 (Cth).

The Boral case involved the sale of concrete block products in the early 1990s in the Melbourne region. Depressed demand combined with entry using newer, lower cost technology resulted in a price war where, for at least some periods, several competitors sold products at prices that were lower than avoidable costs. Eventually some competitors exited the market. While I do not intend to review or comment on the merits of either the applicant’s or the respondent’s position on the facts, I note that the trial court judge found that predation had not occurred because, while there was evidence that Boral had at least one prohibited purpose in mind (i.e., elimination of a competitor), Boral did not possess substantial market power, and, even if it did, it did not use that power.

On appeal, using a different (i.e., narrower) market definition, the Full Court of the Federal Court found that Boral did possess substantial market power. Further, and importantly, the Full Court of the Federal Court concluded that Boral used that power by pricing below avoidable cost for at least some periods of time and by increasing its production capacity during periods of depressed demand (and prices). Moreover, at least two of the three judges accepted that financial strength was evidence of market power, and the willingness to employ it was evidence of use of market power.

Importantly, the court rejected the view that, if a firm engaged in predatory pricing, an expectation of recoupment, at least as economists define the concept, was necessary under ss 46 to establish a breach. For example, Merkel J appeared to acknowledge that Boral’s action would, at best, return profits to “normal” levels. Such profits could not, as a matter of economic theory, result in recoupment through supra-competitive pricing.

Finkelstein J also rejected the view that recoupment is required to demonstrate breach. Thus, he implicitly rejected the view that the legal concept of predatory pricing was consistent with the economic concept of predatory pricing. In doing so, Finkelstein J drew sharp distinctions between the legal treatment of

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40 Avoidable costs are those costs that a firm would not have to incur if it did not produce a specific increment of production. Thus, they are conceptually equivalent to incremental costs (i.e., those costs incurred to produce a specific increment of production).

41 Based on Boral documents expressing the desire to reduce the number of competitors in the industry.

42 On the use issue, the trial judge concluded, in part, that selling below avoidable cost, even for prolonged periods of time, could be a rational business decision in a competitive market (see ACCC v Boral Ltd (2000) 106 FCR 328 at 349).


45 ACCC v Boral Ltd (2000) 106 FCR 328 at 387. While the concept of “normal” profits is not entirely clear from this paragraph in Merkel J’s decision, he suggests that any “recoupment” expected by Boral in this case would not include any prospect of “monopoly rents”.

predatory pricing in Australia and its legal treatment in the United States, where the consistency of the legal and economic concepts had been reflected in *Matshushita* and *Brooke Group*. For example, Finkelstein J apparently distinguished between the required treatment of predatory pricing in Australia as compared with the United States in large part based on presumption that the “monopolisation” standard used in the United States in antitrust litigation is fundamentally more restrictive than the substantial market power standard employed in Australia. This difference, he contended, required a different perspective on recoupment. Whereas, in his view, recoupment through supracompetitive pricing was relatively easy for a monopolist, it was not for a firm that “merely” possessed substantial market power. The fundamental problem with this view is that it provides no economic rationale for predation (since, absent recoupment, the alleged predatory would incur a cost – i.e., the forgone profits from low prices – without ever receiving compensation for incurring this cost).

Furthermore, Finkelstein J attempted to distinguish the treatment of predatory pricing in Australia from that in the United States in two other important respects:

- He maintained that intent has been eliminated from consideration in determining whether predatory pricing had occurred in the United States because the courts there have focused their inquiry on recoupment. His Honour stated that the different construction of s 46 (i.e., than for United States’ antitrust legislation) explicitly required an inquiry into purpose (or “intent”), whereas, in the United States, effects (or outcomes) were the focus of the inquiry (e.g., monopolisation or attempted monopolisation).
- He maintained that below-cost pricing is also not a required element in demonstrating predatory pricing in Australia. Instead all that is required is that price is “set at a level designed to eliminate a competitor or keep a potential competitor from the market” even if the “the price charged might exceed … the average total cost.”

In this latter opinion, Finkelstein J took a position that appeared to be consistent with the recently expressed proposition from another important Australian case – *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd* (2001) 205 CLR 1 – namely (to paraphrase) that, if an action is facilitated by the existence of substantial market power, it may be considered evidence of “use” of that power. Thus, according to this rather vague and ambiguous (in an economic sense) standard, it would be possible that the existence of economies of scale by a firm with substantial market power may ‘facilitate’ profitable pricing at levels below those that some smaller competitors and/or small-scale entrants may be able to match. If so, it appears that the logic specified in the *Melway* decision could interpret this as evidence of use of substantial market power to price in a predatory manner (since

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49 ACCC v *Boral Ltd* (2000) 106 FCR 328 at 399. In this respect, Finkelstein J expressed support for a view used by some proponents of strategic predation theories.
50 *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd* (2001) 205 CLR 1 at 23. Note that economists in the United States and Australia draw a distinction between “market power”, which merely reflects the fact that a firm has some discretion over price because it faces a downward sloping demand curve for its products, and substantial market power (also termed “monopoly power” in the United States), which implies that the firm faces few or no competitive constraints on its behaviour. Many firms possess market power, but relatively few possess substantial market power.
those small actual and/or potential rivals might not be financially viable over the long run at prices charged by an incumbent firm with economies of scale).

**HIGH COURT DECISION IN AUSTRALIA**

The *Boral* decision by the High Court in Australia reversed the ruling of the Full Court of the Federal Court, effectively reinstating the ruling by the trial court. In doing so, the High Court clarified a number of matters that are significant from an economic perspective. Most importantly, the High Court has affirmed that an expectation of recoupment is an essential element in determining whether a firm possesses substantial market power and whether it has taken advantage of that power.\(^{51}\) In this manner, the High Court has demonstrated the compatibility of the economic concepts of predatory pricing (including recoupment) with the construction of s 46. The High Court has noted, again consistent with the relevant economic theory, that recoupment must be achieved through supra-competitive prices, not merely higher (than currently prevailing) prices, especially if current prices are depressed as a result of prevailing economic conditions.\(^{52}\) Further in this vein, the High Court has helped to clarify the distinction between price reductions that are predatory and those that are pro-competitive and therefore pro-consumer.\(^{53}\)

The High Court also specified the manner by which the economic inquiry required by s 46 should be structured. The High Court criticised the “inverted” manner of the inquiry by the Full Court of the Federal Court, which appeared to infer substantial market power and use of that power from purpose.\(^{54}\)

In addition, McHugh J clarified the “facilitation” concept the High Court expressed in *Melway*. He appears to have explicitly rejected the view that firms can take advantage of substantial market power if they merely deploy the efficiency or financial advantages that they possess.\(^{55}\)

Furthermore, one can infer from the High Court’s decision that, even ignoring the need to demonstrate the expectation of recoupment, investigating predatory pricing allegations requires a sophisticated inquiry into costs, economic conditions and strategic considerations. The High Court noted a number of reasons why prices below even avoidable costs might be justified, at least for some period of time, as competitive, not predatory, conduct. These included consideration of market conditions, costs of entry and exit (including customer relations costs), and a broader perspective on profitability for vertically integrated suppliers.\(^{56}\) Most economists would agree with such a view, rejecting the notion that bright-line cost tests can invariably and uncritically be applied to separate pro-competitive from anticompetitive conduct.\(^{57}\)

In other respects as well, the High Court has clarified matters relating to predatory pricing (and other competition matters) by employing a view of market conditions.

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\(^{51}\) E.g., *Boral Besser Masonry Ltd (now Boral Masonry Ltd) v ACCC* (2003) HCA 5 at [124]-[130], [138], [278]-[279] and [292].

\(^{52}\) *Boral Besser Masonry Ltd (now Boral Masonry Ltd) v ACCC* (2003) HCA 5 at [306].

\(^{53}\) E.g, *Boral Besser Masonry Ltd (now Boral Masonry Ltd) v ACCC* (2003) HCA 5 at [32], [60] and [62].

\(^{54}\) Eg *Boral Besser Masonry Ltd (now Boral Masonry Ltd) v ACCC* (2003) HCA 5 at [141], [180]. [181], [194] and [320].

\(^{55}\) *Boral Besser Masonry Ltd (now Boral Masonry Ltd) v ACCC* (2003) HCA 5 at [280] and [317].

\(^{56}\) Eg *Boral Besser Masonry Ltd (now Boral Masonry Ltd) v ACCC* (2003) HCA 5 at [60], [68], [70], [108], [171] and [273].

\(^{57}\) Grout P, “Recent Developments in the Definition of Abusive Pricing in European Competition Policy,” CMPO Working Paper Series No. 00/23 (University of Bristol), Revised March 2001, p. 22. See also *Boral Besser Masonry Ltd (now Boral Masonry Ltd) v ACCC* (2003) HCA 5 at [273].
power that is consistent with economic theory. Significantly, from the perspective of predatory pricing analysis, McHugh J noted that it “is the power to obtain supra-competitive prices that demonstrates market power, not higher or lower prices.” Various comments in the judgment also noted that market power was not synonymous with financial strength or “economic strength.” It was noted that “[c]utting prices is not evidence of market power”, that the fact that some competitors have exited the market in the course of a price war does not necessarily establish that any remaining firms have market power, and that low prices are not properly considered, in and of themselves, as a barrier to entry.

Finally, McHugh J noted the essential similarity between the concept of “monopoly power” as used in antitrust inquiries in the United States and “substantial market power” as used in antitrust inquiries in Australia. This similarity had been called into question in the Full Court of the Federal Court’s decision in Boral.

SOME GENERAL IMPLICATIONS OF THE HIGH COURT’S BORAL DECISION

From an economic perspective, the Full Court of the Federal Court’s Boral decision, combined with some elements of the High Court’s Melway decision created considerable uncertainty regarding the treatment of predatory pricing allegations in Australia, particularly since those decisions appeared to lower significantly the requirements borne by Applicants to demonstrate that pricing had been predatory. However, the recent High Court decision in Boral has clarified matters in Australia and provided a sound economic basis for determining whether pricing could be predatory. The High Court’s decision has also helped to clarify an aspect of Melway that could have been problematic from an economic perspective. Among the several significant economic problems from the Full Court of the Federal Court’s Boral decision that have been substantially eliminated by the High Court’s decision in this matter are:

- At least two of the three judges of Full Court of the Federal Court apparently agreed that no demonstration that recoupment was either likely or expected by the alleged predator was required to sustain a finding of predatory pricing. This is inconsistent with the economic concept of predatory pricing and, therefore, was a serious concern. As noted above, recoupment is integral to that concept and economists agree that, absent an expectation of recoupment through some means, low prices are not, as an economic matter, predatory. Furthermore, recoupment cannot be accomplished, as implied in the decision by Merkel J, by raising prices so that “normal” profits can be earned. In fact, this finding by Merkel J tended to undercut his finding that Boral even possessed substantial market power at all (i.e., because, if it had such market power, it would, by definition, be able to raise price above a level that yielded merely “normal” profits). The High Court, by finding that recoupment was required for pricing to be predatory and that recoupment must be achieved through prices that are supracompetitive (i.e., not merely prices that are higher than previously

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58 Boral Besser Masonry Ltd (now Boral Masonry Ltd) v ACCC (2003) HCA 5 at [306].
59 Boral Besser Masonry Ltd (now Boral Masonry Ltd) v ACCC (2003) HCA 5 at [138].
60 Boral Besser Masonry Ltd (now Boral Masonry Ltd) v ACCC (2003) HCA 5 at [303].
61 Boral Besser Masonry Ltd (now Boral Masonry Ltd) v ACCC (2003) HCA 5 at [287].
62 Boral Besser Masonry Ltd (now Boral Masonry Ltd) v ACCC (2003) HCA 5 at [147].
63 Boral Besser Masonry Ltd (now Boral Masonry Ltd) v ACCC (2003) HCA 5 at [310-312].
64 Boral Besser Masonry Ltd (now Boral Masonry Ltd) v ACCC (2003) HCA 5 at [282] and [290].
prevailing prices or prices that provide normal profits), has eliminated this problem. More important are the comments included in the High Court’s judgment that suggest that the concept of recoupment is perfectly compatible with the construction of s 46 because a reasonable expectation that recoupment can be achieved is both an indicator of substantial market power (e.g., because recoupment can only be achieved through the use of supra-competitive prices) and an indication of use of substantial market power.

- The finding by Finkelstein J that below-cost pricing is not required for predatory pricing was also potentially problematic. The view of pricing evident in the High Court’s decision – which appears to allow consideration of economic conditions, competitor costs, long-run strategic considerations, and benefits gained from vertical integration – undercuts the applicability of simple and/or formulaic tests for predatory pricing.

- The distinction (without an economic difference) between “monopoly power” as utilised in United States antitrust analysis and “substantial market power” as utilised in Australian competition analysis is not appropriate as a matter of economics. As applied in an antitrust economics context the two terms are equivalent. While it is true that economics more generally uses the term “monopoly” to refer to a situation where there is one – and only one – seller in a market, antitrust analysis in the United States applies the term to a broader class of market environments – i.e., those where firms have no or relatively few competitive constraints on their behaviour. Certainly, courts in the United States have upheld monopolisation claims against firms with far lower market shares than 100%. Thus, the High Court has rejected the view, as expressed by the Full Court of the Federal Court, that recoupment should be inherently less likely in Australian predatory pricing schemes than in the United States because the former is concerned with substantial market power while the latter is concerned with monopoly power.

- Combined with the view expressed by the High Court in Melway that “use” under s 46 may be determined on the basis of whether an action has been facilitated in some manner by the existence of substantial market power, there was a danger that the Full Court of the Federal Court’s Boral decision might result in excessive risk that legitimate competitive behaviour would be deemed by the courts to be predatory. This problem could have occurred for two reasons. First, though economists generally consider pricing at (or above) long-run incremental costs (which includes a return on invested capital) to be rational, the Full Court of the Federal Court’s Boral decision appeared to place such pricing outside safe harbours. Second, the Melway decision could have encouraged applicants to allege that legitimate business advantages, such as financial strength or economies of scale, were a basis to assert that substantial market power had been “used” to undercut competitors’ prices. The High Court, in its comments on the meaning of the “facilitation” standard adopted in Melway has helped to clarify that firms with substantial market power can and should deploy and utilise legitimate competitive advantages.

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65 Eg see Tirole J, op. cit., n 2, p 195.
66 Such as deployment of efficiency-enhancing assets possessed by the firm.
67 That is, although such advantages may not confer substantial market power themselves, their existence in combination with such power could be perceived as a “facilitating” factor.
• The High Court’s rejection of the so-called ‘inverted inquiry’ model in both its 
  *Boral* and *Melway* decisions is significant from an economic perspective – even 
  beyond its application in predatory pricing inquiries. The reality of business 
  conduct and the inherently aggressive nature of competitive conduct make it 
  likely that competitors will express (and document) even pro-competitive 
  intentions in anti-competitive terms (e.g., ‘eliminating competitors’). Often 
  market circumstances can result in exit or failed entry (as a consequence of a 
  variety of non-anti-competitive reasons). If power and use can be inferred from 
  such expressions and documents (combined with adverse consequences to some 
  competitors in the marketplace), enforcement errors are more likely than if 
  antitrust inquiries must first establish the existence of market power and use of 
  that power (based on the application of economic theory to the facts and 
  circumstances of the market) as the High Court has indicated.

  Finally, the High Court’s strong endorsement of the view that competition 
  invariably inflicts “damage” on competitors, and on the purpose of the *Trade 
  Practices Act* – to promote competition, not protect competitors – is fully consistent 
  with the economic view of the nature of competition and the objective of 
  antitrust/competition policy, and should promote antitrust enforcement actions 
  that are pro-competitive and efficiency-enhancing. Because low prices, whatever the 
  source, may well inflict harm (e.g., financial hardship) on competitors, a policy that 
  does not adequately distinguish between anticompetitive conduct and other, 
  aggressive, but pro-competitive actions poses a substantial risk of undermining 
  competition, promoting inefficiency and harming consumers.

  One indication of the confusion and potential problems that could have 
  resulted from the view of predatory pricing expressed in the Full Court of the 
  Federal Court’s *Boral* decision is apparent in an analysis submitted in New Zealand 
  in response to acquisitions that recently occurred in the electricity industry in that 
  country. The analysis is interesting because New Zealand’s *Commerce Act 1986* is 
  so similar to Australia’s *Trade Practices Act*. As the authors of that analysis 
  asserted:

  However, it is important to keep in mind that a rational predatory pricing campaign (with the prospect 
  of loss recoupment) is not necessary for a s 36 breach. The scope of the provision is much wider than 
  this. An irrational investment … may be impeached under s 36.

  The economic implications of such assertions are extremely troubling 
  because eliminating an evidentiary requirement that plaintiffs demonstrate a 
  reasonable *ex ante* expectation of recoupment through supracompetitive prices from 
  predatory pricing cases certainly implies a view of predatory pricing that is 
  inconsistent with economic theory. The irony is that so-called “irrational predatory 
  pricing” – i.e., low prices implemented by firms that do not have any expectations of 
  pricing (or the ability to price) supracompetitively (now or in the future) – assuredly 

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68 E.g., see *Boral Besser Masonry Ltd (now Boral Masonry Ltd) v ACCC* (2003) HCA 5 at [86]-[87], [122], [160] and [260].
69 In this vein, the full Federal Court’s apparent view that “rational” or “commercial” motives for behaviour cannot be utilised 
  as an absolute affirmative defence if other elements of s 46 have been demonstrated, could have been quite troubling as an 
  economic matter unless the safe harbour includes actions consistent with those that are feasible in a workably competitive 
70 See Gale S and Fardell R, “Retail Foreclosure: Spot Market Power and Retailing,” *Report to the Major Electricity Users’ 
  Group* (27 September 2001).
71 With s 36 of the New Zealand *Commerce Act* being virtually identical to s 46 of the *Trade Practices Act*.
72 Gale and Fardell, n 48, p 6.
benefits consumers and thus, as a matter of economics, should not represent a competition problem.

THE NEXT FRONTIER IN PREDATORY PRICING IN AUSTRALIA

In discussing the “Developments in Economic Theory” above, it is clear that recent economic analysis of predatory pricing has focused on developing and critiquing strategic theories of predation. Proponents of strategic theory have contended that traditional views of predatory pricing – which they label, somewhat disparingly as “static” theories (as opposed to the “dynamic” perspective allegedly represented by strategic theories) – do not adequately account for conduct observed in the real world. As a consequence, according to these economists, instances of predation that occur are incorrectly viewed as not anti-competitive.

For this reason, some economists have criticised recent United States’ court decisions on predatory pricing (such as the Brooke Group decision) because they manifested a view that “adhere[s] to a static, non-strategic view of predatory pricing.” The more recent American Airlines decision has, for better or worse (depending on one’s views about the plausibility of more dynamic economic theories of predatory pricing), directly addressed this critique, albeit with perhaps an overly restrictive view of the markets in which recoupment expectations must be demonstrated. Assuming other courts follow the U.S. Federal District Court’s lead in that case (an admittedly uncertain proposition), it is clear that hard facts will be required in United States courts for plaintiffs to prevail in claims based on strategic theories of predatory pricing. Not only will specific instances of deterred entry or induced exit be required, but plaintiffs will have to demonstrate practically plausible (or probable) routes by which recoupment could occur or has occurred. Plaintiffs may increase their chances of success if they can convincingly demonstrate that the strategies implemented by defendants explicitly fail more strategic formulations of predatory pricing rules, such as the Ordover-Willig criterion. Left unresolved is whether the height of the hurdle erected by the United States courts in terms of the evidentiary basis for sustaining such claims has been raised too high.

In a similar manner, the status and receptivity of Australian courts to strategic theories of predatory pricing is not clear at this time. While there were elements of strategic theory that were used by Merkel and Finkelstein JJ in the Full Court of the Federal Court decision on Boral, the High Court ultimately appears to have viewed the case from a far more traditional predatory pricing perspective. However, the High Court’s decision does contain numerous references to strategic predation theory (or theories). These provide some (albeit limited) insight into how these theories may be received in the Australian courts and, more importantly, give some guidance to future Applicants who may believe themselves to be victims of predatory pricing.

73 Bolton P, Brodley J and Riordan M, op. cit., (2000), n 16 at 2242. This paper provides a useful summary of the development of modern economic thinking on predatory pricing.

74 The District Court judge in that case followed the Department of Justice’s market definition, which determined each city-pair to be a separate relevant market, and declared that recoupment must occur (or, more precisely, the anticipated recoupment must be expected) within the same relevant market as the predation in order for the action to be anti-competitive.

75 E.g., Australian Competition and Consumer Commission v Boral (2001) 106 FCR 328 at 414 [341].
For example, there are several references in the High Court’s decision to the possibility that incumbents can employ strategic means to erect barriers to entry. The comments of Gleeson CJ, Callinan J, and McHugh J appear to express the view that such barriers can possibly be raised in some circumstances, but that those circumstances do not apply in Boral. Further, the comments they set forth appear to support the view that allegations that strategic barriers have been raised can be rebutted by the fact of entry and by analysis of the extent economic/business conditions and the likelihood that information asymmetries either exist and/or could be sustained, given the characteristics of the market.

Kirby J appears to hold a somewhat different view of strategic barriers – both in the context of the facts of the Boral case and more generally. Viewing “structural barriers” as relatively low in the CMP industry, he is concerned that C&M, although more efficient at the time of its entry than its competitors, still “experienced significant difficulties in surviving in the market.” He appears to ascribe these difficulties to strategic behaviour by incumbents, particularly Boral, which increased capacity, despite the depressed conditions in the industry. Kirby J expresses the view that this action by Boral was meant as a signal to its competitors concerning its commitment to the market and willingness to undercut their prices (e.g., by raising an exit barrier for itself).

In addition, Kirby J expresses the view that Boral’s strategic actions may have been developed as an exclusionary strategy essentially independent of any considerations relating to recoupment in the CMP (concrete masonry products) market in Melbourne. More broadly, and not surprisingly, he expresses support for the view expressed by at least two of the judges of the Full Court of the Federal Court that s 46 does not require recoupment in order to sustain a finding that predatory pricing for a prohibited purpose had occurred. In this respect, his views are inconsistent with both economic theory (as expressed even by proponents of strategic theories of predation, who agree that recoupment is a fundamental element of predation) and the High Court’s majority. However, it is possible that Kirby J intended his remarks to be interpreted in the sense that recoupment by BBM in Melbourne was unnecessary if it could recoup elsewhere (i.e., in other geographic markets) as a result of its actions (i.e., taking a multiple market perspective).

While the implications of these somewhat disparate and inconsistent views on strategic barriers are murky at this time, it is clear that, in Australia as in the United States currently, strategic barriers, as opposed to expressions of intent and/or bright-line, cost-based pricing tests, are likely to be the focus of future predatory pricing cases. It is also clear that Applicants (or their economists) will have to develop substantial evidence of the plausibility (in terms of likely effect), existence, use and significance of such barriers in order to prevail. I think it likely that allegations of strategic predation will focus at least as much on investments and deployment of capacity by incumbents as on pricing. This, in part, will occur in reaction of the failure of the ACCC to prevail in Boral on pricing allegations, despite

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77 The entrant firm in the Melbourne region during the period of depressed prices. C&M utilised a more efficient technology than the incumbents at the time of its entry.
78 Boral Besser Masonry Ltd (now Boral Masonry Ltd) v ACCC (2003) HCA 5 at [356].
80 Boral Besser Masonry Ltd (now Boral Masonry Ltd) v ACCC (2003) HCA 5 at [435].
81 Boral Besser Masonry Ltd (now Boral Masonry Ltd) v ACCC (2003) HCA 5 at [356].
82 Such multiple markets could be geographically distinct and/or segmented by products in some manner.
the fact that Boral may have priced even below avoidable costs (albeit narrowly
defined on the basis of the subsidiary engaged in the manufacture of CMP) on a
number of occasions.

As important, Respondents have scope to rebut allegations of the importance
and use of such barriers by employing business justification defences, citing the
impact of economic/business conditions on conduct and performance in the relevant
markets and citing instances of actual entry in the face of aggressive (but pro-
competitive conduct) by incumbents. Finally, and perhaps most important of all, the
necessity to demonstrate a reasonable expectation of recoupment remains central in
order for Applicants to prevail in predatory pricing cases.