EC 360: Industrial Organization
Exclusionary Practices

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Sherman Act: exclusionary practices

- The Sherman Act states that being a monopoly is not an antitrust violation, but **exclusionary** behavior is a violation
- The courts believe...
  - Aggressive, competitive conduct by a monopolist is highly beneficial to consumers, and that courts should prize and encourage this conduct via antitrust laws
  - Aggressive, exclusionary conduct by a monopolist is deletrious to consumers, and courts should condemn this conduct via antitrust laws
- However, identifying exclusionary behavior is extremely difficult
  - Competitive and exclusionary conduct often look alike

Predatory pricing

Predatory pricing

- **Predatory pricing**: the act of setting a price below cost to force competitors to exit a market
  - A large, dominant firm enters a market with a smaller firm
  - The large firm starts to cut prices low enough that both firms sustain losses
  - The smaller firm can't sustain the losses and exits the market
  - The larger firm, now a monopolist, raises prices in the market, and threatens to slash prices again if another firm enters
- This result relies on several conditions
  - The large firm must have some significant market power
  - The large firm must have enough excess profit to sustain some temporary loss

Conditions to rationalize predatory pricing

- Several demanding conditions must be met in order to make predatory pricing a rational strategy
  - The predator must enjoy some threshold of market power, so that they may sufficiently affect the price
  - Exit barriers (sunk costs) must be low enough that prey firms can exit the industry easily
  - Entry barriers must be high enough that firms cannot easily re-enter the market after the predator firm raises prices

Empirical evidence

Empirical evidence of predatory pricing

- Creating a rule against predatory pricing is difficult
  - What practices should constitute the offense?
- Although allegations of predatory pricing are common, very few antitrust cases have found the defendant guilty
  - Predatory pricing is hard to prove, resulting in a misallocation of judicial resources
  - Potential conviction of innocent firms could discourage competitive pricing

Areeda Turner rule

- The **Areeda Turner rule** can help us analyze whether or not a firm is engaging in predatory pricing
  - Calculate a firm's average total cost (ATC) and marginal cost (MC)
  - If the price charged by the firm is less than both ATC and MC, then the firm is engaging in predatory pricing
  - Graph 7.1

Court cases

Barry Wright Corp. v. ITT Grinnell Corp. (1983)

- ITT Grinnell was accused of excluding Barry Wright from the market for mechanical snubbers (a component in pipe systems in nuclear power plants)
    - Grinnell offered to sign an exclusive contract with Barry Wright from 1977-1979, and help fund their startup if Barry Wright could have a full product line ready
    - Barry Wright could not keep up with Grinnell's demands, and Grinnell instead bought from Pacific Scientific Co. at a bulk discount
    - Barry Wright alleged that Pacific's bulk discount was meant to exclude Barry Wright form the market
- The courts ruled in favor of ITT Grinnell
    - The prices Pacific offered were above Pacific's ATC
    - Pacific had alot of excess capacity, so producing more snubbers would lower Pacific's ATC
    - Encouraging a price cut in this fashion brings us closer to the competitive outcome

Masushita Electric Industrial Co. v. Zenith Radio Corp. (1986)

- Zenith Radio alleged that Masushita Electric had formed a coalition monopoly in Japan and used the excess profits to finance predatory pricing in the US
  - Zenith argued that if the practice were to be allowed, US consumers would eventually face monopoly prices
- The judge ruled in favor of Matsushita, as he believed their market share was not large enough to exhibit significant pricing power
  - Zenith still accounted for 20% market share, while another competitor accounted for 24% market share
  - Masushita did not have a US monopoly, and there was no explicit evidence of collusion
  - This case set precedent for the **incentive logic filter**: the only cases that should go to court are ones where the economic incentives match the evidence

Brook Group Ltd. v. Brown & Williamson Tobacco Corp. (1993)

- Brook Group alleged that a rival cigarette producer, Brown & Williamson, engaged in predatory pricing
  - Brook Group won in a jury court, but it was later overturned by the court of appeals and the Supreme Court
- This case set two precedents
  - The plaintiff must show the defendent charged prices below some "appropriate measure of cost"
  - The plaintiff must show the defendent planned on recouping its losses from charging a price below cost

Recoupment

Predatory pricing

- Recall the firm is profit maximizing, thus the only reason they would choose to price below cost is that they expect to recoup their losses in the future

$$NPV = -\sum_{t=1}^{\tau} \frac{L_t}{(1+r)^t} + \sum_{\tau+1}^{T} \frac{\pi_t}{(1+r)^t}$$

  - *NPV* is the net present value of their strategy
  - L_t is the loss incurred during periods of below-cost pricing
  - π_t is the profit incurred during the recoupment periods
  - r is the discount rate
  - τ is the number of periods the firm incurs losses, and T the number of periods the firm is in the market

- Example 7.1

Bundling

Bundling

- So far in this course, with the exception of predatory pricing, the courts have ruled that most low prices are considered competitive
  - An interesting instance where discounts can be anticompetitive is in **bundled discounts**
- Consider the case of LePage Inc. v. 3M (2004)
  - 3M and LePage were competitors in the market for tape
  - As LePage's market share grew, 3M started to bundle its tape with other unrelated products at a bundled discount (i.e. health care, home care, auto care, stationary products)
  - The bundle discount incentivized retailers to carry 3M tape products over LePage's
  - "The defendant bears the burden of pursuading the jury that its conduct was justified by any normal business purpose" Supreme Court

Bundling: an anticompetitive example

Consider a firm that bundles the following three products:

Product	Price	Cost
Pencils	4.00	2.50
Soap	6.00	4.00
Keys	5.00	2.00

- Suppose a retailer (A) sells all three products, and if the retailer buys 1,000 of each good, then the firm offers a 25% discount

$$TE_A = .75(4,000 + 6,000 + 5,000) = \$11,250$$

- Suppose there exists another producer (B) of soap that can produce it at a cost of \$3.00

$$TE_B = 4,000 + 3,000 + 5,000 = \$12,000$$

- Thus, the bundle excluded an efficient firm from the market

Bundling and predatory pricing

- The discount means the firm is selling its soap for $(.75 \cdot \$6.00) = \$4.50$ compared to $\$3$ from the other producer; however, the more efficient firm is excluded from the market
- The total discount the original firm gave was $(.25 \cdot \$15,000) = \$3,750$
  - The producer of the soap could argue that this $\$3,750$ should all be allocated to the price cut on the soap, whose production cost is $\$4.00$
  - Thus, the soap manufacturer would argue the firm set a predatory price of soap of $\$6.00 - 3.75 = \$2.25$
  - However, this argument falls apart, since the producer of keys and pencils can make the exact same claim
- **Economies of scope** are excluded from antitrust violations
  - If bundling reduces the cost of goods sold, then it's an increase in efficiency and not anticompetitive