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PREDATORY PRICING IN CANADA: THE LAW AND THE ECONOMICS

Donald G. McFetridge*

Ottawa

Stanley Wong†

Toronto

This article discusses the emerging Canadian jurisprudence on predatory pricing in the light of a number of economic theories of predation which have been suggested in the recent academic literature. The article begins with an analysis of the three leading Canadian predatory pricing cases. Economic theories relating to predation and the social control of it are then discussed. Tests for predatory behaviour which have been derived from this body of theory are applied both to the leading Canadian cases and in the interpretation of the existing Canadian legislation. Alternative directions for reform, including both the elimination and the broadening of the predation offence, are also considered.

Les auteurs de cet article traitent du droit canadien en plein développement qu'est la fixation malhonnête des prix et, pour ce faire, passent en revue un certain nombre de théories avancées récemment dans les textes théoriques. Ils commencent par une analyse des trois décisions principales qui ont été rendues

* Donald G. McFetridge, of the Department of Economics, Carleton University, Ottawa, Ontario.

† Stanley Wong of the Ontario Bar, Toronto, Ontario. The research for this paper was completed while this author was Associate Professor of Economics, Carleton University, Ottawa, Ontario.

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sur la fixation malhonnête des prix. Ils étudient ensuite les théories économiques se rapportant à celle-ci et à la façon dont la société lutte contre elle. Ils appliquent enfin aux affaires canadiennes les plus importantes ainsi qu'à l'interprétation de la législation canadienne un certain nombre de critères dérivés de l'ensemble de ces théories. En conclusion, ils proposent de nouvelles avenues qui pourraient être suivies en vue d'une réforme, y compris l'élimination de l'infraction qu'est la fixation malhonnête des prix ou encore son extension.

Introduction

There has, in recent years, been a virtual explosion of the academic literature on predatory behaviour. At the same time a body of case law has emerged on predatory pricing in Canada. The purpose of this article is to discuss the three major Canadian predatory pricing cases in the context of the economic approaches to predation suggested in the recent literature.

Part I provides a legislative history of the offence of predatory pricing, and analyses the three leading cases. Part II looks at the economist's definition of predation, and considers a number of economic approaches to whether, and if so in what way, predation ought to be controlled. Part III applies these approaches to the leading Canadian cases, and Part IV considers the extent to which they may in fact be compatible with the existing Canadian legislation. By way of conclusion, some suggestions are made on the implications for the more general reform of competition law of both the Canadian experience with predatory pricing and the economic theories of predation.

I. Predatory Pricing and the Major Canadian Cases

A. The Offence of Predatory Pricing

The offence of predatory pricing was introduced into Canadian law in 1935 as part of section 498A of the Criminal Code:¹

498A (1) Every person engaged in trade or commerce or industry is guilty of an indictable offence and liable to a penalty not exceeding one thousand dollars or to one month's imprisonment, or, if a corporation, to a penalty not exceeding five thousand dollars, who . . .

(c) engages in a policy of selling goods at prices unreasonably low for the purpose of destroying competition or eliminating a competitor.

The constitutionality of section 498A was confirmed by *Reference Re Section 498A of the Criminal Code*.² In 1953 this provision was renumbered and amended to read:

¹ R.S.C. 1927, c. 36, as amended S.C. 1935, c. 56, s. 9.

² [1936] S.C.R. 363, [1936] 3 D.L.R. 593, (1936), 66 C.C.C. 161, *aff'd sub. nom.*, *Attorney-General of B.C. v. Attorney General of Canada*, [1937] A.C. 368, [1937] 1 D.L.R. 688, (1937), 67 C.C.C. 193 (P.C.)

412 (1) Every one engaged in trade, commerce or industry who . . .

(c) engages in a policy of selling goods at prices unreasonably low, having or designed to have the effect of substantially lessening competition or eliminating a competitor, is guilty of an indictable offence and is liable to imprisonment for two years.³

It was no longer necessary to prove that an accused had the "purpose" of destroying competition or eliminating a competitor. It became sufficient to show that the policy in question had the effect of substantially lessening competition or eliminating a competitor *or* was designed to have such effect.

In 1960 section 412(1)(c) was repealed and re-introduced in an amended form as section 33A of the Combines Investigation Act:⁴

33A (1) Every one engaged in a business who . . .

(c) engages in a policy of selling articles at prices unreasonably low, having the effect or tendency of substantially lessening competition or eliminating a competitor, or designed to have such effect, is guilty of an indictable offence and is liable to imprisonment for two years.

There were three substantive changes introduced by this amendment. First, the provision applied to every one engaged in a "business" instead of "trade, commerce or industry". Second, the offence is with respect to the selling of "articles" instead of "goods". Third, the offence was widened in scope to include a policy which has the "tendency" to substantially lessen competition or eliminate a competitor.

Section 33A(1)(c) was renumbered as section 34(1)(c) in the 1970 revision of the Statutes of Canada.⁵

The present formulation of the offence of predatory pricing, found in section 34(1)(c) of the Combines Investigation Act, was enacted in 1975:⁶

34 (1) Every one engaged in a business who . . .

(c) engages in a policy of selling products at prices unreasonably low, having the effect or tendency of substantially lessening competition or eliminating a competitor, or designed to have such effect, is guilty of an indictable offence and is liable to imprisonment for two years.

B. *Canadian Cases on Predatory Pricing*

For analytical purposes, section 34(1)(c) may be divided into the following elements:

- (1) every one engaged in a business;
- (2) engages in a policy of selling products;

³ Criminal Code, S.C. 1953-54, c. 51, s. 412.

⁴ R.S.C. 1952, c. 314, as amended by An Act to Amend the Combines Investigation Act and the Criminal Code, S.C. 1960, c. 45, ss. 12, 21.

⁵ Combines Investigation Act, R.S.C. 1970, c. C-23, s. 34(1)(c).

⁶ *Ibid.*, as amended S.C. 1974-75-76, c. 76, s. 16(1).

- (3) at unreasonably low prices;
- (4) having the effect or tendency of substantially lessening competition or eliminating a competitor or designed to have such effect.

In the fifty-year period in which the offence of predatory pricing has been part of Canadian law, there have only been six reported cases. They have dealt with the second, third and fourth of the four elements set out above.⁷ There is little disagreement that the three leading cases are *R. v. The Producers Dairy Ltd.*,⁸ *R. v. Hoffmann-LaRoche Ltd.*,⁹ and *R. v. Consumers Glass Ltd. and Portion Packaging*.¹⁰ Accordingly, only these cases are discussed.¹¹

(1) *R. v. The Producers Dairy Ltd.* ¹²

In the latter part of 1961 the Ottawa area milk market had four major dairies. There were also at least five others serving parts of the market. Producers, Borden, Clark and Capital, the four major dairies, were also the main suppliers of supermarket chain stores.

To gain a larger share of the chain store market, Clark offered on November 16 and 17, 1961 at all four stores of Steinberg's supermarket chain a free quart of milk for each quart of Clark's milk purchased. At the time Clark had the smallest share of the Steinberg business. This offer was a departure from the trade practice of giving price concessions only in connection with the opening of new stores. Producers responded by reducing its prices not only to Steinberg but also to other wholesale customers. This price reduction enabled Producers' wholesale customers to sell Producers' milk at the same price as the advertised price for Clark's. Borden, another major distributor, matched Producers' offer. No other Ottawa dairy made any price reductions. Door to door sales fell off

⁷ There has been no discussion of "everyone engaged in a business". "Business" is defined in section 2 of the Act as including:

(a) manufacturing, producing, transporting, acquiring, supplying, storing and otherwise dealing in articles and

(b) acquiring, supplying and otherwise dealing in services.

With respect to "engaged in a policy of selling products", "product" has not been subjected to judicial scrutiny. It is defined in section 2 as including an "article" and a "service", and those two words are in turn defined in broad terms.

⁸ (1966), 50 C.P.R. (2d) 265 (Ont. C.A.).

⁹ (1980), 109 D.L.R. (3d) 5, 28 O.R. (2d) 164, 53 C.C.C. (2d) 1 (Ont. H.C.), aff'd (1981), 125 D.L.R. (3d) 607, 33 O.R. (2d) 694, 62 C.C.C. (2d) 118 (Ont. C.A.).

¹⁰ (1981), 124 D.L.R. (3d) 274, 33 O.R. (2d) 228, 60 C.C.C. (2d) 481 (Ont. H.C.).

¹¹ The other three cases are: *R. v. Ray*, Police Court, South Burnaby, B.C., December 11, 1957; unreported, Government No. 50-1; *R. v. Howard*, Police Court, South Burnaby, B.C. March 19, 1958; unreported, Government No. 51-1; *R. v. Fairmont Plating (Alta.) Ltd.*, Alta. S.C.T.D., January 17, 1977; unreported, Government No. 255-1.

¹² *Supra*, footnote 8.

and most chain stores bought their requirements from Producers or Borden. The low prices were withdrawn after forty-eight hours as the result of a meeting attended by the nine area dairies and the union representing the delivery men. Members of the union had threaten to refuse to work because they were adversely affected by the decline in home deliveries caused by the price war.

At a hearing before the Restrictive Trade Practices Commission, the Director of Investigation and Research alleged that Producers and Borden engaged in predatory pricing contrary to section 33A(1)(c) of the Combines Investigation Act,¹³ as amended, that these dairies and the union conspired to lessen competition contrary to section 32 of the Act, and that seven other dairies were parties to that conspiracy. The Report of the Commission concluded that only the allegation of predatory pricing against Producers was well founded.¹⁴ In respect of the allegation of predatory pricing against Borden, the Commission found that in "marked contrast" to the aggressiveness of Producers, Borden's "participation in the price war was purely defensive and self-protecting".¹⁵

The charge of predatory pricing against Producers Dairy was dismissed at trial. An appeal by the Crown was dismissed by the Court of Appeal. The two main issues in the case were whether Producers engaged in a policy within the meaning of the section 33A(1)(c) and whether the effect or intent of that policy, assuming that it was proven to exist, was to substantially lessen competition or to eliminate a competitor.

On the first issue, there was uncontroverted evidence at trial that Producers intended to continue the low price into the following week and to expand the offer to include all its customers, wholesale and retail. On that evidence the Commission had concluded that there was a policy within the meaning of the section:¹⁶

A "policy" within the meaning of section 33A of the Act entails the adoption of a premeditated course of action which is then implemented and has some continuity.

¹³ *Supra*, footnote 4.

¹⁴ Report of an Alleged Combine in the Matter of the Sale and Distribution of Milk in the Ottawa Area, Restrictive Trade Practices Commission No. 30 (Ottawa, 1964), p. 18.

¹⁵ *Ibid.*, p. 19. In the opinion of the Commission, the agreement to end the price war which resulted from a meeting of the dairies and the union was not contrary to section 32, the conspiracy provision of the Act:

The purpose of the agreement to end the price war was not to set a fixed or definite price for milk but to return to the normal competitive price system. The Commission cannot accept that an agreement to return to these conditions in effect prior to the war could constitute an undue lessening of competition in the industry.

The participation of the union in the making of the agreement was "not considered by the Commission as being related to prices or to any lessening of competition" (p. 19) but to the purpose of ensuring job security.

¹⁶ *Ibid.*, p. 18.

The fact that Producers intended broadening its price war and did not countermand its first immediate response is indicative of such a policy.

It is clear that the withdrawal of the low price after forty-eight hours was seen by the Magistrate as sufficient evidence that there was not a policy within the meaning of the section. He concluded:¹⁷

Any arrangement made by Producers with their wholesale customers . . . related to the following week and should be considered as preparation. These arrangements were subject to cancellation. They were cancelled and in my opinion, had nothing to do with whether or not the company had engaged in a policy as set out in the section.

The Court of Appeal agreed with the Magistrate's view of what is meant by "policy":¹⁸

[policy] as used in the section contemplates something more than, as here, the adoption of a temporary expedient to meet an aggressive, competitive move aimed directly at an important customer of the respondent.

In respect of the issue of effect or intent, the Commission found that Producers retaliatory actions were out of proportion to Clark's initiative and concluded that "[the] only reasonable explanation would be that Producers intended disciplining Clark and the Ottawa market generally".¹⁹

On the other hand Magistrate Strike held that the accused's action was not taken to lessen competition but "solely for the purpose of meeting competition"²⁰ and that the "dislocation of business" for a two-day period had little effect on competition. The Court of Appeal also agreed that Producers "did what was complained of . . . to meet aggressive competition aimed at weaning away one of its important customers, competition which introduced a new price element in the wholesale field in Ottawa".²¹

(2) *R. v. Hoffmann-LaRoche Ltd.*²²

Hoffmann-LaRoche is significant in at least three respects. First, it was the first conviction for predatory pricing under section 34(1)(c) of the Act (or its predecessor sections). Second, it provided for the first time a comprehensive analysis of the required elements of the offence. Third, it addressed the issue of the constitutionality of the Act and the prosecutorial authority of the Attorney-General of Canada.²³ Only the first two issues are discussed here.

¹⁷ *R. v. The Producers Dairy Ltd.*, *supra*, footnote 8, at p. 269.

¹⁸ *Ibid.*, at p. 271.

¹⁹ *Op. cit.*, footnote 5, at p. 18.

²⁰ *Ibid.*, at p. 268.

²¹ *Ibid.*, at p. 270.

²² *Supra*, footnote 9.

²³ See *Attorney General for Canada v. Canadian National Transportation Limited*, [1983] 2 S.C.R. 206, (1983), 3 D.L.R. (4th) 16, [1984] 1 W.W.R. 193, and a commentary thereon by Neil Finkelstein (1984), 62 Can. Bar Rev. 182.

The accused, Hoffmann-LaRoche, is a large drug company. It had a patent monopoly in the production and distribution of two tranquilizers, chlordiazepoxide and diazepam, which it had developed and which were marketed under the names "Librium" and "Valium" respectively. In 1969 as the result of changes in patent legislation, other companies entered the market.

The charge focused on the tactics employed by Hoffmann-LaRoche to counteract the entry of Frank Horner, another drug company, into the hospital segment of the tranquilizer market.²⁴ The strategy of the accused in the hospital market took the following form:

- (1) Various deals for Librium and Valium at large discounts;
- (2) Supply of Librium under three \$1 tenders to governments;
- (3) Free Valium to hospitals and governments over two six-month periods.

The accused was convicted only with respect to the free Valium programme. The conviction was affirmed by the Court of Appeal.

At the outset of his analysis of the elements of the offence, the trial judge, Linden J., observed that the philosophy underlying the entire Act is:²⁵

... to foster fair competition in the marketplace to the benefit of Canadian consumers and to prevent agreements or activities that interfere with that fair competition, even though these agreements or activities may make sound business sense to those involved in them.

On the facts of the case three principal specific issues fell to be decided:

- (1) did the accused engage in a "policy" of "selling" articles;²⁶
- (2) were the prices charged by the accused "unreasonably low";
- (3) did the accused's policy have the effect or tendency of substantially lessening competition or eliminating a competitor, or was it designed to have such an effect.

On the first issue, Linden J. held that the accused was engaged in a policy of selling articles. He decided that a policy within the meaning of the section involves a conscious decision and conduct by the accused of a continuing and repetitive nature. It encompasses "a planned and deliberate course of conduct by responsible employees of the company".²⁷ The

²⁴ For a good discussion of the tactics employed by Hoffman-LaRoche, see Paul K. Gorecki, *Monopoly, Entry and Predatory Pricing: The Hoffmann-LaRoche Case* (1983), in K. Tucker (ed.), *Firms and Markets: Essays in Honour of B.S. Yamey* (London, Croom Helm, forthcoming).

²⁵ *Supra*, footnote 9, at pp. 34 (D.L.R.), 193 (O.R.), 30 (C.C.C.) (H.C.).

²⁶ It was not disputed that the accused was engaged in a business.

²⁷ *Supra*, footnote 9, at pp. 35 (D.L.R.), 194 (O.R.), 31 (C.C.C.) (H.C.).

court found that the Librium and Valium deals were eventually approved or authorized by management, even if they were not at the outset.

Defensive price-cutting in response to the aggressive tactics of a competitor may fall outside the scope of the section, but conduct over months and years, as was the case with Hoffmann-LaRoche, was not immune from prosecution "merely because a competitor attacked first or merely because the new lower price schedule is not a permanent one".²⁸ That the accused may have acted in self-defence was held to be irrelevant to the issue of whether there was a policy, but to be a factor going to the issue of whether prices were unreasonably low and the issue of whether the intent of the accused was to substantially lessen competition or to eliminate a competitor.

The distribution of products by the accused at a zero price, with or without a sale of some quantities at a non-zero price, was characterized as selling within the meaning of the section because it could not be denied that the giveaways were instituted in the expectation of reaping profits in the long term.

On the second issue, the reasonableness of the price, the accused raised a preliminary matter as to what was the relevant market. The accused submitted that it would be artificial to just look at the hospital segment, since Horner and other rivals competed in all segments of the market. On this view, the prices charged by the accused were generally higher than its competitors. There was no doubt in Linden J.'s opinion that the hospital segment was the relevant market since all competitors treated this segment differently in terms of sales tactics, pricing, service and accounting treatment. Moreover, it was established that the accused considered success in the hospital segment to be crucial for success in the entire market.

On the main question, Linden J. held that the reasonableness or unreasonableness of a price is to be determined objectively. A price may be unreasonably low even though the seller honestly believed otherwise. The state of mind of the accused is relevant to the issue of predatory intent.

A price-cost test was rejected by Linden J. because, in his opinion, the very use of the word "unreasonably" suggests a more flexible test than some simple price-cost formula. Price below cost is not held to be unreasonable unless consideration has been given to all the circumstances. Such consideration entails taking into account all economic costs including "the direct production costs as well as any potential future savings or benefits".²⁹ Accordingly, a price below direct production costs may not

²⁸ *Ibid.*, at pp. 36 (D.L.R.), 195 (O.R.), 32 (C.C.C.).

²⁹ *Ibid.*, at pp. 40 (D.L.R.), 199 (O.R.), 36 (C.C.C.).

be unreasonable "if sales in a related market will be facilitated, or if future market benefits will be gleaned . . .".³⁰

Four factors were identified as being relevant to the determination of whether a price is unreasonably low. First, the difference between production cost or accounting cost and the sale price is important. The greater the difference, the more likely the price is suspect. A price below cost may or may not be unreasonable.³¹

Even if something is sold for a zero price, this is not necessarily an unreasonably low price. Whether a price is unreasonably low must depend on all the circumstances of the sale. In one context a particular price may be unreasonably low, whereas in a different context the same price may not be.

Linden J. did concede that a price above cost cannot be unreasonable.³²

Second, the length of time during which an article was sold at questionable prices is significant. A price which was reasonable may become unreasonable with the passage of time. Third, all the circumstances of the sale must be taken into account. Defensive price-cutting, even made pre-emptively, is perceived differently from offensive price-cutting. The fourth factor is whether external or long-term economic benefits will accrue to the seller by selling at below cost. Examples of such instances given by Linden J. were situations where a business is experiencing economic hardship, or where a seller wishes to gain representation in a particular market or market segment for prestige or economic reasons.

Applying these considerations, Linden J. held that the various deals for Librium and Valium, some below and some above cost, were for a finite period, were defensive in nature and were made in pursuit of demonstrable long-term benefits. Accordingly, they were held not to be unreasonable. The one dollar government tenders for Librium were not sales at unreasonably low prices:³³

Although the reduction in price was significant, effectively to free goods, there were only three such sales over a relatively short period of time, during a very competitive period. The long-term benefits of such a manoeuvre were viewed by Roche as worth the cost I accept Mr. Nowotny's evidence that the tenders were made only to test reactions and, consequently, although they were sales below cost, they were not sales at unreasonably low prices in all of the circumstances.

The accused was also acquitted in respect of these tenders because the indictment did not include sales to governments.

³⁰ *Ibid.*

³¹ *Ibid.*, at pp. 38 (D.L.R.), 197 (O.R.), 34 (C.C.C.).

³² *Ibid.*, at pp. 41 (D.L.R.), 200 (O.R.), 38 (C.C.C.).

³³ *Ibid.*, at pp. 44 (D.L.R.), 203 (O.R.), 40 (C.C.C.).

However, the court concluded that the free Valium programme was objectionable. The sale at a zero price for two six-month periods, albeit in response to the aggressive tactics employed by Horner, was held not to be justified:³⁴

Roche was entitled to counter-attack and to reduce its prices to meet the competition, or even to better it, but to reduce the prices to zero was overdoing it. If they had matched or even bettered Horner's prices by 10% or 20%, this would probably have been legitimate competition. To go all the way to completely free goods for a six-month period, however, I find was an over-reaction to an admittedly serious threat A million dollars in lost sales for the six-month period, forecast by Roche, was too large a price to pay for this benefit in any legitimate economic sense. If sales at the zero price in these circumstances were not for unreasonably low prices, then it would be hard to imagine any situation where they would be.

Similarly, the second six-month giveaway was held to be a sale at unreasonably low prices.

The third matter to be decided was whether the offending policy had the effect or tendency to substantially lessen competition or to eliminate a competitor, *or* was designed to have such effect.

That Horner virtually withdrew, albeit temporarily, from the hospital market in face of the giveaways was held not to be sufficient to establish the requisite effect:³⁵

There was virtually no competition in diazepam before Horner's launch, because Roche had the patent which gave them a monopoly on sales of diazepam. By temporarily subduing Horner's efforts in the hospital arena, its competition and that of the other potential competitors was lessened to a degree, but it may not have been *substantially* lessened. After all, Horner's share of the hospital market was only tiny (\$66,391 in 1970-71—4.74% of its total Vivol sales). This would hardly affect Roche's domination of that market. Moreover, the proportion of Horner's hospital sales did not vary much during or after the Valium give-away period (3.04% in 1971-72; 3.16% in 1972-73; 5.35% in 1973-74; 4.69% in 1974-75; 4.66% in 1975-76).

Neither was Horner eliminated from the market since it continued to make some Vivol sales to hospitals.

There was no doubt, in Linden J.'s view, that predatory intent existed. First, the use of aggressive language in certain memoranda evidenced this intent. Referring to the use of the word "abort" in a memorandum commenting on the effect of a tactic to counter Horner's efforts, the trial judge said:³⁶

This language is not the language of healthy competition; rather it is the language that evinces the express desire to eliminate competitors and to lessen competition.

The inference of predatory intent was also based on the fact that the accused was prepared to lose two million six hundred thousand dollars worth of sales of Valium to prevent a forecast loss of six hundred thou-

³⁴ *Ibid.*, at pp. 45 (D.L.R.), 204 (O.R.), 41 (C.C.C.).

³⁵ *Ibid.*, at pp. 47 (D.L.R.), 205-206 (O.R.), 43 (C.C.C.).

³⁶ *Ibid.*, at pp. 48 (D.L.R.), 207 (O.R.), 44 (C.C.C.).

sand dollars in sales to Horner. The price reductions of the accused were described to be "so out of line with those of the attacker . . . , their purpose must be suspect".³⁷

The Court of Appeal judgment did not differ in any significant respects from the trial judgment as to the interpretation of the section. Hoffmann-LaRoche appealed, *inter alia* on the ground that the conviction was not supported by the evidence. On this ground three main issues were raised. First, it was submitted that the hospital market was not the relevant market. On this submission, Martin J.A. held, citing *R. v. J.W. Mills & Son Ltd. et al.*,³⁸ that what is the relevant market is a question of fact.³⁹

What constitutes a relevant market is essentially a question of fact depending on the circumstances underlying the particular offence alleged.

In finding that the trial judge was entitled on the evidence to find that the hospital market was a relevant market, Martin J.A. pointed out that the hospital sales of the accused were not insignificant in relation to the total sales and that the accused treated the hospital market as a separate market. In disposing of this submission, Martin J.A. also held that the fact that substitute products could have been purchased was irrelevant when the gist of the offence was that the accused provided free Valium to hospitals for the purpose of eliminating a competitor.

Second, it was submitted that there was insufficient evidence to support the finding that the accused had the intent to substantially lessen competition or to eliminate a competitor. This submission was rejected. Martin J.A. stated that the trial judge found the necessary intention not only on the basis of documentary evidence, as suggested by the accused, but also on the basis of the actions of the accused. Moreover, he rejected the suggestion that actions taken in response to competitive action or threat thereof or to protect markets would preclude a finding that these actions evidence the necessary intent.

Third, it was submitted that giving free Valium to the hospitals did not constitute selling within the meaning of the section. Martin J.A. confirmed the finding of the trial judge that the programme of free Valium was part of the selling policy of the accused and taken in the expectation of long-term benefits.

(3) *R. v. Consumers Glass Company Ltd. and Portion Packaging*⁴⁰

Portion, a wholly owned subsidiary of Consumers Glass, manufactured a wide range of plastic products. These products included lids for

³⁷ *Ibid.*, at pp. 52 (D.L.R.), 211 (O.R.), 48 (C.C.C.).

³⁸ [1968] 2 Ex. C.R. 275, at p. 305, 56 C.P.R. 1 at p. 34, *aff'd* [1971] S.C.R. 63, (1970), 24 D.L.R. (3d) 464, 1 C.C.C. (2d) 420.

³⁹ *Supra*, footnote 9, at pp. 619 (D.L.R.), 706 (O.R.), 130 (C.C.C.) (Ont. C.A.).

⁴⁰ *Supra*, footnote 10.

drinking cups. In 1975 it was the sole Canadian supplier of small lids, known as "K" series lids, to those manufacturers of cups who did not make their own lids for these cups. Portion had five such customers. On September 1, 1975 Amhil entered the market for small lids with the productive capacity of supplying the entire Canadian market. The company was formed by the former general manager and the former sales manager of Portion.

For some years prior to the entry of Amhil, Portion experienced declining sales volume. In order to make use of idle plant capacity and thereby offset some of the overhead costs, about seventeen per cent of its production (in 1973) was sold in the United States at below their total costs of production but above their total variable costs.⁴¹ Nevertheless, only seventy per cent of its productive capacity was utilized. Portion's forecast of the market for lids was gloomy. It was concerned that some of its customers would "go captive", that is, decide to produce their own lids, since the necessary equipment costs only about two hundred thousand dollars.⁴² An internal report, dated January 1, 1974, predicted that one its three largest customers would "go captive" in 1976.⁴³ Another report, dated June 17, 1975, estimated that a new entrant, encouraged by Portion's customers, would take a major share of the market.⁴⁴ Faced with the prospect of continued declining sales volume, Portion decided as early as November 1974 to leave the lid market.⁴⁵ It planned to produce drinking cups which would use up some of the lid-making capacity and develop new products which would use the remaining plant capacity formerly used to produce lids.

To facilitate its entry into the market, Amhil offered a two to three per cent discount off the price then charged by Portion. For L-700 lids Portion charged three dollars per 1000. The cost of production, excluding overhead and profit, was \$1.46 per 1000. In October 1975 Portion responded by offering discounts, depending on quantity purchased, of up to sixteen per cent. Amhil, in November, 1975, increased its discount to sixteen per cent, regardless of quantity purchased. Portion matched this offer. The discount of sixteen per cent was continued through 1976. In December 1976 Portion offered an additional five per cent to any of its customers who purchased its entire requirements from Portion. The discount, totaling up to twenty-one per cent, was maintained by Portion through 1977 and 1978. In February 1978 Amhil decided to raise its prices by ten per cent but Portion did not.⁴⁶

⁴¹ *Ibid.*, at pp. 278-280 (D.L.R.), 232-234 (O.R.), 485-487 (C.C.C.).

⁴² *Ibid.*, at pp. 277 (D.L.R.), 232 (O.R.), 484 (C.C.C.).

⁴³ *Ibid.*, at pp. 278-279 (D.L.R.), 232-233 (O.R.), 485-486 (C.C.C.).

⁴⁴ *Ibid.*, at pp. 282 (D.L.R.), 236 (O.R.), 488-489 (C.C.C.).

⁴⁵ *Ibid.*, at pp. 280 (D.L.R.), 234 (O.R.), 487 (C.C.C.).

⁴⁶ For this sequence of events see, *ibid.*, at pp. 281-285, 289-292 (D.L.R.), 235-240, 244-246 (O.R.), 488-492, 496-499 (C.C.C.).

Amhil lost about fifty-two thousand-dollars in its first year of operation and fifty-five thousand dollars in its second year. Portion incurred losses as well. Moreover, Portion's market share declined from one hundred per cent in September 1975 to below sixty per cent in December 1976. By February 1978 Portion retained only thirty per cent of the market. Some time in 1979 Portion dropped out of the market for small lids and, as well, large lids. Thereafter, Amhil became the sole Canadian supplier.

Portion and its parent company, Consumers Glass, were charged with engaging in predatory pricing in the small lids market between October 1975 and March 1978. They were acquitted.

The main issue at trial before O'Leary J. was whether the prices charged by Portion were "unreasonably low" within the meaning of section 34(1)(c). For O'Leary J. the task was to fix a legal standard to distinguish predatory practices from competitive ones, but not so rigid that the forces of competition are thwarted:⁴⁷

The whole object of competition is to maximize profits by taking as much business as possible away from rivals, and so the mere fact one competitor lowers prices so as to take business from a rival to the point that the rival might be forced from the market-place cannot, by itself, determine whether predatory pricing was involved.

The Court cited with approval the observation of Schnacke D.J. in *Transamerica Computer Co. v. International Business Machines Corp.*⁴⁸ that a test based strictly on intent may be impossible to define, or unworkable in practice, without undermining the process of vigorous competition.

At trial Professor Donald F. Turner, for the accused, advocated the adoption of the so-called Areeda-Turner test. The only explicit requirement for an inference of predation under the Areeda-Turner standard is that the accused is selling at a price which is less than average variable cost. For the Crown, Professor Douglas Greer advanced the test that there is predation if price is below average total cost and there is predatory intent.

O'Leary J. observed that the Areeda-Turner test had been widely adopted in American courts, but that it was rejected explicitly by Schnacke D.J. in *Transamerica* in favour of a qualified average total cost standard that price below average total cost would be illegal if it was unreasonable. Such price would not be unreasonable if a monopolist was liquidating excess, perishable or obsolete merchandise; minimizing losses in face of shrinking demand; or experiencing chronic excess capacity.

In O'Leary J.'s opinion the various price reductions by Portion were made in order to maximize the contribution to fixed overhead, even

⁴⁷ *Ibid.*, at pp. 293 (D.L.R.), 247 (O.R.), 500 (C.C.C.).

⁴⁸ (1979), 2 Trade Cases 79, 618, at p. 79, 637.

though losses were incurred. Commenting on the October 1975 decision to offer discounts of up to sixteen per cent, O'Leary J. said:⁴⁹

It made good business sense to lower prices and retain as much of the market as possible as long as by doing so Portion maximized the contribution its lid-making capacity would make towards fixed overhead. When there is chronic excess manufacturing capacity in regard to a particular product (here there was more than double the required capacity) competition and the desire to make as high a contribution as possible towards fixed overhead will naturally drive down the price of the product below the total cost of manufacturing that product and towards but not below the variable cost of manufacturing the product. In short, it is better for a manufacturer to produce and sell at a loss, but still at a price that allows a contribution to be made towards fixed overhead, than to cease production and suffer the loss of having to bear all the fixed overhead. The decisions taken at the October, 1975 meetings and subsequently, by Consumers and Portion, were nothing more than attempts by them to retain as much of the small lid market as possible at prices that would result in the largest possible contribution being made towards fixed overhead.

Similarly, O'Leary J. saw the December 1976 decision to offer a further five per cent discount totalling up to twenty-one per cent as "nothing more than an effort by Portion to keep as much of the small lid business as possible, to make the best possible contribution to fixed overhead".⁵⁰

It is clear that O'Leary J. was persuaded to adopt the Areeda-Turner test, albeit in a qualified form:⁵¹

I conclude however that where there is no evidence that the accused was not profit maximizing or loss minimizing, and where chronic excess capacity exists, an accused cannot be said to have sold at unreasonably low prices, regardless of its intent, if at all times it sold at prices above its average variable cost, there being no suggestion that such price was not also above its average marginal cost.

O'Leary J. found as a fact that at all times Portion sold at a price above average variable cost, and concluded that it was not selling at an unreasonably low price within the meaning of the section. He recognized, however, that the Areeda-Turner test may not be appropriate in all cases of predatory pricing.

As an alternative basis for the acquittal, O'Leary J. considered the application of the Greer test:⁵²

Even if I were to adopt the view that any price below average cost is suspect, and look at the intent with which that price was adopted, I would still conclude that the accused did not adopt such a price in order to lessen competition or eliminate Amhil as a competitor but simply to minimize its losses and so the price charged was reasonable. The mere fact the accused knew the price Portion was selling at might tend to eliminate Amhil from the market-place does not make unreasonable a price that minimized Portion's loss.

⁴⁹ *Supra*, footnote 10, at pp. 284 (D.L.R.), 238 (O.R.), 490-491 (C.C.C.).

⁵⁰ *Ibid.*, at pp. 290 (D.L.R.), 244 (O.R.), 497 (C.C.C.).

⁵¹ *Ibid.*, at pp. 300 (D.L.R.), 254-255 (O.R.), 507 (C.C.C.).

⁵² *Ibid.*, at pp. 300 (D.L.R.), 255 (O.R.), 507 (C.C.C.).

In O'Leary J.'s opinion, minutes and memoranda concerning Portion's response to Amhil's entry indicated "an intention to compete with Amhil" and "do not reflect an existing scheme to put Amhil out of business".⁵³ He also refused to infer intent on the basis of evidence that Portion reduced its price below average total cost with the knowledge that Amhil would incur losses because Portion did so to minimize losses.⁵⁴ Nor would the judge infer a predatory intent from the fact Portion passed up opportunities to increase its prices even when faced with an increase in the price of the main raw material used to make lids. He accepted the explanation that to have raised prices would have resulted in larger losses.⁵⁵

In the circumstances the decision of Amhil to enter the market is puzzling. Amhil, being formed by two former senior employees of Portion, entered with the knowledge that Portion was operating its plant at seventy per cent capacity in a declining market. It knew or ought to have known that the market could not support two firms each with the productive capacity of supplying the entire market, and a new entrant would precipitate a fall in the price with losses a likely result for at least one if not both suppliers. The only explanation seems to be that the two former employees knew that Portion planned to leave the lids market and thought that it could push Portion to leave a little sooner. The resistance by Portion can be explained in part by the fact that these two former employees were considered to be responsible for the decline in Portion's sales.⁵⁶

C. Conclusions on the Current Law

The cases decided to date appear to have settled what is meant by "engaging in a policy of selling products". They do not make it clear what is the test for determining if prices are "unreasonably low", or when the policy will, in general terms, be held to have lessened or been designed to lessen competition.

Hoffman-LaRoche decided that to engage in a policy of selling requires that there be a planned and deliberate course of conduct of actual selling for a sufficient length of time. It approved the decision in *Producers Dairy* that a price reduction lasting for some forty-eight hours did not constitute a policy, even though the accused had planned, if need be, to extend the scope and duration of the price reduction. However, defensive price cutting may, depending on the circumstances, be an aspect of a "policy"⁵⁷ and selling may include the distribution of free goods motivated by commercial considerations.

⁵³ *Ibid.*, at pp. 286 (D.L.R.), 241 (O.R.), 493 (C.C.C.).

⁵⁴ *Ibid.*, at pp. 290-291 (D.L.R.), 245 (O.R.), 497 (C.C.C.).

⁵⁵ *Ibid.*, at pp. 291 (D.L.R.), 246 (O.R.), 498 (C.C.C.).

⁵⁶ *Ibid.*, at pp. 286 (D.L.R.), 241 (O.R.), 493 (C.C.C.).

⁵⁷ Defence may be the motive for acting, but whatever the motive the action may nonetheless amount to a policy.

The cases reveal two distinct approaches to the determination of when prices are "unreasonably low".⁵⁸ In *Hoffman-LaRoche* Linden J. thought that Parliament intended a flexible test,⁵⁹ and, as we have seen, he suggested four factors that had to be taken into account.⁶⁰ Two comments may be made on these factors.

First, Linden J.'s first consideration was "the actual difference between the production cost or accounting cost and the sale price".⁶¹ There is some ambiguity as to what Linden J. meant by "cost", "production cost" and "accounting cost", as the terms as commonly used are not definitionally equivalent. Nor is it always clear whether "cost" means average total cost or average variable cost. The proposition, "[i]f an article is sold for more than cost, it can never be held to be unreasonable",⁶² suggests average total cost. On the other hand, cost evidence referred to in the judgment appears to be in the form of variable or avoidable costs.

Linden J. does not adopt any cost test except the proposition quoted above that price above cost cannot be unreasonable. He would even be prepared to accept that a zero price is not necessarily unreasonable.⁶³ He does say, however, that the greater the difference between cost and price, the more likely that the price is unreasonable.

Second, the other three factors referred to by Linden J. are really part of the general rubric of the circumstances of the sale. If one looks at the examples given in the judgment in relation to each of these factors, it would seem that they are designed to accommodate three possible defences to charges of unreasonableness; promotions, defensive price cutting, and loss leading.

The other approach to the construction of unreasonableness is found in *Consumers Glass*. The standard adopted by O'Leary J. is that where there is chronic excess capacity and no evidence that a higher price might have reduced losses, price below average total cost but above average variable cost is not unreasonable. It is, in substance, the Areeda-Turner test, although O'Leary J. recognized that this approach may not be applicable in every case.

⁵⁸ The market in respect to which the determination falls to be made is a matter of fact; *supra*, text at footnote 29.

⁵⁹ The proposal in Bill C-13 (House of Commons of Canada, Third Session, Thirtieth Parliament, 1977) to substitute "abnormally low" for "unreasonably low" suggests an easier test for a conviction: see Bruce Dunlop, *Price Discrimination, Predatory Pricing and Systematic Delivered Pricing* (1979), in J. Robert S. Prichard, W.T. Stanbury, Thomas A. Wilson (eds.), *Canadian Competition Policy: Essays in Law and Economics* (1979), pp. 405-420, at p. 412.

⁶⁰ *Supra*, the text commencing after footnote 30.

⁶¹ *Supra*, footnote 9, at pp. 41 (D.L.R.), 200 (O.R.), 38 (C.C.C.) (H.C.).

⁶² *Ibid.*

⁶³ *Ibid.*, at pp. 41 (D.L.R.), 200 (O.R.), 38 (C.C.C.).

In sum, the jurisprudence on unreasonableness is not well-settled notwithstanding the existence of two judgments that address this issue. The approach of *Hoffmann-LaRoche* characterized by its flexibility, is too difficult to apply. In any given fact situation, it would be virtually impossible to predict the outcome. On the other hand, the precision with which O'Leary J. expressed the reasoning for the acquittal of the accused in *Consumers Glass* may well diminish the influence of this case. It could be argued that the use of the Areeda-Turner standard is confined to situations of chronic excess capacity.

Assuming a policy of selling at unreasonably low prices, it must then be shown that the policy had the effect or tendency of substantially lessening competition or eliminating a competitor, or that it was designed to have such an effect.

There has been judicial determination of "substantially lessening competition". In *Hoffmann-LaRoche* Linden J. concluded that the temporary withdrawal of Horner as the result of the free Valium programme of Hoffmann-LaRoche was not a substantial lessening of competition because there was virtually no competition in the hospital market for diazepam before Horner's entry and because Horner had an insignificant market share of between three to five per cent of hospital sales at all times between 1970 and 1976. This suggests that for competition to be substantially lessened, the rival(s) deterred by the alleged predator must already be in the market and have a significant share thereof. Thus, it appears that the deterrence of entry by a potential competitor or the growth of an existing but small competitor would not constitute a substantial lessening of competition.

No case has considered when a policy would have the "effect or tendency" of substantially lessening competition or eliminating a competitor.⁶⁴ The decided cases have focussed on whether what the accused did was designed to have such an effect. The inference of the requisite intent is made on the basis of documentary evidence and the conduct of the accused.

What type of documentary evidence would evidence the requisite intent appears to depend on the circumstances. Thus, in *Hoffmann-LaRoche* Linden J. considered as inoffensive talk, reflective of a competitive spirit, the challenge made to make "E-M eat their blue capsules" or the discussion of "filling the pipelines" and "loading the channels".⁶⁵

⁶⁴ Although section 34(1) states that a policy that has the effect or tendency to eliminate a competitor would be sufficient for a conviction (assuming the other elements are proven), it is difficult to discern the purpose behind the prohibition of eliminating a competitor. It has often been said that the purpose underlying combines legislation is to protect competition and not competitors. Under this rationale, instances of elimination, alleged to have deleterious effects on competition, could be examined to see whether there was a substantial lessening of competition.

⁶⁵ *Supra*, footnote 9, at pp. 49 (D.L.R.), 208 (O.R.), 45 (C.C.C.) (H.C.).

. . . much of the language relied upon by the Crown as evidence of the guilty design is only the colourful jargon of the market-place or of the sports world. . . . much of it is indicative only of a macho spirit, of an enthusiastic participation in a contest.

But the prohibited state of mind was considered to be reflected by the following expressions: "notice to all present and future parasites that we mean business"; "tender business should be secured *at all cost*"; "massive retaliation"; "scare tactic" to "plug" the Valium market; "abort Horner's efforts".⁶⁶

The conduct of the accused may also be indicative of the presence or absence of predatory intent. Defensive price-cutting, if completely out of line with the actions of a rival, may be suspect.⁶⁷ In *Consumers Glass* O'Leary J. found predatory intent was absent when the accused was loss minimizing. The problem with inferring intent from such evidence is that if the same evidence is used to infer unreasonableness, as is often the case, to what extent are the two elements independent requirements.

By way of summary, we shall consider, in light of the Canadian jurisprudence, the limits placed on the price response of an incumbent to the entry or growth of a competitor.

One approach, exemplified by *Hoffman-LaRoche*, would permit the incumbent to respond in kind, so-called meeting the competition. In the appropriate circumstances the incumbent may price below cost or even sell at a zero price. An overreaction such as extending the scope or duration of price-cutting may be suspect. An aggressive response may not be offensive if it was one time or lasted a short period of time. The approach of *Consumers Glass* would limit any price response to above variable cost. Whether pricing above average variable cost would be a complete defence remains an open question.

The elimination of a competitor would be sufficient for a conviction if the price-cutting was otherwise offensive. To substantially lessen competition would require that the market share of an existing competitor with a significant share of the market is drastically reduced.

What would constitute predatory intent is unpredictable. The use of aggressive language may be sufficient but not necessary. Similarly, the conduct of the incumbent may evidence the requisite intent even though the same evidence may be used to infer the unreasonableness of the response.

⁶⁶ *Ibid.*, at pp. 48-50 (D.L.R.), 208-209 (O.R.), 53 (C.C.C.). It is difficult to appreciate the distinction between inoffensive, colourful jargon of the marketplace and expressions which evidence a predatory intent.

⁶⁷ *Ibid.*, at pp. 52 (D.L.R.), 211 (O.R.), 48 (C.C.C.).

II. *Economic Approaches to Predation*

A. *Defining Predation*

In the broadest terms predation may be defined as the subjugation or elimination of competitors or potential competitors for the purpose of dominating or monopolizing a market. The decision to engage in predatory behaviour is generally viewed as an investment decision. The predator makes a rational decision to incur costs, often in the form of a reduction in current profits, in the expectation of receiving compensatory benefits in the form of future monopoly profits.

Classical predation, as it has come to be known, involves pricing below cost in order to drive out *existing* rivals. The definition of predation given by Linden J. in *Hoffmann-LaRoche* reflects the concern of the Canadian jurisprudence with classical predation:⁶⁸

One company, the predator, decides to sell its product at a very low price in order to put his competitor out of business, because they cannot or will not sell at such a low price. If the competitor goes out of business, the predator may then increase his prices, make back any loss as a result of the predatory campaign and continue to reap the benefits of greater profits, because his former competitor has now departed from the scene.

Spence has argued that classical predation should be distinguished from strategic predation.⁶⁹ The essential feature of classical predation, according to Spence, is that it is directed against an existing firm, that is, the predator reacts to entry or expansion once it has occurred. On the other hand, strategic predation involves positioning or pre-emptive behaviour on the part of incumbents to *deter* potential entry or expansion.

An incumbent following a positioning strategy makes an irreversible commitment the effect of which is to leave a relatively small portion of the cost of production avoidable. The incumbent's response to entry is then predetermined. It will be innocent in the sense that it does not involve an avoidable sacrifice of profits. It will be entry-detering in the sense that the incumbent will have positioned itself so that this innocent or, more objectively, passive but non-co-operative behaviour will guarantee losses to the entrant. If entry were to occur, the incumbent's income would also fail to cover historic costs. Given the irreversible nature of the commitment to the market, these losses cannot now be avoided. Given the opportunity to avoid similar losses by staying out, the rational potential entrant stays out.

⁶⁸ *Ibid.*, at pp. 33 (D.L.R.), 192 (O.R.), 29 (C.C.C.).

⁶⁹ Michael A. Spence, *Competition, Entry and Antitrust Policy*, Federal Trade Commission, Bureau of Economics, Mimeo (1981).

In our view strategic entry deterrence must involve a credible threat to impose losses on an entrant.⁷⁰ A threat is only credible if it is still in the incumbent's interest to carry it out once entry has occurred. The central conclusion of the contemporary theory of entry deterrence is that a necessary condition for this to be the case is the existence of sunk costs.⁷¹ If participation in a market does not involve significant sunk costs (irreversible investments) the market is defined in contemporary terms as being "contestable". In this case, threats not to yield market share and other predatory threats will not be credible and will not deter entry. The reason is that, if there are no sunk costs, both the incumbent and the potential entrant have the same avoidable costs and they compete for the market on essentially the same terms.

The existence of sunk costs commits the incumbent to the market. It now has lower avoidable costs than potential entrants. Threats to impose losses on potential entrants become credible, and strategic entry deterrence becomes a possibility. In the current terminology, markets which require participants to incur significant costs which are then sunk are referred to as less than contestable or non-contestable markets.

Strategic entry deterrence can take many forms. It may involve building more or larger plants, holding larger inventories, engaging in more advertising or research and development, or producing more brands on a larger output at all points in time than would be optimal in the absence of a threat of entry. In general, incumbents will adjust along a number of margins, undertaking more investments which have a significant irreversible component and increasing the "sunk" element in all investments. Strategic entry deterrence can involve virtually limitless combinations of instruments, and it occurs at the time the requisite investments are made. It is deployed against all comers, both existing firms wishing to expand and potential entrants, for as long as the sunk assets involved have value.

The control of strategic entry deterrence involves some serious problems. First, successful entry deterrence does not necessarily reduce welfare.⁷²

⁷⁰ Several analyses of strategic entry deterrence do not demonstrate that the predatory threats their legal rules are designed to prevent are credible; see in particular F.M. Scherer, *Predatory Pricing and the Sherman Act: A Comment* (1976), 89 Harv. Law Rev. 869; O.E. Williamson, *Predatory Pricing: A Strategic and Welfare Analysis* (1977), 87 Yale Law. J. 284. There is obviously no need for rules to prevent threats that would not be entry deterring.

⁷¹ In addition to sunkness, indivisibilities and the nature of the post-entry "game" will determine the extent to which an incumbent can position itself to deter entry. For an excellent and relatively simple exposition of this idea, see A.K. Dixit, *The Role of Investment in Entry Deterrence* (1980), 90 Economic Journal 95.

⁷² See J.E. Stiglitz, *Potential Competition May Reduce Welfare* (1981), 71 American Economic Rev. 184.

If allocative efficiency is our goal, we may not wish to prohibit all or perhaps any entry deterring behaviour. Second, if entry deterrence is to be controlled, it would be necessary either to evaluate the full range of investment activities of large firms and establish which of these activities would have been optimal absent the threat of entry, or to define predation so as to make the exploitation of strategic positioning illegal. Obviously the first option would be extremely costly, not to say, impossible given the present state of professional knowledge. The second requires that the courts distinguish between innocent behaviour and behaviour which is apparently identical but which was pre-ordained by earlier strategic commitments.

To illustrate, what the courts would be confronted with is a post-entry scenario of a passive but non-co-operative incumbent pricing at or above avoidable (average variable) cost but below historical average total cost. The incumbent will assert that the latter is no longer relevant. Given the capacity added to the market by the entrant, no one is able to recover his total cost. There is no aggressive behaviour. No other response by the incumbent would make a greater contribution to overhead. The incumbent's pre-entry capacity can be deemed excessive only in the sense that it did not accommodate entry on the scale chosen by the entrant(s).

A rule which makes it an offence for an incumbent to price below average total cost would eliminate strategic entry deterrence. But, as we will argue below in Part II, B when we examine average cost rules, it would do so only at the cost of convicting many firms engaged in unobjectionable behaviour. Specifically, an average cost standard would effectively impose upon incumbents the duty of planning output and capacity so as to maintain the income of entrants, even mistaken ones, at or above their total costs.

The central role of irreversible investment in strategic entry deterrence also has implications for classical predation. To the extent that costs are sunk, predation against existing firms, firms that have already entered or expanded and thus have the same commitment to the market as the predator, will be futile. The same will be true of a strategy of "predatory entry" as described by West in connection with the *Safeway* case.⁷³ The victim can be eliminated from the market only by maintaining prices below avoidable cost which may be a small fraction of total (historical) cost. Prices above avoidable cost will bring re-entry. If there are no sunk assets existing firms can be driven out but new entrants cannot be excluded.

In sum, strategic entry deterrence is not necessarily welfare reducing and would, in any case, be costly to control. The same feature of market

⁷³ *R. v. Canada Safeway Ltd.* (1973), 12 C.P.R. (2d) 3 (Alta. T.D.). See Douglas S. West, *Market Predation in a Spatially Extended Market: Theory and Evidence*, Purdue University, Department of Economics, Mimeo (1981).

structure, irreversible market-specific investment, that makes strategic entry deterrence possible also makes classical predation less likely.

Informed reaction to the possibility of strategic predation has taken one of two forms. The first is to argue that it increases the probability of incorrectly convicting innocent competitive (non-predatory) behaviour at any level of enforcement and thus augments the case for *per se* legality or a minimalist standard. The second is to argue that, provided they are sufficiently broad and are applied with sufficient sophistication, workable rules can be formulated which will reduce entry deterring behaviour without impairing the competitive process. These two approaches are discussed in Part II, B, below.

While predation has generally been viewed and analyzed as an investment, some writers have suggested that it may also be a form of consumption.⁷⁴ In this case an individual destroys the business of another out of malice rather than to achieve market power. Although it is open to a number of interpretations, the evidence in a number of Canadian cases reveals considerable animosity between the predator and the victim, sometimes because the latter had left the employ of the former and had entered business as a competitor.⁷⁵ The evidence is often not inconsistent with a consumption motive for predation. While some observed cases of predation may be explained in terms of the consumption motive, it does not follow that the prohibition of predation as consumption would be allocatively efficient. The reason is that, unlike the case of common assault or arson, the loss imposed on the victim is offset by the benefits derived by consumers from lower prices and by the utility derived by the predator from his actions.⁷⁶

B. Control of Predation⁷⁷

The appropriate treatment of predation can be discussed in a benefit: cost context.⁷⁸ The benefit of a policy which makes predation an offence

⁷⁴ See, for example, H.A. Demsetz, Barriers to Entry, Law and Economics Workshop Series, Faculty of Law, University of Toronto (1981).

⁷⁵ See, for example, *R. v. J.W. Mills & Sons Ltd.*, *supra*, footnote 38.

⁷⁶ Demsetz, *op. cit.*, footnote 74, pp. 21-22. The same type of reasoning applies to predation by mistake. In this case below-cost prices are a consequence of the negligence of one or more competitors. Again a loss incurred by the "predator" and its rivals will be offset by the gain experienced by consumers.

⁷⁷ See, for a more complete survey, Joseph Brodley, George A. Hay, Predatory Pricing: Competing Economic Theories and the Evolution of Legal Standards (1981), 66 Cornell Law. Rev. 738; Frank H. Easterbrook, Predatory Strategies and Counterstrategies (1981), 48 Univ. Chicago Law Rev. 263; John S. McGee, Predatory Pricing Revisited (1980), 23 J. Law and Economics 289.

⁷⁸ Richard Schmalensee, On the Use of Economic Models in Antitrust: The *Realemon* Case (1979), 127 U. Pa. Law Rev. 994, at pp. 1018-1019; Frank H. Easterbrook, Predatory

depends first, on the probability of correctly identifying predatory behaviour and thus deterring predation and, second, on the magnitude of the monopoly losses avoided by deterring predatory behaviour. The cost of a policy which stamps predation with illegality depends, first, on the probability of incorrectly identifying competitive behaviour as predatory hence deterring the former; second, on the magnitude of the losses incurred as a consequence of the resulting reduction in competition; and, third, on the cost of enforcing the anti-predation ordinance. In general, if one is of the opinion that successful monopolization does not involve large welfare losses or that the probability of correctly identifying predatory behaviour as such at reasonable cost is low then the appropriate policy would be to avoid any prohibition of it (*per se* legality) or to adopt a minimalist standard which would result in the conviction only of the most blatant offenders. If one is of the opinion that the social losses from successful monopolization are very large and that predatory behaviour can correctly be distinguished from normal competition at reasonable cost then the correct policy involves a broadly based prohibition against predation.

(1) *Per Se* Legality

One of the essential tenets of the "Chicago" approach to industrial organization is that the prohibition of predation is not worthwhile.⁷⁹ This view is the result of scepticism regarding the opportunities for and the magnitude of the social losses flowing from monopolization. Monopoly power cannot be exploited in the absence of barriers to entry. The Chicago view is that barriers to entry as described by Bain do not exist and that the principal restrictions on entry are regulatory in nature or flow from cartel-like arrangements with potential competitors. On the occasions when monopolization might be regarded as profitable, predation is thought to be an inferior method, relative to merger and cartelization, of achieving it. As Posner puts it:⁸⁰

... firms cannot in general obtain or enhance monopoly power by unilateral action — unless, of course, they are irrationally willing to trade profits for position. Consequently, the focus of the antitrust laws should not be on unilateral action; it should instead be on: (1) cartels and (2) horizontal mergers large enough either to create monopoly directly, as in the classic trust cases, or to facilitate cartelization by drastically reducing the number of significant sellers in the market.

Given its demonstrable inferiority as a business tactic, a proscription of predation, however defined, could not, in the Chicago view, be socially beneficial. It would necessarily involve a disproportionate number of erroneous convictions—incorrectly labelling as predatory, and thus

Pricing and Innovations: Comment, Federal Trade Commission, Bureau of Economics, Mimeo (1981), p. 3.

⁷⁹ See Richard A. Posner, *The Chicago School of Antitrust Analysis* (1979), 127 U. Pa. Law Rev. 925.

⁸⁰ *Ibid.*, at p. 928.

discouraging, behaviour that was in fact competitive. On the other side, there would not be a large reduction in the losses from predation-based monopoly since these were minimal in the first place.

While much of the traditional Chicago view on barriers to entry and the possibility of successful entry deterring behaviour has been rendered invalid by the emergence and development of the positioning or strategic behaviour literature, the conclusion that predation should be deemed *per se* legal may continue to stand. As the discussion of the definition of predation indicated, the possible existence of strategic entry deterrence, if anything, makes the case for the proscription of classical predation weaker, and there are severe problems associated with the control of positioning itself.

In sum, the case for *per se* legality is that classical predation is a poor investment and will seldom be observed and that while strategic predation may or may not be common, it will be costly to distinguish from legitimate competitive behaviour.

The case against *per se* legality could take either one of two forms: (1) classical predation is sufficiently common to justify a minimalist rule that would prohibit the most extreme or unambiguous manifestations of it; (2) strategic (entry deterring) predation is common and rules can be formed which correctly identify it.

(2) *Minimalist Standards*

(a) Areeda-Turner

In common with the Chicago school, Areeda and Turner believe predation to be relatively rare.⁸¹ Instead of opting for *per se* legality, however, they argue in favour of the *per se* illegality of a relatively narrow range of predation. Their approach has been used in a number of United States cases.⁸²

Under the test proposed by Areeda and Turner, the existence or absence of predation turns on the relationship between price and cost. Their conclusions may be summarized as follows:

- (1) a price above marginal cost is conclusively presumed lawful;
- (2) a price below marginal cost is conclusively presumed unlawful unless it remains above average total cost;
- (3) since marginal cost is generally difficult to infer from accounting records, average variable cost may serve as a proxy for marginal cost yielding these conditions:

⁸¹ Phillip Areeda, Donald F. Turner, *Predatory Pricing and Related Practices under Section 2 of the Sherman Act* (1975), 88 Harv. Law Rev. 697.

⁸² Phillip Areeda, Donald F. Turner, *Antitrust Law: An Analysis of Antitrust Principles and Their Application* (1978), Supplement (1982).

- (i) a price above "reasonably anticipated" average variable cost is conclusively presumed lawful;
- (ii) a price below "reasonably anticipated" average variable cost is conclusively presumed unlawful.⁸³

The reliance on "reasonably anticipated" average variable costs allows for some latitude in the interpretation of historical accounting data and also for situations in which costs are falling over time as learning occurs within the firm.⁸⁴ The *per se* illegality of prices below average variable cost has the obvious implication that there are no defences for such prices. Defences of promotional pricing (at least for an incumbent "monopolist") and meeting the competition are explicitly rejected.⁸⁵

Areeda and Turner argue that price discrimination should be regarded as predatory only if the discrimination also involves a violation of the average variable cost rule.⁸⁶ The existence of discrimination would be neither necessary nor sufficient to support an inference of predation.⁸⁷ The concept of predatory investment is similarly rejected, except in the case of increases in promotional expenditures timed to coincide with the appearance of an entrant and which, if counted as a variable cost, would raise average variable cost above price.

Areeda and Turner justify their rule, in part, as one which enforces welfare-maximizing behaviour, to wit, marginal cost pricing. The principal merit of their rule actually lies in its simplicity and its coverage. As its critics continually point out, this rule will never result in the conviction of firms engaging in strategic entry deterrence. It therefore will not involve the courts in cases in which, as the discussion of the definition of predation indicated, the probability of incorrectly labelling competitive behaviour as predatory is relatively high.

One should never observe a firm pricing below average variable cost intentionally. If pricing below average variable cost is observed it must be the case that:

- (1) the firm is engaged in predation; or
- (2) the firm has erred in its price-output decision; or
- (3) the observer has measured cost incorrectly.

While it does have the virtues both of simplicity and of minimizing the probability of erroneous convictions, the Areeda-Turner rule is not without problems in the area it does cover. The problems generally relate to the measurement of costs. First, a multiproduct firm may set the prices

⁸³ *Loc. cit.*, footnote 81, at p. 733.

⁸⁴ *Ibid.*, at p. 715.

⁸⁵ *Ibid.*, at pp. 713-716.

⁸⁶ *Ibid.*, at pp. 724-728.

⁸⁷ The implication is that section 34(1)(b) of the Act is redundant.

of some of its products below avoidable cost for reasons unrelated to predation. A razor blade producer may find it profitable to sell razors at prices below their marginal cost. A naive application of Areeda-Turner would find this unlawful. The proper approach would be to subtract the profits made on the additional razor blade sales, which were made possible by the below cost price of the (complementary) razors, from the cost of the razors for purposes of the avoidable cost calculation.⁸⁸

Second, what is defined as variable or avoidable cost depends on the time period in question. Depending on the contractual relationships between a firm and its input suppliers, costs commonly regarded as variable may not be avoidable over periods of a month or perhaps longer.⁸⁹ Labour costs, for example, may not be immediately avoidable if notice must be given or may be avoidable only in part over much longer periods if laid off workers are paid part of their salaries. Whether a price is below avoidable cost or not will then depend on how long it was in effect.

Third, and more generally, measured cost may differ markedly from opportunity cost. The latter has been defined as the value, in the mind of the decision maker, of the best alternative foregone as a consequence of the decision. In a market where a reputation for reliable service has a value it will be costly to be absent from the market even if participation in it involves providing service at a price below avoidable cost. In many cases what we may learn from the difference between price and average variable (accounting) cost is the minimum value attached by the firm to its reputation. Areeda and Turner argue that adjudication of this type of a reputation defence is beyond the competence of the courts and reject it.⁹⁰ Whether the application of their test would result in a significant number of incorrect convictions as a consequence remains to be seen.

(b) McGee

McGee⁹¹ also adopts the position that predation is relatively rare and that, if there must be a predation rule, it should be framed so as to apply only in cases where there is virtually no plausible "innocent" or "competitive" explanation for the behaviour of the accused. This reasoning led him to propose a qualified Areeda-Turner test.⁹² McGee proposed that prices above average variable or marginal cost (whichever is less) should be presumed lawful and that prices lower than this should be unlawful when accompanied by evidence of predatory intent or effect and when they do not involve promotions of either new or discontinued products.

⁸⁸ See J.A. Ordover, Robert D. Willig, *An Economic Definition of Predation: Pricing and Product Innovation* (1981), 91 *Yale Law J.* 8.

⁸⁹ See discussion of *Producers Dairy*, *infra*, Part III.

⁹⁰ *Loc. cit.*, footnote 81, at pp. 715-716.

⁹¹ *Loc. cit.*, footnote 77.

⁹² *Ibid.*, at p. 326.

McGee's definition of predation is the narrowest we have found. It could be characterized as Areeda-Turner plus intent. It also allows defences which Areeda and Turner would not allow — at least for dominant firms.

(3) *All Inclusive Rules*

(a) Posner

Posner has suggested that predatory pricing be defined as “pricing at a level calculated to exclude from the market an equally or more efficient competitor”.⁹³ He continues:⁹⁴

Only two practices fit this definition. The first is selling below short-run marginal cost. . . . The second practice that is predatory under my definition is selling below long-run marginal cost with the intent to exclude a competitor.

Posner defines long-run marginal cost as “average balance sheet costs” (presumably he means income statement costs) divided by “the number of units of output produced”. As an additional safeguard, he suggests that it should be proved that the market has characteristics predisposing it toward the effective use of predatory pricing.⁹⁵

Although Posner maintains that his short-run rule has major advantages over the minimalist rules of Areeda-Turner and McGee,⁹⁶ it does not and the discussion above of the minimalist rules applies.

Posner's long-run rule would cover strategic behaviour, provided there was also evidence of exclusionary intent. Most discussions of intent relate to classical (reacting) rather than strategic (positioning) entry deterrence. In the classical context, evidence of intent has generally involved statements about what the accused was going to do to a specific competitor.⁹⁷ Strategic entry deterrence is unlikely to involve evidence of this kind. Decisions are made, perhaps years in advance, to make expenditures which will have among their virtues the feature of pre-empting all future entrants, whoever they may be, without any further action by the incumbent. There need not and generally will not be any discussion of the consequences of an attempt by any firm, let alone a specific one, to enter the pre-empted market at some future date. Reliance on evidence of intent is generally regarded as unsatisfactory in the context of classical predation.⁹⁸

⁹³ Richard A. Posner, *Antitrust Law: An Economic Perspective* (1976), p. 188.

⁹⁴ *Ibid.*, pp. 188-189.

⁹⁵ *Ibid.*, p. 191.

⁹⁶ *Loc. cit.*, footnote 79, at pp. 925-926.

⁹⁷ See *R. v. J.W. Mills & Sons Ltd.*, *supra*, footnote 38; and Report Concerning the Production, Distribution and Sale of Zinc Oxide, Restrictive Trade Practices Commission (Ottawa, 1958), pp. 78, 110, 112.

⁹⁸ See Areeda, Turner, *loc. cit.*, footnote 81, at p. 699; Williamson, *loc. cit.*, footnote 70, at p. 287; Posner, *op. cit.*, footnote 93, p. 190. The problems faced by the courts are aptly summarized in Richard O. Zerbe jr., Donald S. Cooper, *An Empirical and*

It is even less satisfactory, in our view, in the context of strategic entry deterrence.

Absent intent, the Posner approach is an injunction against pricing below average cost. This would appear to require that existing firms make long-run capacity decisions and short-run output decisions so as to accommodate present and future entrants. Large incumbents would be required to hold a pricing umbrella over all other market participants and this would not encourage efficiency on the part of either group.⁹⁹

(b) Greer

Greer argues for a rule comprised of:¹⁰⁰

. . . (1) pricing below average total cost (as a surrogate for long-run marginal cost) plus (2) substantial evidence of predatory intent. Requiring (3) a probable lessening of competition would also be desirable.

He defends his rule on the grounds that the courts are experienced in dealing with intent¹⁰¹ and with average total (as opposed to variable) cost,¹⁰² and that predation can involve pricing below average total but not average variable cost, something which would be lawful under Areeda-Turner.

Unlike virtually all other commentators, Greer argues that evidence of intent is reliable and lists a number of types of evidence of predatory intent, including such actions as "eliminating a customary price premium" or passing up "clear opportunities" to increase price.¹⁰³ Indeed, it is difficult to see how a firm's price could fall below and remain below

Theoretical Comparison of Alternative Predation Rules (1982), 61 Texas Law Rev. 655, at p. 689:

The early reliance on intent ultimately proved to be unwarranted. Both courts and commentators became increasingly dissatisfied with the idea that an action that was ordinarily encouraged—the cutting of prices—could be transformed into an illegal activity—a predatory price cut—by the mental state. Although defining a proscribed activity by the coincidence of a mental state and an action was accepted in criminal law, it appeared misplaced when applied to predation. From the courts perspective, such an approach ran into two problems. First, price cutting was generally lauded by the established economics system, if not seen as absolutely essential to the functioning of the system. Second, as commentators began to point out, the free enterprise system demanded an attempt by all businesses to drive its competitors out of business. Simply stated, judges found it increasingly difficult to justify labelling some price cuts as illegal and others as lawful on the basis of an intent presumably shared by all good competitors.

⁹⁹This is noted by Scherer, *loc. cit.*, footnote 70, at p. 876; Easterbrook, *op cit.*, footnote 78, p. 19.

¹⁰⁰Douglas F. Greer, A Critique of Areeda and Turner's Standard for Predatory Practices (1979), 24 Antitrust Bulletin, 233, at p. 261.

¹⁰¹*Ibid.*, at p. 247.

¹⁰²*Ibid.*, at p. 259.

¹⁰³*Ibid.*, at pp. 247-249.

average total cost for any reasonable period of time without running afoul of Greer's standard.

While the concept of average total cost may be easier for the courts to deal with, it is not free of ambiguity. Are the firm's assets to be evaluated at historical or opportunity cost? What set of market conditions are to be assumed in the calculation of opportunity cost? How is the cost of capital to be measured? These problems are every bit as troublesome as those which plague the measurement of avoidable cost.

(4) *Other Tests*

(a) Jostkow-Klevorick

Jostkow and Klevorick¹⁰⁴ combine an initial structural test for predation with a price or price-cost test that draws something from Areeda-Turner and McGee, something from Posner and Greer and something from Baumol.¹⁰⁵

The initial structural analysis involves, first, the examination of the size distribution of firms and its stability. A market in which the dominant firm held a stable seventy per cent would receive further scrutiny while one in which the dominant firm held a declining forty per cent would not. Second, the traditional (and in our view incorrect) conditions of entry (scale economies, capital requirements, advertising) would be investigated. The greater are scale economies, capital requirements and advertising, the more likely it is that the case would receive further scrutiny. Third, the "dynamic effects of competition on costs and products" would be determined. The more important is technological change, and the smaller the portion of it emanating from the dominant firm, the more likely it is that the case would receive further scrutiny.

A case that has not been screened out in the structural analysis would then be subjected to various behavioural tests. Following the reasoning underlying the Areeda-Turner and McGee rules, the Jostkow-Klevorick test considers that a price cut below average variable cost can have no other purpose than sacrifice of short-run profits for long-run monopoly profits.¹⁰⁶

... the adoption of a strategy of pricing below average variable cost by a dominant firm confronted with entry is *sufficient* to demonstrate predation.

Following Posner and Greer, the Jostkow-Klevorick rule also adopts a test defined in terms of average total cost.¹⁰⁷

¹⁰⁴ Paul L. Jostkow, Alvin K. Klevorick, *A Framework for Analyzing Predatory Pricing Policy* (1979), 89 Yale Law J. 213.

¹⁰⁵ See the discussion of Baumol, *infra*, the text commencing at footnote 112.

¹⁰⁶ *Loc. cit.*, footnote 104, at p. 252.

¹⁰⁷ *Ibid.*, at p. 253. Zerbe, Cooper, *loc. cit.*, footnote 98, at p. 691 have suggested a cost-based test which is essentially the same as the first two elements of the Jostkow-

... a price response that does not cover average total cost should be presumed predatory unless the dominant firm can show that this strategy maximizes short-run profits.

There is a qualification to this test. The dominant firm could defend sub-average cost prices by showing that the industry was declining or that entry occurred on too large a scale. If the dominant firm is deemed to have been carrying excess capacity, however, the presumption of predation stands.

In common with the analysis of Baumol which is discussed below, the Joskow-Klevorick test considers the permanency of any price cuts. Price reductions to points above average total cost would be presumed predatory if they were withdrawn within two years and the withdrawal could not be justified by independent increases in cost or demand.¹⁰⁸

While consideration of the market share is a sensible addition to somewhat simplistic tests such as the Areeda-Turner test, which deems all prices less than average variable cost to be predatory regardless of the market context in which they occur, the balance of the structural analysis makes less sense. The Joskow-Klevorick test relies on a largely discredited theory of entry barriers and ignores the conditions which must prevail to make a market something less than contestable.¹⁰⁹ It makes the commission of an offence conditional on a set of market characteristics which are beyond both the knowledge and the control of the alleged predator. A firm would not know an offence had been committed until, for example, someone conducts some research and concludes that the industry concerned happens to have an "advertising barrier to entry".

There are also problems with the rebuttable presumption of predation when prices fall below average total cost. Consider the proposition that this presumption is rebuttable by evidence that the industry was declining or that entry occurred on a too large scale. What is meant by the term "declining"? Surely the definition of decline is a function of the expectations previously held. Unfulfilled expectations of rapid growth can have the same consequences as a decline given expectations of stability. What is meant by the concept of entry occurring on too large a scale? Obviously any entry which pushes prices below average cost has occurred on too large a scale. What scale of entry are incumbents obliged to plan for?

Next, consider the proposition that, in any event, the presumption of predation stands if the dominant firm is deemed to have been carrying excess capacity. How does one determine whether the incumbent domi-

Klevorick test. Specifically, a price below average veritable cost when output is *below* "normal" is presumptively predatory as is a price below average total cost when output is *above* normal.

¹⁰⁸ *Ibid.*, at p. 255.

¹⁰⁹ This is noted by, *inter alios*, McGee, *loc. cit.*, footnote 77, at p. 319.

nant firm has carried excess capacity? Positioning occurs or can occur on many margins. While excessive scale in a single plant has received a great deal of attention, there is no evidence that it is among the more important entry-detering investments. Moreover, there are a number of models of entry-detering behaviour,¹¹⁰ in which the incumbent makes use of all its pre-entry capacity. This means that there are no idle machines for the prosecution to adduce as evidence.¹¹¹

(b) Baumol

Baumol¹¹² has proposed that any price cut made by an incumbent after the entry of a competitor must be maintained for five years after entry or threat of entry. Prices could be adjusted upwards when demand or cost or the price level change.

Baumol's approach derives from his work on contestable markets.¹¹³ A market is contestable if any price in excess of minimum long-run average cost will attract new entrants who will undercut existing firms and take over the market. A contestable market has the virtue that, regardless of the number of firms in it, price can not be held above long-run average cost. In effect, competition for the market replaces competition within the market.

The purpose of Baumol's rule is to ensure that competition for the market has the desired effect. It does this by making illegal a strategy of pricing above cost and reducing price to cost only when entry is threatened. Thus, under the Baumol rule, incumbents can hold the market only by pricing at (minimum) long-run average cost *at all times*.

Baumol's rule entails difficulties both of a conceptual and an operational nature. Price decreases after the entry of new firms and price increases after the exit of existing firms are expected to occur in competitive (contestable) markets which are functioning normally. The Baumol rule would, in these cases, erroneously label as predatory normal competitive behaviour.

Other writers on predation have been more concerned with entry deterrence in non-contestable markets. In the latter case the ultimate deterrent to entry lies in the certain knowledge among potential entrants that their entry will cause a price decline which cannot be reversed, at least in the short run. Indeed, it is this certainty that there can be no

¹¹⁰ Dixit, *loc. cit.*, footnote 71.

¹¹¹ Problems associated with the requirement that all price reductions be "quasi permanent" are considered in the discussion of the Baumol standard; see the immediately following text.

¹¹² W.J. Baumol, Quasi-Permanence of Price Reductions: A Policy for Prevention of Predatory Pricing (1979), 89 Yale Law J. 1.

¹¹³ W.J. Baumol, John C. Panzar, Robert D. Willig, Contestable Markets and the Theory of Industry Structure (1982).

consequence of entry other than a loss-inducing price decline which marks a market non-contestable. The enforcement of Baumol's rule would do nothing to change this.

Suppose, however, that a potential entrant misreads the circumstances and enters the market. Price will fall as a consequence and will not rise until the sunk investment of one of the existing firms (including the new entrant) has depreciated and exit (failure to reinvest) occurs. In this case there will be a "demand" rationale for the price rise in the sense that there will be excess demand at the existing price after the exit of one producer. Moreover, should it be among the survivors, the entrant will be as eager as any for this price rise to occur. Indeed, to deny a price rise until after five years have elapsed, as Baumol suggests, is virtually to guarantee that entry will be unprofitable and thus to further discourage it.

In sum, there are persuasive arguments to the effect that, if it were applied, the Baumol rule would be counter-productive. There are also barriers to its application which appear to be virtually insuperable. What, for example, is a demand, cost and price level adjusted price? At what point was entry anticipated? Who is to calculate this price over each five year period after entry is anticipated?

(c) Williamson

Williamson has proposed that dominant firm response to new entry be regarded as predatory in the short-run if the dominant firm increases its output by more than ten per cent over "a simple trended average on recent sales" for a period of twelve to eighteen months after entry has occurred.¹¹⁴ A dominant firm which holds output unchanged in the face of new entry would be deemed non-predatory, provided that the market price is not less than average variable cost.¹¹⁵ In the long-run, sustained production by dominant firms or successful entrants would be regarded as predatory if price is less than average cost.¹¹⁶ Insofar as established firms are concerned, Williamson would regard prices below average variable cost and sustained pricing between average total and average variable cost unaccompanied by evidence of excessive capacity, as predatory.¹¹⁷

Williamson's test contains something of the Areeda-Turner, Posner and Joskow-Klevorick rules. It would require that price cover average variable cost at all times and average total cost in the long-run (which is not defined). It would apparently convict either or both the incumbent(s) and the entrant(s) if price failed to cover total cost over the long-term.

¹¹⁴ *Loc. cit.*, footnote 70, at pp. 297-305.

¹¹⁵ *Ibid.*, at p. 333.

¹¹⁶ *Ibid.*, at p. 334.

¹¹⁷ *Ibid.*, at p. 337.

Although it is a small part of Williamson's test for predation, his output rule has received most of the attention. An increase in output after entry is, in Williamson's view, presumptively predatory. However, the kind of behaviour which the rule was designed to prevent makes very little sense in theory, has not been shown by Williamson to have occurred and is also consistent with a non-predatory response to new entry.¹¹⁸

(d) Scherer

Scherer¹¹⁹ argues that whether the elimination or exclusion of rivals is socially harmful, and should be an offence, depends on the circumstances. Scherer would not convict a dominant firm which cut prices below marginal cost and drove out rivals, provided the dominant firm continued to produce the output formerly produced by its ex-competitors and did so at a lower marginal cost. On the other hand Scherer would regard a price above marginal cost as predatory if it resulted in a future reduction in industry output and/or an increase in industry unit cost.¹²⁰

It is not predation itself to which Scherer objects but predation which results either in the elimination of the output once provided by the victim or its continued supply at a higher cost. He would therefore require that the market situation in which predation is alleged to have occurred be examined. If rivals are more efficient (at the margin) or if industry output is lower as a consequence of their exclusion or departure, prices exceeding marginal or average variable cost may be deemed predatory. If rivals are less efficient or their output is replaced with no increase in cost, prices less than marginal cost may be judged non-predatory.¹²¹

... long-term economic welfare is maximized in some cases when the monopolist's price exceeds its marginal cost and in other cases when marginal cost is undercut. Key variables in determining the point at which long-term welfare-lost minimization occurs include relative cost positions of the monopolist and fringe firms, the scale of entry required to secure minimum costs, whether fringe firms are driven out entirely or merely suppressed, whether the monopolist expands its output to replace the output of excluded rivals or restricts supply again when the rivals withdraw, and whether any long-run compensatory expansion by the monopolist entails investment in scale economy-embodiment new plant.

The problem with the Scherer test is that firms will not know *ex ante* whether their price and output decisions are in violation of the law. Compensatory prices may be deemed predatory if, upon subsequent investigation, they are found to be coincident with the departure of a more efficient competitor. Prices which are below marginal and average variable cost might be socially beneficial if they hasten the departure or deter

¹¹⁸ See McGee, *loc. cit.*, footnote 77, at pp. 307-316.

¹¹⁹ *Loc. cit.*, footnote 70.

¹²⁰ *Ibid.*, at pp. 889-890.

¹²¹ *Ibid.*, at p. 890.

the entry or expansion of firms which turn out to be less efficient at the margin than the alleged predator. To prove an offence it would presumably be necessary to establish that industry output had been curtailed and/or shifted to higher cost sources over a significant time period as a consequence of the actions of the accused and that the latter acted in the knowledge that this would be the case. Given the difficulty of establishing *ex post* that industry output is lower and/or more costly, it would appear virtually impossible to establish that the accused knew *ex ante* that this would be the case.¹²²

(e) Ordoover and Willig

These authors would deem predatory any behaviour which is profitable only because it causes a rival to exit:¹²³

. . . predatory objectives are present if a practice would be unprofitable without the exit it causes, but profitable with the exit.

A two stage test is proposed. If an industry is characterized by horizontal concentration, "entry hurdles" and "re-entry barriers", then the investigation proceeds to the examination of the behaviour of the alleged predator. If these market characteristics are not present, the investigation is discontinued.

Entry hurdles exist when the investment required to participate in the market in question is not fully reversible, that is, where at least some costs associated with entry are sunk. Re-entry barriers exist when a firm having left the market must make an additional irreversible investment to re-enter.

The second stage test involves a search for a strategy that would have been more profitable to the alleged predator, given the "continued viability" of the rival. A price below marginal cost would be regarded as predatory because ". . . a slight reduction of the incumbent's output flow would raise profits under the premise of the continued viability of the rival".¹²⁴ A price below average cost is predatory because "an elimination of the incumbent's output flow would raise his profits under the same

¹²² In *The State of Competition in the Canadian Petroleum Industry, Volume VI, The Marketing of Gasoline* (1984), the Director of Investigation and Research attempts to demonstrate that the Scherer requirements for predation have been met. He argues, at p. 201 of Volume VI:

Thus the key to predation is the finding not just that the price cutter intended to eliminate a competitor. . . but the aggressor knew his competitor was more efficient. . . . Scherer properly defines efficiency at the margin, that is, in terms of avoidable cost. The evidence adduced by the Director relates entirely to historical average costs. On the evidence, there is no indication that the expansion of the independent gasoline retailers would have resulted in any cost saving in either the short or the long-run.

¹²³ *Loc. cit.*, footnote 88, at p. 9.

¹²⁴ *Ibid.*, at p. 17.

premise".¹²⁵ These rules are modified to apply to multiproduct firms. Prices above marginal and average cost may be deemed predatory if the incumbent also produces a substitute. Prices below marginal and average cost may not be predatory if the incumbent also produces a complementary product.¹²⁶

Finally, Ordover and Willig derive a test for predatory product innovation. A predatory innovation is one which would be unprofitable but for the elimination of the pre-existing technology from the market.¹²⁷ The concept of re-entry barriers is crucial here. As long as the old technology remains posed to re-enter the market any innovation which is profitable must also be socially beneficial. If, however, the old technology, once driven from the market, cannot re-enter except at significant cost, an innovation may be profitable but not socially beneficial. The question then becomes one of proving that the accused committed resources to a specific innovation in the knowledge that the latter would not be profitable unless a rival technology was driven from the market and was unable to return. In cases where the accused controls the existing technology it would be necessary to prove that the innovation would have been unprofitable had the accused not withdrawn or virtually withdrawn the existing technology.¹²⁸

There are a number of problems with the Ordover-Willig approach. It confines itself to cases in which there has been a (permanent) exit of a market participant.¹²⁹ Cases which involve disciplining of rivals or entry deterrence are ignored. Moreover, given the structural prerequisite of sunk investment, it is entry deterrence rather than the elimination of rivals which we would expect to observe. Ordover and Willig have, in essence, defined an offence (the elimination of a rival in the presence of sunk costs) that will seldom, if ever, be observed.

Although they are rather vague about it, Ordover and Willig would apparently find the largest firm in the market guilty of predation whenever another firm left the market and price was below either marginal or average cost and the structural pre-conditions existed. When price is below average cost the profitable course of action for the "incumbent" is to leave the market. The implicit assumption here is that the victim not only remains "viable" but maintains his output.

In common with the Posner, Greer and Joskow-Klevorick approaches, the Ordover-Willig test imposes the entire burden of avoiding prices below average cost and the concomitant exit of smaller producers on the

¹²⁵ *Ibid.*

¹²⁶ *Ibid.*, at p. 21.

¹²⁷ *Ibid.*, at p. 26.

¹²⁸ *Ibid.*, at pp. 41-42.

dominant firm. This is tantamount to requiring the dominant firm to hold a price "umbrella" over fringe producers.¹³⁰ Indeed, it is more serious than that. It appears to make the dominant firm responsible for rectifying the capacity and output mistakes of all other market participants even if the former must leave the market to do it.

For predatory innovation as Ordoover and Willig have defined it to occur, the pre existing technology must be excluded from the market and be unable to return. The only case in which it is at all likely that this could occur is where the alleged predator also controls (completely) the preexisting technology. Even here, there are legitimate reasons for withdrawing an older technology from the market.¹³¹

III. *Application of Economic Tests to Canadian Cases*

In this section the economic approaches which were discussed in Part II are applied to the three leading Canadian cases of predatory pricing. The purpose of this exercise is to determine whether in any given fact situation, the tests derived from these economic approaches would find the existence of predatory behaviour.

A. *Producers Dairy*

Evidence on the costs of processing and distributing fluid milk and on the prices received from its sale at the wholesale and retail levels were presented at the hearing before the Restrictive Trade Practices Commission.¹³²

Unprocessed milk destined to be sold to stores and homes was priced at thirteen and one-quarter cents per quart; milk to be resold to processing plants for the manufacture of powdered milk, butter and other dairy products was priced at six and one-third cents per quart. Both prices were the result of an agreement between the association representing producers and the association representing distributors. The total cost of homogenized milk processed and delivered to the stores was between eighteen and three-quarters and nineteen cents per quart: thirteen and one-quarter cents to the producers; two to two and one-quarter cents for processing; two and one-quarter cents for packaging and handling; one and one-quarter cents for delivery. We shall assume for ease of reference that the cost of processing is two and one-quarter cents, the maximum value. Thus, the total cost of a quart of milk is considered to be nineteen

¹²⁹ Easterbrook, *op. cit.*, footnote 78, pp. 7-9.

¹³⁰ Easterbrook, *ibid.*, p. 19; Scherer, *loc. cit.*, footnote 70, at p. 876.

¹³¹ Easterbrook, *ibid.*, pp. 29-30.

¹³² *Supra*, footnote 14.

cents.¹³³ In the period just before the price war, the price per quart paid by the chain stores to the distributors was twenty-one cents per quart which included a rebate of one-half cent per quart. During the price war the price charged by Producers and Borden was effectively ten and one-half cents per quart.

It is not clear from the Report of the Commission whether nineteen cents was the average total cost or just the average variable cost. No distinction was made between variable and fixed cost. We can conclude however that the price charged by Producers and Borden during the price war of ten and one-half cents per quart was below average total cost which at minimum was nineteen cents per quart.

A comparison between price and average variable cost can be made under various assumptions about the components of average variable cost.

Assume that the cost of unprocessed milk, the amount paid to the producers, was not avoidable (in the sense that the dairies were required to take the farmers' output) and all other costs were variable. The price charged of ten and one-half cents per quart would be greater than the average variable cost of five and three-quarters cents. The amount calculated for average variable cost should be considered to be a maximum since some of the processing costs, the so-called plant costs, are likely to be fixed. Labour costs may also be fixed if there are limitations on lay-offs under collective agreements.

Next, assume that the cost of unprocessed milk was also avoidable and therefore variable. The price of ten and one-half cents would then be below the average variable cost of thirteen and one-quarter cents for unprocessed milk plus five and three-quarters cents for processing, packaging, handling and delivery.

Finally, consider the assumption that the cost of unprocessed milk was fixed but that the unprocessed milk can be diverted to the plants producing powdered milk and other dairy products. The Commission noted that these plants "played a very important part during the price war because the dairies that did not participate in it could, through them, dispose of the milk on hand".¹³⁴ The unprocessed milk that was to be used for milk to be sold to the stores and homes could be sold to these plants at six and one-third cents per quart. Since the cost of unprocessed milk destined for these plants was also six and one-third cents, the net cost of this option to the dairy would be the cost of handling, which was

¹³³ These cost figures were given in the evidence of a senior official of Dominion Dairies, one of the smaller dairies, but were considered by the Commission to be representative of the entire milk industry; *ibid.*, pp. 7-8.

¹³⁴ *Ibid.*, pp. 4, 15-16.

considered to be negligible.¹³⁵ Of course, if all dairies made such transactions, the price received would likely fall.

The existence of the option to ship the unprocessed milk to the plants producing dairy products implies that for Producers and Borden the cost of unprocessed milk for the production of fluid milk to be sold to the stores and homes can be treated as an avoidable cost. Therefore, price would be below average variable cost if the latter included at least the cost of unprocessed milk as thirteen and one-quarter cents.

In sum, price was below average total cost. If the cost of unprocessed milk was avoidable either because shipments of the milk could be cancelled at no cost or they could be diverted to the plants producing dairy products, price was below average variable cost. If the cost of unprocessed milk was unavoidable, price was above average variable cost.

Except under the assumption that the cost of unprocessed milk was unavoidable, the behaviour of Producers and Borden would be considered to be predatory under the Areeda-Turner test. If, in addition there was evidence of predatory intent, the behaviour would be predatory under the McGee standard as well since neither dairy could justify its price reductions as promotion of new products or clearance of old stock. With evidence of predatory intent, the behaviour of either Producers or Borden would be considered predatory under the Posner/Greer standard since price was below average total cost.

There would not be predation under the Joskow-Klevorick test since characteristics of the wholesale milk market would not meet the threshold requirement for the application of various behavioural tests. Producers and Borden were considered to have the "edge" in the chain store part of the wholesale business,¹³⁶ but neither could be considered to be dominant in the Joskow-Klevorick sense of having a market share of more than forty per cent. Furthermore, there was no significant barrier to entry since the other major dairies did supply the chain stores prior to the price war.

There would be predation under the Baumol test since the price decrease was withdrawn after forty-eight hours. A possible defence here is that pressure by the union might be regarded as an exogenous change in costs.

If the increase in shipments by Producers or Borden is considered to be an increase in output, there was predation under the first branch of the Williamson test. There would be predation under the second branch as well if there was continuation of pre-entry output, which was not the case, at price below average variable costs.

¹³⁵ *Ibid.*, p. 15.

¹³⁶ *Supra*, footnote 8, at p. 266.

The behaviour of Producers and Borden would not be found to be predatory under either part of the Scherer test. For predation to be established under the first part, there should be evidence that there was a cartel in the distribution of milk, that Clark's price initiative was an attempt to break out of cartel discipline and that Producers' response was an attempt to re-impose cartel discipline. In addition, it must be shown that in the absence of Producers' "disciplinary" actions, industry output would have been higher with resulting lower prices. The fact that Producers and Borden maintained, or possibly increased industry output during the price war through larger shipments into the chain store part of the market is of no relevance to the Scherer test. In respect of the second part of the test, there was no evidence that Producers and Borden were producing at a higher cost than Clark or the other dairies that withdrew from supplying the chain stores.

Since Producers or Borden could have increased short-run profits by increasing their prices, there would be predation under the Ordover-Willig test if the cost of unprocessed milk was avoidable.

B. Hoffmann-Laroche

(1) *Chlordiazepoxide: Sales to Hospitals (July 1968-January 1970)*

Linden, J. accepted the evidence that transactions involving a year's free supply of the ten milligramme dosage with the purchase of a year's supply of the five and twenty-five milligramme dosages "involved many sales to hospitals below cost" where cost was defined "exclusive of overhead".¹³⁷ He concluded that the requisite intent existed on the basis of the finding of "an unacceptable state of mind",¹³⁸ reflected by the following statement made in connection with a one for two deal on Librium suggested in March, 1968:¹³⁹

... "Such a move will 'fill the pipelines' and will serve notice to all present and future parasites that we mean business."

If we take cost exclusive of overhead as variable cost then the sales to hospitals would be predatory under the Areeda-Turner test.

Given the finding of intent, McGee would also find these sales predatory. This finding under the McGee test would be confined to the hospital sales made between March, 1969 and January, 1970. The ten milligramme dosage in tablet form which was supplied free between July 1968 and March 1969 was regarded as "obsolete".¹⁴⁰ This action would fall within the defence allowed by McGee of the clearance of discontinued lines.

¹³⁷ *Supra*, footnote 9, at pp. 15-16 (D.L.R.), 174-175 (O.R.), 13 (C.C.C.) (H.C.).

¹³⁸ *Ibid.*, at pp. 49 (D.L.R.), 208 (O.R.), 46 (C.C.C.).

¹³⁹ *Ibid.*, at pp. 15 (D.L.R.), 174 (O.R.), 11 (C.C.C.).

¹⁴⁰ *Ibid.*

A conviction under the McGee rule also implies a conviction under the Posner and Greer tests which require price below average total cost plus intent.

The Joskow-Klevorick test requires that evidence regarding market structure be considered first. First, the eighty-three per cent of the Librium market in 1968 enjoyed by Hoffmann-LaRoche would be sufficient to warrant further consideration.¹⁴¹ Second, it is not clear that there were significant barriers to entry into the Librium market. It was unnecessary to duplicate the research and development undertaken by Hoffmann-LaRoche. Certification under Parcost and other programmes obviated the need to build up a reputation for quality and generic substitution stipulations reduced the necessity to advertise. Third, since Hoffmann-LaRoche was the major innovator rather than the competing compulsory licensee, it is not obvious that restricting the ability of Hoffmann-LaRoche to exclude entrants would favour innovation. Application of the Joskow-Klevorick test would result in an acquittal on the structural grounds of easy entry and the innovative record of the dominant firm. If, for some reason, structural grounds for proceeding were found, the second stage application of the average variable cost test would result in a conviction.

Application of the Baumol test would result in a conviction in that one for two promotions were offered and withdrawn many times after the entry in to the chlordiazepoxide market began.¹⁴²

Application of the Williamson test would result in a conviction under the average variable cost branch of his test and, depending on how the long-run is defined, under his average total cost test as well. There is some evidence, albeit inconclusive, which might also result in a conviction under the output test. The one for two offers were designed by Hoffmann-LaRoche to "fill the pipelines", which implies that there would be no market for the products of the new entrants.¹⁴³ There is some evidence that sales rose "in that period" but, unfortunately, Linden J. does not specify which period this is.¹⁴⁴

The application of the Scherer test would result in an acquittal on the ground that, given the ease of entry into the market, Hoffmann-LaRoche could not have restricted output in the long-run.

Given the apparent absence of significant entry or re-entry hurdles, the application of the first or structural stage of the Ordoover-Willig test would result in an acquittal. If entry hurdles were, for some reason, deemed to be significant, the Ordoover-Willig test would lead to convic-

¹⁴¹ *Ibid.*

¹⁴² *Ibid.*, at pp. 14 (D.L.R.), 173 (O.R.), 10 (C.C.C.).

¹⁴³ *Ibid.*, at pp. 14-15 (D.L.R.), 173-174 (O.R.), 10-11 (C.C.C.).

¹⁴⁴ *Ibid.*, at pp. 15 (D.L.R.), 174 (O.R.), 11 (C.C.C.).

tion on the ground that selling at a price less than variable cost would not be in the best interest of Hoffmann-LaRoche, given the continued viability of Horner and others as competitors.

(2) *Government Sales (September 1969-April 1970)*

Since during this period three successful bids submitted by Hoffmann-LaRoche were one dollar each, the price charged under each contract was clearly less than variable costs. Accordingly, application of the Areeda-Turner test would result in a conviction.

Evidence on whether the requisite intent existed is less clear. In concluding that the one dollar tenders were not "unreasonably low", Linden J. accepted the explanation offered by the accused:¹⁴⁵

... [the purpose of] these bids was merely testing the market, to see the reaction of its customers and its competitors to this tactic of virtually free goods.

He further reasoned that there was "no risk whatsoever that these three sales would have any impact at all in lessening competition".¹⁴⁶ These findings would support the inference that there is an absence of intent to lessen competition. Application of the McGee, Posner and Greer tests would, therefore, result in an acquittal. On the other hand, these same tests would convict if the "unacceptable state of mind" which prevailed during the sales to hospitals between July 1968 and January 1970 applied to these sales to governments as well.

Application of the average variable cost branch of the Williamson test would result in a conviction. The "withdrawal" of one dollar bids by Hoffmann-LaRoche would also warrant a conviction under the Baumol test.

If structural grounds for proceeding (barriers to entry or re-entry) could be found to exist there would be a conviction under the average variable cost branch of the Joskow-Klevorick test and also, for reasons given in the analysis of hospital sales, under the Scherer and Ordover-Willig tests.

(3) *Diazepam: Hospital and Government Sales*

In May, 1970 Horner had entered the diazepam market offering large discounts and, in some cases, free goods. To counteract this marketing strategy of Horner, Hoffmann-LaRoche provided between June 1970 and June 1971 Valium free of charge to hospitals and bid one dollar on all government tenders. These sales were obviously at a price less than variable cost. Apparently prior to the entry of Horner, the variable cost

¹⁴⁵ *Ibid.*, at pp. 16-17 (D.L.R.), 175-176 (O.R.), 13 (C.C.C.).

¹⁴⁶ *Ibid.*, at pp. 44 (D.L.R.), 203 (O.R.), 40 (C.C.C.).

was about one-third of the selling price.¹⁴⁷ This evidence would be sufficient for a conviction under the Areeda-Turner test. Given the finding that the accused had the requisite intent,¹⁴⁸ application of the McGee, Posner and Greer tests would also result in a conviction.

The application of the Joskow-Klevorick test would probably result in an acquittal on structural grounds. Until early in 1970 Hoffmann-LaRoche had a monopoly for diazepam, but by 1974 there were seventeen brands of diazepam being marketed in Canada.¹⁴⁹ Gorecki reports that Hoffmann-LaRoche's share of the diazepam market went from one hundred per cent in 1969 to 71.7 per cent in 1973.¹⁵⁰ Although Hoffmann-LaRoche's market share throughout this period was of a significant size, the loss of thirty per cent of the market in three years suggests the absence of entry barriers. If the second stage average variable cost tests were applied, there would, of course, be a conviction.

There is no evidence on Hoffmann-LaRoche's output or shipments before and after the entry of Horner or others. Application of the average variable cost branch of the Williamson test would, of course, result in a conviction.

The offer of free diazepam after Horner's entry and its subsequent withdrawal after a year would be sufficient for a conviction under the Baumol rule. Hoffmann-LaRoche would probably not be convicted under the Scherer test because its actions were not, on the evidence, likely to have resulted in a restriction of supply over the longer-term.

Under the Ordovery-Willig test, Hoffmann-LaRoche would be convicted because prices in excess of average variable cost would have been more profitable given the continued viability of Horner. The test allows, however, for a complementary product defence for below cost pricing. It would have made sense to offer diazepam to hospitals at lower price than to retail pharmacies and Hoffmann-LaRoche may well have done so. Even so, the price to hospitals prior to Horner's entry was well above variable cost.¹⁵¹ The question is whether the complementary product defence would support the reduction of Hoffmann-LaRoche's hospital price to well below variable cost just after Horner's entry. The answer would almost certainly have to be "no".

C. *Consumers Glass*

The judgment itself found that there was no predation under either the Areeda-Turner or Greer tests

¹⁴⁷ *Ibid.*, at pp. 19 (D.L.R.), 178 (O.R.), 15 (C.C.C.).

¹⁴⁸ *Ibid.*, at pp. 47-48 (D.L.R.), 207-208 (O.R.), 43-44 (C.C.C.).

¹⁴⁹ *Ibid.*, at pp. 17 (D.L.R.), 176 (O.R.), 13 (C.C.C.).

¹⁵⁰ *Op. cit.*, footnote 24, p. 17.

¹⁵¹ *Supra*, footnote 9, at pp. 21 (D.L.R.), 180 (O.R.), 17 (C.C.C.) (H.C.).

The behaviour of Portion would not be considered predatory under the McGee test since there was an absence of predatory intent.

Portion's actions would also pass both parts of the Scherer test. There was no evidence that Amhil was deterred from entering or expanding, such deterrence being a precondition for the application of the test. In fact, Amhil's market share increased steadily during the period in question, reaching seventy per cent in February 1978 and ultimately one hundred per cent in 1979. Clearly, there was no net reduction in industry output. There was no evidence that Amhil was more efficient than Portion.¹⁵²

There would not be predation under the Joskow-Klevorick test. Although the market share of the accused was one hundred per cent in September 1975, it had declined to thirty per cent by February 1978 and finally to zero per cent in 1979. There were apparently no significant barriers to entry which would have enabled Portion to enjoy the fruits of the alleged predation. Indeed, it was one of the fears of the Portion management that any of its customers could "go captive" by buying the necessary equipment for only two hundred thousand dollars. The fact that Amhil was able to enter the market by renting the necessary equipment is further evidence. Since on the facts the threshold requirements are not satisfied, the second part of the test in the form of various price tests is irrelevant.

There would not be predation under the Baumol test since Portion's price decreases were never withdrawn. In fact, its prices fell throughout the period in question.

The Williamson test would not find predation. There was not any increase in output or even continuation of pre-entry output. Since the small lid market was price inelastic, a decrease in price would not increase quantity demanded.¹⁵³ In these circumstances, the declining market share of Portion implies that its output was also decreasing.

It is clear from the judgment of O'Leary J. that there was not a course of action that Portion could have pursued which would have been more profitable to it and less unfavourable to Amhil. O'Leary J. found that Portion did forego opportunities to raise prices, for example, when the price of polystyrene, the raw product used in the production of lids, increased, but concluded that Portion did so only to avoid incurring larger losses.¹⁵⁴ Therefore, there would not be predation under the Ordovery-Willig test.

¹⁵² *Supra*, footnote 10, at pp. 281 (D.L.R.), 235 (O.R.), 488 (C.C.C.).

¹⁵³ *Ibid.*, at pp. 291-292 (D.L.R.), 246 (O.R.), 498-499 (C.C.C.).

¹⁵⁴ *Ibid.*

IV. *Economic Tests and Section 34(1)(c) of the Act*

In this section we shall consider the extent to which the economic tests discussed in Part II may be used in the interpretation of section 34(1)(c) of the Act. This exercise differs from that in Part III wherein we applied each of the economic tests to the fact situation of the leading cases prosecuted under section 34(1)(c) to determine whether predatory behaviour would be found to exist. We were, therefore, not mindful of whether the application of a test was consistent with the language and judicial interpretation of section 34(1)(c).

Whether an economic test is of assistance in the interpretation of section 34(1)(c) is not an easy question to answer. The economic tests discussed herein were proposed for the interpretation of Section 2 of the Sherman Act,¹⁵⁵ the provision under which predation is usually prosecuted in the United States. The generality of the language used in the provision is evident:

Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding one million dollars if a corporation, or, if any other person, one hundred thousand dollars, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.

This generality has provided considerable latitude for the judicial interpretation of this provision. The opportunity for judicial creativity, in turn, has encouraged the development of various tests for predation based on economic analysis and is reflected in the diverse nature of the economic tests that have been proposed. It may not be an exaggeration to say that the American jurisprudence on the offence of predation, unencumbered by the statutory language, has developed in a way more characteristic of a common law offence than a statutory offence.

In contrast, section 34(1)(c) uses more precise language, requiring that a number of distinctive elements be established. It is therefore not obvious how the economic tests may be used in the interpretation of section 34(1)(c), notwithstanding the fact that two tests, namely, the Areeda-Turner and Greer tests, have been applied in the case of *Consumers Glass*.

The economic tests throw little light on the interpretation of the elements of engaging in a business and of engaging in a policy of selling in section 34(1)(c). None of the economic tests explicitly consider these elements. There is little doubt, however, that each test is intended to deal with the activities of a business. As for the element of policy, it appears that some but not all tests require that the alleged predatory behaviour be part of a policy, in the sense that it is planned and/or of some duration.

¹⁵⁵15 U.S.C.A.

Beyond this, the economic tests discussed in this article do not contribute materially to the interpretation of "policy" as the term is used in section 34(1)(c).

With the exception of the Scherer test, each economic test is formulated in whole or in part in terms of prices charged by the alleged predator, and, therefore, may by of assistance to the interpretation of the element of unreasonably low prices.

The Areeda-Turner test which is formulated solely in terms of the relationship between price and average variable cost is clearly relevant to the question of what are unreasonably low prices. Such application was favoured by O'Leary J. in *Consumers Glass*.¹⁵⁶ It should be noted however the Areeda-Turner test may be difficult to reconcile with the judgment in *Hoffman-LaRoche* wherein Linden J. stated that the relationship between price and cost is only one aspect of "unreasonableness".¹⁵⁷

A variant on the Areeda-Turner interpretation of unreasonableness is provided by the McGee test. It also requires the absence of justification for pricing below average variable cost, such as promotion of new products or the clearance of old stock. This gloss on the Areeda-Turner approach is in the spirit of Linden J.'s position that "unreasonableness" means more than just some price-cost formula.

From the perspective of the Posner and Greer tests, it could be argued that unreasonably low prices mean price below average total cost. This interpretation of unreasonableness was applied in *Consumers Glass* by O'Leary J. as an alternative basis for an acquittal. As we have already noted, the use of average total cost rather than variable cost may be consistent with Linden J.'s analysis of the unreasonableness element.

The Baumol test, which prohibits the withdrawal within five years of a price decrease in response to new entry or threat thereof except by reason of exogenous cost or demand changes or inflation, provides a different interpretation of the unreasonableness element. The rationale underlying the Baumol test is inconsistent with Linden J.'s approach. Linden J. recognized that reducing price to meet competition is relevant to the question of whether a price is unreasonably low. A necessary implication of the Baumol standard is that meeting the competition is not a defence.

Another interpretation of unreasonableness may be derived from the second branch of the Williamson test which prohibits the continuation of pre-entry output with price below average variable cost. Viewed in this light, this branch of the test is a variant of the Areeda-Turner interpreta-

¹⁵⁶ *Supra*, Part III, B.

¹⁵⁷ We have already noted the question of whether "cost" as used by Linden J. refers to average total cost or average variable cost; see, *supra*, Part I, C.

tion. Evidence that the alleged predator maintained pre-entry output and price below average variable cost could support the inference that the price was unreasonably low. The first branch of the Williamson test can not be applied to section 34(1)(c) since it speaks of a prohibition against output increases.

The second part of the Joskow-Klevorick test consisting of three price propositions is also of relevance. The first proposition is just a statement of the Areeda-Turner price-average variable cost formula and the third proposition which prohibits any reduction of price to average total costs that is not withdrawn within two years is a variant of the Baumol test. A different interpretation of unreasonableness may be derived from the second proposition, which states that a price between average total and average variable cost is presumptively predatory, rebuttable with evidence of excess capacity beyond the control of the alleged predator.¹⁵⁸

The Scherer test is of no assistance in the interpretation of the element of unreasonableness since it is concerned only with the efficiency implications of any alleged predatory action in the form of price cutting or otherwise and not with the unreasonableness *per se* of the price behaviour of the alleged predator.

The Ordover-Willig test, which focusses on the course of action that the alleged predator ought to have followed, does not make an independent contribution to the interpretation of unreasonableness. It was pointed out above that in the short-run, this test is equivalent to the Areeda-Turner test and in the long-run, it becomes the Posner/Greer test without the requirement of intent.

As for the element of predatory intent, the economic tests may be divided into two groups. The first group includes those tests which deny any role for predatory intent or is silent thereon: Areeda-Turner, Joskow-Klevorick, Baumol, Williamson, Scherer and Ordover-Willig. Predatory intent is an explicit requirement in the tests of the second group: McGee and Posner/Greer. The McGee test adds to the Areeda-Turner test the requirement of predatory intent. Predation is found to exist if price is below average variable cost and there is an absence of evidence which negatives an inference of intent such as promotion of new products or clearance of old stock. McGee is also prepared to infer intent from predatory language. Posner speaks of the intent to exclude a competitor. Greer is the most explicit in suggesting what might constitute sufficient evidence of intent. For Greer, predatory intent may be founded on such evidence as the elimination of a customary price premium, the foregoing of clear opportunities to increase prices or predatory language.¹⁵⁹

¹⁵⁸ See Zerbe, Cooper, *loc. cit.*, footnote 98.

¹⁵⁹ *Loc. cit.*, footnote 100., at p. 247.

In respect of the alternative requirement of the effect of elimination of a competitor or substantial lessening of competition, there are more divergent views among the economic tests.

The Greer¹⁶⁰ and Scherer tests would look for direct evidence of substantial lessening of competition in the form of the exit or the cessation of certain activities (including attempted entry) by one or more competitors. The evidence required by the Greer test is described as follows:¹⁶¹

Thus a rule based on intent plus pricing below full cost might be improved by inclusion of a proviso calling for convincing demonstration that competition has been injured (or is likely to be injured) as might be shown by the alleged victims substantial losses or actual demise in a market of at least moderately high concentration.

The Scherer test, which is concerned with the efficiency implications of any alleged predatory conduct, requires evidence that the price set by the alleged predator has caused the victim(s) to reduce output and either that this output has not been replaced or that it has been replaced but at a higher cost.

The Baumol test finds direct evidence of lessening of competition not in the exit of a competitor but in the price increase following the exit. We would note, however, that neither the Scherer nor the Baumol test provides for the independent determination of the unreasonableness and substantial lessening elements of the offence.

The remaining tests infer the substantial lessening of competition from more indirect evidence. The approach of the Joskow-Klevorick and the Ordoover-Willig tests is to infer a substantial lessening of competition if unreasonably low prices are charged in markets with a specified set of structural characteristics, to wit, high and stable concentration and the prevalence of significant barriers to entry and re-entry. Although he is somewhat less explicit, Posner can also be regarded as taking this approach.¹⁶² The reasoning underlying this approach is that given market dominance and barriers to entry, the monopoly power which is the reward of predation will not soon be eroded either by the expansion of existing rivals or by new entrants. This reasoning provides a motive for predation and the evidence used to infer a substantial lessening of competition might also serve as indirect evidence of intent.

The other tests are not as specific regarding the market circumstances under which an unreasonably low price might also be deemed to have the effect of lessening competition. The proponents of these tests

¹⁶⁰ Greer actually states that evidence regarding a probable lessening of competition would be "desirable"; *ibid.*, at p. 261.

¹⁶¹ *Ibid.*, at p. 260.

¹⁶² *Op. cit.*, footnote 93, pp. 191, 55-71.

make it clear, however, that their tests are intended to apply in concentrated markets where entry is difficult. Williamson states that he is concerned principally with the response of dominant firms and collusive oligopolies to new entry.¹⁶³ Areeda and Turner couch most of their discussion in terms of the practices which a monopolist might follow which should be deemed predatory.

Conclusion

Our analysis allows us to draw conclusions with respect to three issues of interest: the case law under section 34(1)(c) of the Act as it stands; alternative interpretations of the elements of the offence of predatory pricing under section 34(1)(c); and offences which are related to section 34(1)(c).

The case law under section 34(1)(c) remains ambiguous with respect to both what constitutes an unreasonably low price and what constitutes lessening of competition. A price below average variable costs is not a necessary requirement for the offence. Nor would an action which resulted in the elimination of a small competitor or a potential competitor.

A number of tests for predatory behaviour have been suggested for application in cases under section 2 of the Sherman Act in the United States. In our view the Areeda-Turner test is the least costly of these tests in that it entails a low probability of convicting innocent behaviour and requires relatively little in the way of information gathering, interpretation and enforcement effort. The Areeda-Turner test has been widely used in the United States and has been applied in one case in Canada.

The tests for predation which have been suggested for use in the American context can be of assistance in the interpretation of the elements of the offence under section 34(1)(c). Application of the Areeda-Turner test would imply that an unreasonably low price is defined as one which is below average variable cost. A substantial lessening of competition could be inferred from evidence regarding market structure as Joskow and Klevorick and Ordoover and Willig have suggested. Relevant evidence here would include the market shares of the accused and other major market participants, the stability of these shares, and, perhaps, an assessment of the costs associated with entering the market.

Our view is, in essence, that for an offence under section 34(1)(c), there must be, at least, pricing below average variable cost by a firm with

¹⁶³ Dominant firms are defined as having a sixty per cent market share in industries where entry is not easy. Collusive oligopoly is regarded as most likely to prevail in concentrated, mature, homogenous product, uniform costs industries; see Williamson, *loc. cit.*, footnote 70, at p. 292.

a large and stable market share. The adoption of the Areeda-Turner test carries with it the presumption that there is little to be gained and much to be lost by prosecuting cases involving pricing above average variable cost and market structures not involving obvious obstacles to entry into the industry. The Areeda-Turner test is a minimalist test and its adoption would imply that relatively few cases would be brought under section 34(1)(c). The question then arises as to whether that section is necessary at all.

This question is also raised by an examination of the leading cases under section 34(1)(c). In our view *Hoffman-Laroche* is the only unambiguous example of predatory pricing but the losses which occurred in this case were borne largely, if not completely, by the predator. If the leading cases are presumably the most glaring examples of predatory pricing to come to the attention of the government, then the inescapable conclusion is that the section is not needed.

The problems associated with defining what constitutes an offence under section 34(1)(c) lead us to some, admittedly speculative, questions regarding other sections of the Act and the proposed amendments thereto which deal with various aspects of predatory behaviour. Is the separate offence of predatory geographic discrimination under section 34(1)(b) necessary? Should predation be inferred under section 34(1)(b) if predation under section 34(1)(c) cannot be established?

How are the more general offences involving abuse of dominant position proposed in the Bill C-29 amendments to the Act to be defined?¹⁶⁴ New concepts are being introduced. Can we be hopeful that the courts would be more successful in dealing with such concepts as predatory squeezing, freight equalization, use of fighting brands, pre-emption of scarce facilities or product specialization? Given the difficulty experienced in defining what is a predatory price, we are sceptical that the development of a workable jurisprudence in the area of abuse of dominant position is a reasonable prospect.

¹⁶⁴ Bill C-29, House of Commons of Canada, Second Session, Thirty-Second Parliament, 1983-84. The Bill died on the order paper on the defeat of the Liberal government in September 1984.