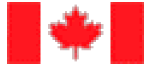

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Draft

Competition Bureau

ENFORCEMENT GUIDELINES FOR ILLEGAL TRADE PRACTICES: UNREASONABLY LOW PRICING POLICIES

Under Paragraphs 50(1)(b) and 50(1)(c) of the *Competition Act*

March 8, 2002

Canada

PREFACE

Competition delivers many benefits to consumers, including competitive prices and product choices. Low prices are usually a good indication that competition is healthy and active in the marketplace. While competitive prices and low pricing are beneficial to consumers generally, certain pricing behaviour can be designed to frustrate and interfere with the process of competition in the longer term. This type of undesirable pricing behaviour may have short-term benefits for the consumer but will ultimately lead to higher prices or other anti-competitive effects. These guidelines address paragraphs 50(1)(b) and 50(1)(c) of the *Competition Act* (the "Act") which set out criminal offences of geographic price discrimination and selling products at prices unreasonably low.

The Competition Bureau (the "Bureau") first published its *Predatory Pricing Enforcement Guidelines* in 1992 to clarify its enforcement policy and to ensure that the public understood when low pricing might result in an investigation under the *Competition Act* (the "Act"). Those guidelines, which addressed only paragraph 50(1)(c), evaluated predatory pricing using a two-stage approach. The first stage evaluated an alleged predator's ability to exercise market power and recoup losses incurred as a result of a policy of predatory pricing. The second stage involved an assessment of whether the prices in question were below average variable cost, otherwise known as the Areeda and Turner test. However, since that time, there have been changes in the economy as well as developments in economic thinking concerning low-pricing behaviour. For this reason, the original guidelines have been updated to reflect a modern perspective on low-pricing issues. These guidelines have adopted three principal changes.

First, the ability to recoup losses will no longer be considered as the primary screening criterion. Rather, it is properly considered as one of many factors for determining whether or not unreasonably low anti-competitive pricing policies have been adopted. However, the Bureau is of the view that, while an ability to recoup losses can be an indicator of a policy of unreasonably low pricing, it is not an element necessary to be proven under paragraphs 50(1)(b) and 50(1)(c).

Secondly, in carrying out the cost-revenue analysis to determine below-cost selling, the Bureau will use 'avoidable cost' as opposed to average variable cost and average total cost used in the previous guidelines. It is now recognized that average variable cost is not appropriate for the analysis of a firm producing multiple products. Accordingly, avoidable cost is the appropriate standard which will be used in the Bureau's analysis addressing both single-product and multi-product firms.

Finally, the Bureau has included a new section in these guidelines dealing specifically with unreasonably low pricing resulting from market expansion.

The Bureau is always aware of business realities. In today's fast paced, global economy, markets are constantly changing, demanding flexible and innovative responses to competitive challenges. Transparency and certainty of enforcement efforts are essential in this context. These Guidelines explain how the Bureau enforces these provisions of the Act, with the aim of deterring anti-competitive behaviour and, at the same time, avoiding a chilling effect on normal and healthy price competition.

Konrad von Finckenstein, Q.C.
Commissioner of Competition

Interpretation

These Guidelines supersede all previous statements of the Commissioner of Competition (the "Commissioner") or other officials of the Competition Bureau.

The Guidelines explain the general approach of the Commissioner and the Bureau to the administration and enforcement of the legislation. They are not intended to restate the law or to constitute a binding statement on how the Commissioner will exercise his discretion in a particular situation. Consequently, they should not replace the advice of legal counsel. Enforcement decisions of the Commissioner or the Attorney General of Canada, and the ultimate resolution of issues, depend on the surrounding circumstances. Guidance regarding a specific situation may be requested from the Bureau through its Program of Advisory Opinions. These guidelines and advisory opinions are also not intended to bind or affect in any way the discretion of the Attorney General in the prosecution of matters under the Act. Final interpretation of the law is the responsibility of the courts.

How to Contact the Competition Bureau

These Guidelines and other publications of the Bureau are available on the Internet at the Bureau's Web site address. To obtain general information, make a complaint under the provisions of the legislation, or request an advisory opinion, please contact the Bureau by any one of the means listed below:

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PART 1: INTRODUCTION

The purpose of the *Competition Act* is to maintain and encourage competition to achieve important economic objectives. These include providing consumers with competitive prices and product choices as well as ensuring that small and medium-sized enterprises have a fair opportunity to participate in the Canadian economy.

Vigorous price competition is a hallmark of competitive markets. In most cases, lower prices are driven by competitive market forces, and consumers benefit from the rivalry among the firms in that market. Given the objectives of the Act, it might seem a bit puzzling that there should be any concern about unreasonably low prices. However, while the Act encourages vigorous price competition, it also ensures that marketplace transactions are conducted on the basis of fair, competitive rivalry rather than through anti-competitive behaviour. Unreasonably low pricing is one example of such behaviour. It means involvement in a policy of selling below cost in order to deter entry into a market, or to force competitors out of a market. While consumers may benefit from the resulting low prices for a brief period, they can be harmed in the long-run if the low pricing leads to diminished competition and, ultimately, higher prices or reduced levels of service, product quality or innovation.

Distinguishing between low prices resulting from illegal behaviour and those stemming from legitimate competitive rivalry can be difficult. The Bureau exercises caution when considering enforcement action against alleged unreasonably low pricing behaviour in order not to inhibit beneficial price competition.

The Guidelines that follow are organized into five parts:

- Part 2 describes the geographic price discrimination and unreasonably low pricing provisions of the *Competition Act* (paragraphs 50(1)(b) and 50(1)(c)).

- Part 3 provides an overview of how the Bureau administers and enforces the Act. In particular, it focuses on how the Bureau screens cases of alleged unreasonably low pricing in such a way that its resources are directed to those most likely to harm the competitive process.

- Part 4 explains how the Bureau interprets the specific elements that must be proved in order to establish a violation of paragraphs 50(1)(b) and 50(1)(c).

- Part 5 explains how the Bureau views low pricing resulting from market expansion of a well established firm into a new market.

- Part 6 describes the different enforcement outcomes that could result from allegations of unreasonably low pricing.

PART 2: RELEVANT PROVISIONS

The *Competition Act* contains both criminal and civil provisions. Criminal offences are prosecuted before criminal courts, and offenders can face substantial fines and even imprisonment. Civil matters are adjudicated by the Competition Tribunal which has powers to issue injunctive and remedial orders with respect of mergers and anti-competitive practices which are likely to prevent or lessen competition substantially.

Though anti-competitive low pricing is covered by several provisions of the Act, it is most commonly addressed under paragraphs 50(1)(b) and 50(1)(c), which are criminal provisions, and sections 78 and 79, the civil abuse of dominance provisions. The Bureau's approach to the administration and enforcement of sections 78 and 79 is described in its *Enforcement Guidelines on the Abuse of Dominance Provisions*.

The following section summarizes the elements of paragraphs 50(1)(b) and 50(1)(c). A more detailed discussion can be found in Part 4 of these Guidelines.

Paragraphs 50(1)(b) and 50(1)(c)

Paragraphs 50(1)(b) and 50(1)(c) state:

> *Everyone engaged in a business who ...*
>
> *(b) engages in a policy of selling products in any area of Canada at prices lower than those exacted by him elsewhere in Canada, having the effect or tendency of substantially lessening competition or eliminating a competitor in that part of Canada, or designed to have that effect, or*
>
> *(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 that effect,*
>
> *is guilty of an indictable offence and liable to imprisonment for a term not exceeding two years.*

Paragraphs 50(1)(b) and 50(1)(c) require the following minimum elements that must be proved beyond a reasonable doubt for an offence to occur:

1. the firm or person against whom allegations are made must be engaged in a business;

2. the low pricing must be part of a "policy of selling products"; and

3. the policy must have at least one of the following effects or designs:

    - the effect or tendency of substantially lessening competition;

- the effect or tendency of eliminating a competitor;
- be designed to substantially lessen competition; or
- be designed to eliminate a competitor.

The two provisions differ from each other in the following respects:

4. 50(1)(b) requires proof of a policy of selling products at prices that are lower in one area of Canada compared to another (*prices exacted lower than elsewhere in Canada)*;

5. 50(1)(c) requires proof of a policy of selling products at prices that are unreasonably low.

PART 3: ENFORCEMENT CONSIDERATIONS

In administering and enforcing the *Competition Act*, the Bureau's key objective is to safeguard the process of competition. In cases involving paragraphs 50(1)(b) and 50(1)(c), the Bureau applies the Act in a manner that maintains and promotes healthy, vigorous price competition, while deterring anti-competitive conduct. Identifying truly harmful low-pricing behaviour requires that a delicate balance must be struck; otherwise, anti-competitive activity might go unchecked, or legitimate price competition might be inhibited.

Typical complaints received by the Bureau regarding low pricing allege a competitor's excessively low prices threaten to drive the complainant's firm (and possibly others) from the market. Complainants usually ask the Bureau to explain the steps involved in an investigation and to determine whether the low-pricing activity of their competitor warrants the Bureau taking enforcement action. Complainants then provide the Bureau with the relevant information supporting the allegations, including information on prices, the magnitude and duration of price reductions and costs. The Bureau considers the quality and quantity of the evidence provided, as well as the likelihood that continued investigation would uncover further evidence. The Bureau also prioritizes its cases in order to make effective and efficient use of its financial and human resources.

1. Thresholds for Examination

When the complaint involves alleged low-pricing behaviour, the Bureau first makes an initial assessment to confirm that the alleged behaviour is not legitimate price competition, and also to ensure that the Bureau pursues enforcement actions where unreasonably low pricing is likely to harm the competitive process. For example, complaints regarding low pricing sometimes reveal upon examination that the competitor was selling at prices above their costs. The courts have concluded that selling at prices which are above costs can never be unreasonable and does not offend paragraphs 50(1)(b) and 50(1)(c).

If prices appear to be below cost, the Bureau then defines the relevant market both

geographically and in terms of products. This procedure assists the Bureau in determining the field in which firms are competing, the extent of that competition, and the effects on competition and competitors of the behaviour proscribed under the Act. Defining a relevant market is not an end in itself, but is part of a framework of analysis that is used to determine the competitive effects of alleged anti-competitive behaviour.

Defining a relevant market involves a variety of considerations. For one, it is necessary to determine, from both the demand and the supply side, how easily products can be substituted. Substitutes are considered to be in the same market. The Bureau looks at the functional characteristics of products, including their physical and technical characteristics, and their end use. The views, strategies and behaviour of sellers and buyers are important as well, especially in terms of how they respond to changes in the relative prices of products. Transportation costs and shipment patterns can also help to define the geographic dimensions of the market.

Once the relevant market has been defined, the Bureau assesses the likelihood that the behaviour will harm competition, and therefore consumers and businesses. The following considerations are taken into account:

- A low-pricing incumbent firm with an existing market share of less than 35% is considered to be less likely to engage in low-pricing behaviour harmful to competition. In order not to discourage legitimate price competition, the Bureau will not examine further the alleged low pricing by the incumbent firm unless their market share is considerably greater than their rivals.

- If the low-pricing firm has a market share of more than 35% but barriers to entry into the market are low, the Bureau will also conclude that the low-pricing conduct is more likely to be of the kind that benefits the economy, consumers and businesses. Consequently, no further examination is performed.

- In cases where the low-pricing incumbent firm has a market share of more than 35%, or if its market share is considerably greater than its rivals, and barriers to entry are significant, the Bureau will continue to examine whether the elements of paragraphs 50(1)(b) or 50(1)(c) have been violated.

2. Preliminary Examination

If the thresholds described above are met, the Bureau continues with a preliminary examination of the lawfulness of this behaviour, based on the elements of unreasonably low pricing described in Part 4 of these Guidelines. The Bureau pays particular attention to the duration, frequency, depth, and pattern of the low-pricing behaviour. The Bureau also examines any price-cost information that might be available, although it recognizes that information about the low-pricing firm's costs might be limited at this early stage of the process. Where the low-pricing firm is a well established firm expanding into a new market, the Bureau also seeks to determine whether the firm's low pricing represents a temporary introductory price promotion or another legitimate business low-pricing objective such as selling off perishable inventory.

3. Formal Inquiry

At the conclusion of the preliminary examination, the Bureau will recommend whether or not there is reason to believe that an offence has been, or is likely to be, committed, and the Commissioner may decide to commence a formal inquiry under the Act to determine all relevant facts. The decision to commence a formal inquiry is based on whether the low-pricing activity meets the required elements of the Act.

Once a formal inquiry is underway, the Bureau can make use of court-authorized formal powers to gather further evidence about matters under investigation. These powers can include orders for oral examination of witnesses under oath, written returns of information and/or the production of records as well as orders for search-and-seizure.

At the conclusion of the inquiry, the Bureau will decide how the case should be resolved. The range of resolutions available is described in the Bureau's *Conformity Continuum Information Bulletin*

4. Option of Proceeding under Section 79

The Bureau may also address unreasonably low pricing under section 79, the abuse of dominance provision of the *Competition Act*. This is a non-criminal (or "civil") provision that seeks to address abusive behaviour by a firm or firms dominant in the marketplace that engage in a practice of anti-competitive acts which are likely to prevent or lessen competition substantially. Section 79 authorizes the Commissioner to apply to the Competition Tribunal, a specialized body composed of judges and lay members, for remedies that are reasonable and necessary to overcome the anti-competitive effects of activity which meets the elements of

section 79.[1] The application of section 79 to unreasonably low pricing is addressed more specifically in section 4.3 of the Bureau's *Enforcement Guidelines on the Abuse of Dominance Provisions.*

The Bureau will pursue allegations of unreasonably low pricing under section 79 when there is a dominant player, or a dominant group of firms, in the market. To determine the presence of dominance, the Bureau examines market shares and barriers to entry and assesses whether the players in question substantially or completely control the class or species of business.

When the prerequisite elements have been met and pricing conduct falls within the scope of both paragraph 50(1)(c) and section 79 of the *Competition Act*, the particular facts of each case dictate which provision the Bureau should employ to remedy the situation.

If a firm has a history of non-compliance with the Act or the nature of the conduct is egregious, a referral to the Attorney General with a recommendation of prosecution under section 50 with its consequent punitive remedies is appropriate.

The Bureau usually will proceed with an abuse of dominance inquiry when the provisions of section 79 are established and there is also an element of unreasonably low pricing as part of a broader pattern of anti-competitive acts. Finally, when evaluating whether to undertake civil or criminal proceedings, the Bureau weighs the effectiveness of remedies available to the Competition Tribunal under section 79 against the criminal sanctions available under section 50.

5. *Alternative Case Resolution*

In appropriate cases, the Bureau attempts to resolve the matter through alternative case resolution, thereby avoiding a full inquiry or judicial proceedings. This reduces uncertainty, saves time and avoids lengthy court actions. Written undertakings (a commitment to do or not to do something) may eliminate the need for further Bureau action. The Bureau may accept an undertaking if it remedies the effects of anti-competitive activity. Some matters can be settled simply by having the Bureau contact the company involved to explain the law.

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[1] Section 79 provides that the Competition Tribunal may make behavioural and structural orders against a respondent firm(s) to overcome the effects of the practice of anti-competitive acts. Under section 79, the Tribunal does not have the power to impose monetary fines or order imprisonment. However, section 66 provides criminal penalties for failing to comply with a Tribunal order. Additionally, if the amendments to the *Competition Act* relating to the airline industry in Bill C-23 are adopted, the Competition Tribunal will have the authority to impose monetary penalties up to a maximum of $15 million against an airline carrier where the Competition Tribunal has found that a dominant carrier has abused its dominant market position.

PART 4: ELEMENTS OF UNREASONABLY LOW PRICING

If the thresholds for examination described in Part 3 have been met, the Bureau will then analyze the evidence to determine if the elements of the offence are met. This part provides guidance on how the Bureau interprets the specific elements that must be proved under paragraphs 50(1)(b) and 50(1)(c).

It is important to note that one particular factor can have a bearing on several elements of an offence. For example, the conduct of a firm, or the impact of its anti-competitive conduct, can be used as evidence both of the firm's capacity to exercise market power, and of underlying policy of selling at unreasonably low prices. Likewise, a factor can relate to elements described both in paragraph 50(1)(b) and in 50(1)(c). The Bureau examines all these elements with the knowledge that pricing decisions are made in the context of a complex and dynamic marketplace. ***It is important to note that each of the three elements must be proved in order to successfully establish an offence.***

Once again the elements of paragraphs 50(1)(b) and 50(1)(c) are:

1. the firm or person against whom allegations are made must be engaged in a business;

2. the low pricing must be part of a "policy of selling products"; and

3. the policy must have one of the following effects or designs:

    - the effect or tendency of substantially lessening competition;
    - the effect or tendency of eliminating a competitor;
    - be designed to substantially lessen competition; or
    - be designed to eliminate a competitor.

Again, the two praragraphs differ from each other in the following respects:

4. 50(1)(b) requires proof of a policy of selling products at prices lower in one area of Canada than in another;

5. 50(1)(c) requires proof of a policy of selling products at unreasonably low prices.

1. Engaged in a Business (Paragraphs 50(1)(b) and 50(1)(c))

The unreasonably low pricing provisions apply to persons "engaged in business". Subsection 2(1) of the Act defines "business" as including the following:

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

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

It also includes the raising of funds for charitable or other non-profit purposes.

2. Policy of Selling Products (Paragraphs 50(1)(b) and 50(1)(c))

Paragraphs 50(1)(b) and 50(1)(c) state that low pricing must be part of a "policy of selling products". Under section 2 of the Act, a product is defined as either an article or a service.

As part of its deliberations, the Bureau considers whether the selling activity of the firm in question is a legitimate short-term competitive tactic, or whether it is sufficiently long term or repetitive to be considered a pricing strategy. In *R. v. The Producers Dairy Limited,* the Ontario Court of Appeal interpreted "policy" as meaning more than the adoption of a temporary measure to counteract an aggressive, competitive move aimed directly at an important customer of the low-pricing firm. It found that the low pricing in question, which lasted two days, did not constitute a policy.[2] In *R. v. Hoffmann-La Roche*, the Ontario Court of Appeal stated that sales made on a one-time basis are unlikely to constitute a policy. Rather, the selling needed to be ongoing or repeated. In the latter case, the Court found that products "given away" at no charge for a six-month period constituted a policy of selling.[3]

When determining whether low pricing constitutes a policy, the Bureau considers the surrounding circumstances. In *Hoffmann-La Roche,* the Court found that any course of pricing action as a "policy of selling", it must be established that it was planned and deliberate conduct by responsible employees of the company. For example, evidence that a program is aimed at eliminating a competitor through below-cost pricing can indicate that the pricing is part of a planned course of action.

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[2] *R. v. Producers Dairy Ltd.* (1966), 50 C.P.R. (2d) 265; see also *R. v. Carnation Co.,* (1968), 58 C.P.R. 112 (Alta. C.A.)

[3] *R. v. Hoffmann-La Roche* (1980), 28 O.R. (2d) 164 affirmed (1981) 33 O.R. (2d) 694 (C.A.)

A particular price which applies to one, or relatively few, market transactions is unlikely by itself to constitute an unreasonably low pricing policy. Similarly, prices which may have applied generally in the market for only a brief period of time are unlikely to represent the sort of "policy of selling" contemplated in paragraphs 50(1)(b) and 50(1)(c) of the Act. On the other hand, in markets where the bulk of purchasing is done over a short period of time, such as seasonal markets and those where infrequent large tender calls constitute a significant portion of market transactions, the Bureau may well conclude that prices applied over a short period reflect a "policy of selling products" as envisaged by the provisions.

It is possible for an offence to be committed even if the pricing strategy does not ultimately result in a substantial lessening of competition or the elimination of a competitor. The Bureau is of the view that it should not have to wait to take action until an unreasonably low pricing policy has had a noticeably anti-competitive impact. In addition, to constitute a "policy of selling", it is not necessary to show that the low-pricing behaviour was officially authorized by the company.

3. Competitive Impact

Under both paragraphs 50(1)(b) and 50(1)(c), it must be proved that the policy has one of the following three anti-competitive effects:

(a) the effect or tendency of substantially lessening competition;

(b) the effect or tendency of eliminating a competitor; or

(c) be designed to substantially lessen competition or eliminate a competitor.

Paragraphs 50(1)(b) and 50(1)(c) differ from each other in terms of the relevant geographic market toward which the effect, tendency or design is aimed. The geographic price discrimination elements of paragraph 50(1)(b) require proof that the alleged low-pricing firm engaged in a policy of selling at prices in the geographic market that were lower than prices it charged at the same time elsewhere in Canada and the policy had the proscribed effect (or the tendency or design to have this effect) in the geographic market in which the low pricing occurred. Paragraph 50(1)(b) does not require prices to be unreasonably low. The unreasonably low pricing provision in paragraph 50(1)(c) requires that a policy of selling at prices that are unreasonably low having the proscribed effects, but does not require a comparison of prices in different geographic markets or regions.

The Bureau is of the view that the word "tendency" in 50(1)(b) and 50(1)(c) implies more than the mere possibility that the policy will produce one of the proscribed effects. To avoid characterizing potentially pro-competitive low pricing as anti-competitive, the Bureau interprets this word as requiring evidence that the low-pricing policy, if continued, will *probably* have a proscribed effect.

Where the alleged unreasonably low pricing policy has already caused demonstrable and measurable economic effects, these effects can be used to assess the extent of the harm to competition and competitors. However, where the policy has not been in place for long enough to have this impact, the Bureau assesses the likelihood of competitive harm occurring over time. An unreasonably low pricing policy by a firm with considerable financial strength relative to its competitor(s) will be more likely to bring about the effects proscribed by the Act. This kind of firm may be better able to outlast competitors in a period of sustained price reductions.

Similarly, the Act prohibits anyone engaged in business from adopting low-pricing policies designed to substantially lessen competition or eliminate a competitor even where the policy is not effective or in place for a long enough period of time to achieve its intended objectives.

A consideration of the effects, tendencies or designs which must be proved under paragraphs 50(1)(b) and 50(1)(c) follows.

(a) Effect or Tendency of Substantially Lessening Competition

Generally, in competition law matters, a substantial lessening of competition occurs when an anti-competitive practice, policy or merger transaction creates, preserves or enhances market power, that is, the ability to profitably influence price, quality, service or innovation, relatively independently of market forces. A substantial lessening of competition does not require the creation or preservation of a monopoly or the virtual elimination of all sources of competition in a market.

While the degree and duration of the lessening of competition are relevant to determining the extent of market power, rigid numerical criteria (such as a particular percentage price rise over a period of years) are not required. A detailed explanation of market power can be found in the Bureau's *Merger Enforcement Guidelines* and in various decisions of the Competition Tribunal.[4]

The principal indicators of market power are market shares and levels of concentration in, and barriers to entry to, the relevant market. However, the actual behaviour of a firm can also be important. The ability to engage in conduct which is predatory, exclusionary or disciplinary can itself be a good indication of the presence of market power.

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[4] See, for example, *Canada (Director of Investigation and Research) v. NutraSweet Co*. (1990), 32 C.P.R. (3rd) 1 (Comp. Trib.) and *Canada (Director of Investigation and Research) v. Laidlaw Waste Systems Ltd.* (1992), 40 C.P.R. (3rd) (Comp. Trib.).

Levels of Concentration and Market Share

The level of market concentration and the market share held by the low-pricing firm are important factors affecting its potential for exercising market power. Market concentration is the extent to which leading suppliers control the supply of a product in a market. It is measured by the number of sellers in the market, and their combined market share. The Bureau is of the view that the greater the level of concentration in the relevant market, the more likely it is that a policy of unreasonably low pricing will adversely affect competition and competitors. The Bureau analyzes the impact of the alleged low-pricing policy on concentration levels and market shares to determine whether the policy has maintained or increased the market share of the alleged low pricing incumbent firm.

Evidence of persistently high market shares can be an indicator of market power because, over time, the maintenance of high market shares depends on the ability to prevent competitors and new entrants from increasing their share of the available business. This can be accomplished through legitimate means, such as greater efficiency or better products, or through improper means, such as anti-competitive behaviour.

Differences in the relative size of market shares can also be important. For example, a firm with relatively moderate market share may be able to exercise market power if that share is considerably greater than its rivals.

As noted in the discussion of Enforcement Considerations, the Bureau usually will pursue cases where the low-pricing incumbent firm has a market share of more than 35%.

Conditions of Entry and Exit

Barriers to entry or exit can create and entrench the exercise of market power. Where entry into the market is prevented or inhibited, it will be easier for a firm to recoup the money it lost as a result of its below-cost pricing. After a competitor has been eliminated, barriers to entry will allow the firm to raise its prices without attracting new competitors into the market.

i) Structural Barriers

Barriers to entry or exit include structural factors which prevent or inhibit the entry of new firms into a market, or the exit of firms from a market. Barriers to international and interprovincial trade, sunk costs and regulatory requirements are examples of structural barriers.

New entrants often are at a cost disadvantage relative to incumbent firms, particularly where initial production and/or sales are not sufficient to achieve economies of scale or scope. Tariff or non-tariff barriers to international trade, such as quota or ownership restrictions, impose costs on potential foreign competitors which are not borne by domestic firms. Similarly, interprovincial barriers to trade and regulatory control over entry may present potential entrants with considerable, and possibly insurmountable barriers to entry. For example, if approval from a government regulatory body is

required to enter a market or industry, this might well pose a barrier, in terms of time, cost and risk associated with entry.

A scarcity of production inputs, or a lack of access to necessary technology, could also represent an important cost disadvantage to potential entrants. In some cases, necessary inputs and technology may be controlled by existing industry members, including the firm in question. The firms may be integrated to such an extent that they significantly control the sources of raw materials used in the down-stream production processes, or possess patent rights to products and processes necessary for the most efficient production of the goods in question. Such controls, however legitimately they have been obtained, may nevertheless represent obstacles to the effective entry of competitors into the markets involved.

The need to make investments that cannot be recovered if entry is unsuccessful is referred to as "sunk costs". The latter can impede entry in two ways. First, they may be so significant relative to total entry costs and expected rates of return that they deter entry altogether, or prolong the time required to become an effective competitor. Second, even if such barriers do not completely deter entry, they may lead firms to decide to enter at a reduced scale, in an effort to minimize financial risk. This latter circumstance may in turn result in entry which does not represent effective competition to the existing market participants.

A common form of sunk costs involves the need to invest in market-specific assets. For example, in some manufacturing industries the highly sophisticated, specialized equipment dedicated to the production of unique products may have little or no appreciable value outside the specific application for which it is intended. Where such sunk costs represent a significant part of the investment needed for entry or expansion, they are viewed by potential entrants as being higher risk investments.

ii) Behavioural Barriers

The market power of a firm can be enhanced by behaviour which creates or strengthens barriers to entry. In any given industry there may be a number of factors which promote product differentiation advantages. Non-price factors such as technical service, reputation, geographic proximity, and even well established buyer/seller relationships may influence a buyer's purchasing decisions and favour the incumbent firm. Where such non-price factors appear to be significant in terms of quickly attaining the level of sales required to succeed, they may pose a hindrance to effective and sustainable entry to a market.

Strategic behaviour by an incumbent firm may also make new entry more difficult. A firm may engage in conduct that could have an adverse effect on existing rivals or even potential entrants in order to deter their entry. The Commissioner will consider whether entry will be impeded or delayed by an incumbent by looking for behaviour such as the following:

- using excess capacity to increase outputs and depress prices in response to an entry attempt;

- excessive investment in research and development or advertising;
- pre-emptive acquisitions of inputs required by an entrant to enter the incumbent's market; or
- pre-emptive expansion of capacity.

Barriers to exit can include sunk costs and other costs such as regulatory requirements which impose significant costs on firms exiting a market. For example, a firm may have to remediate a production site to comply with environmental regulations once production ceases at its premises. Barriers to exit may increase the incentive of a firm to sell at below-cost prices to discipline competitors to compete less vigorously or end price discounting as well as increase the prospects that competitors will increase prices as opposed to exiting the market.

iii) Reputational Barriers

A firm can also deter entry by establishing a reputation for unreasonably low pricing. By demonstrating its willingness to price below cost, a firm can signal to potential competitors that it will respond aggressively if they attempt to enter its markets. The creation of a barrier to entry by virtue of reputation can increase a firm's market power and enhance the exclusionary effects of its conduct.

If the incumbent firm is successful at persuading the entrant that its continued presence or expansion in the market will be met with a strategy of unreasonably low pricing, then the entrant will discontinue its expansion and possibly exit the market. The incumbent firm thereby creates a reputation for unreasonably low pricing that deters the entry or expansion of other firms in that market or in other markets in which the incumbent competes. In any given market, an unreasonably low pricing policy used to gain a reputation is more likely when the firm in question operates in more than one geographic or product market. An incumbent firm with "deep pockets" might use its superior access to operating funds in order to help it cover the costs of its pricing strategy. If the financing of an entrant is conditional on its ongoing profitability, then an incumbent's unreasonably low pricing policy can reduce the entrant's access to credit and increase its financing costs. In such circumstances, a policy of selling at low prices is more likely to have the effect, tendency or design proscribed by paragraphs 50(1)(b) and 50(1)(c).

In determining whether the firm has a reputation for unreasonably low pricing, the Bureau will conduct an analysis that compares the subject market(s) with conditions in other "similar" markets where the firm is not present. To determine whether the firm enjoys less competition in the subject market(s), the Bureau will consider whether:

(i) concentration of firms is higher in markets in which the firm operates than in *similar* markets in which it does not;

(ii) the firm's sales and profits in markets in which it operates are higher for a substantial period

than are typically observed for firms operating in *similar* markets;

(iii) low prices charged by the firm in the past have resulted in exit and no new entry for an extended period after the low-pricing policy has been discontinued; and

(iv) higher prices failed to induce new firms to enter the market.

In evaluating the potential for new entry, the Bureau will consider the time it is likely to take the firm to raise prices and recoup the costs of the pricing strategy. As a rule of thumb, the Bureau will begin with a two-year time period, and then adjust for the nature of the industry. For example, in an industry where only minimal investment and expertise is required and where there is a history of rapid effective entry, the Bureau will evaluate the possibility of new entry in response to a significant price increase over a period significantly shorter than two years. If entry is likely within the relevant time period, then the probability of recouping the losses from the low-pricing strategy is reduced. The approach to entry conditions is discussed in more detail in *Merger Enforcement Guidelines.*[5]

iv) Ability to Recoup Losses

When a firm has market power, it can more easily recoup foregone revenue due to its below-cost pricing. The ability to recoup losses in this way is an additional indication of market power, whether it occurs in the market where the low pricing took place or in another market. A firm can recover its losses by increasing prices by a large amount in a short period of time, or by increasing prices by a series of small amounts over a longer period, during which new entry is unlikely to occur. Alternatively, a firm can recoup losses incurred in one market by exercising market power in another product or geographic market(s). A firm's reputation for unreasonably low pricing can deter its competitors from lowering their prices or expanding their operations, and can deter potential competitors from entering a market, for fear of provoking an aggressive response. Such "reputational" effects can increase the firm's market power and thus make it easier to recoup losses. Low-pricing behaviour can also be motivated by reasons other than recoupment. For example, it may be rational for a firm to adopt a low-pricing policy and sacrifice present profits in order to preserve the long-term stability of an existing market structure. Additionally, a low-pricing policy could assist in establishing an industry standard to exclude others or maintain market control.[6]

The Bureau is of the view that, while an ability to recoup losses will continue to be a factor to be considered, it is not a necessary element to be proven under paragraphs 50(1)(b) and 50(1)(c).

(b) Effect or Tendency of Eliminating a Competitor

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[5] See, part 4.6, "Barriers to Entry" pp. 33-36 and Appendix I of the *Merger Enforcement Guidelines.*

[6] See, for example, *Australian Competition and Consumer Commission v. Boral Limited et. al.*, FCA Australia.

To conclude that a competitor has been eliminated, the Bureau must be satisfied that a competing firm has, in fact, gone out of business or is otherwise no longer in a position to be an effective competitor in a particular market. Strategic-pricing behaviour that deters entry also constitutes a form of competitor elimination, and the Bureau considers such behaviour as meeting this element of the offence.

In cases in which the alleged low-pricing behaviour has not been in place long enough to eliminate a competitor but likely will have this effect if it continues, then this element of the offence will also have been met. The Bureau examines evidence from the competitor showing its financial status and projections for its future viability in the market to determine whether elimination is a likely result of the low-pricing policy.

(c) Designed to Substantially Lessen Competition or Eliminate a Competitor

A low-pricing policy can also violate paragraphs 50(1)(b) and 50(1)(c) when it is "designed" to have the effect of substantially lessening competition or eliminating a competitor. The Bureau is of the view that this element is met if it is proven that the accused engaged in the prohibited conduct in order to cause either of these effects, even if the strategy is entirely ineffective in achieving its objective.

This is different from the other scenarios in that the Bureau seeks evidence of the aim of the policy. This evidence can be direct or indirect in nature. The Bureau examines a number of factors, including for example, the magnitude of the price cuts and the losses thereby incurred, the absence of any other rationale for the price cuts (such as excess capacity in the market or the need to dispose of perishable goods), and documentary and oral evidence describing the alleged low-pricing firm's aim. The design or aim of the policy can be inferred on the basis of these and other factors surrounding the introduction of the low-pricing policy.

4. Prices Lower than Those Exacted Elsewhere in Canada: Paragraph 50(1)(b)

Section 50(1)(b) requires proof that a person has engaged in a policy of selling products "in any area of Canada at prices lower than those exacted by him elsewhere in Canada".

It is not unusual for the same products to be simultaneously sold at different prices in different geographic markets. Prices can be influenced by variations in costs, market demand or the intensity of local competition. Requiring a firm to charge the same prices in all of the markets in which it operates risks inhibiting legitimate price competition. For example, a firm may decide to forego competitive price incentives in one local market if it is required to similarly reduce its price in all of its markets. For these reasons, the Bureau does not investigate every case where there are price differences among geographic markets in Canada. Rather, to avoid inhibiting legitimate competition, it will only investigate cases where the selling of a product in one local market at prices lower than in another market in Canada will ultimately harm the process of competition (see Part 3 above).

5. Prices That Are "Unreasonably Low" (Paragraph 50(1)(c))

Paragraph 50(1)(c) requires proof of a policy of selling products at "prices unreasonably low". The Bureau regards these words as encompassing more than just the amounts of the prices or their relationship to costs. The Bureau's analysis also takes into account the context in which the firm competes. What may on the surface appear to be unreasonably low pricing may be a justifiable response to the behaviour of a competitor, or to other market conditions.

i) Price-Cost Comparison

To determine whether a specific price is low enough to be considered "unreasonable", the Bureau determines whether the firm charging the price was able to cover its costs of supplying the product(s) in question. The rationale for this cost-based test is that it is reasonable to expect that a business will operate with a view to covering its costs. A firm that charges a price insufficient to do this without a legitimate business justification will not pass the Bureau's cost-based test.

When conducting its cost-based test, the Bureau recognizes avoidable cost as being the relevant cost concept. Avoidable costs refer to all costs that could have been avoided by a firm had it chosen not to sell the product(s) in question. In general, avoidable costs do not include sunk costs.

For the purposes of the price-cost analysis, there are two timing issues that need to be addressed: the time period over which the cost-based analysis is carried out, and the time period over which the costs of the firm are avoidable. The resolution of both these issues will depend on the availability of price and cost data, the period of time in which unreasonably low pricing is alleged, and the need to take account of random variations or fluctuations in demand. The second timing issue will also depend in part on the standard amount of time taken by a firm's management to assess business performance and implement any required changes.

Ordinarily, a multi-product firm incurs costs that are typical for the production of all its products or for a particular group of products. Thus, when the Bureau conducts its cost-based test for an allegation of unreasonably low pricing concerning only one of the firm's products, it will consider any common costs incurred in that product's production as unavoidable and hence excluded from its analysis. This reflects the fact that the firm still needs to incur these costs in order to produce other products not subject to the low-pricing allegation. Thus the Bureau's cost test based on avoidable cost does not require a firm to cover its fully allocated cost.

In the absence of business justification, the Bureau will consider a price that is below avoidable cost to be unreasonable, since in the normal course of business, a policy of selling at a price below this measure of cost would be profit maximizing only because of its anti-competitive effects. A firm pricing below avoidable cost is better off ceasing production altogether or increasing its price(s).

ii) Business Justifications for Low Pricing

Jurisprudence under section 50(1)(c) requires that the Bureau take legitimate business low-pricing objectives into consideration.[7] For example, it may be reasonable for a company to sell excess, obsolete or perishable goods, or products for which demand is shrinking at below-cost prices. In the case of temporary cost increases or demand decreases, a firm may use below-cost pricing to retain existing customers or to build inventory in anticipation of increased business in the future. Companies may use below-cost promotional pricing to induce customers to try a new product. A firm may also use below-cost prices together with high volume production to gain production experience quickly in order to become more efficient in the future when it plans to recoup its costs. In each case, the Bureau considers the particular competitive context of the pricing in question, with no single factor predominating.

There also may be other legitimate business reasons for pricing below cost. One such reason may be to remain competitive with a competitor's low prices. For example, if a new entrant lowers prices to establish a presence in a market, an incumbent firm may respond to this action in the short run by matching those prices. There is jurisprudence to the effect that 'meeting the competition' can be a defence to a charge of pricing below cost in certain circumstances. Generally, this situation would not be considered by the Bureau to be unreasonably low pricing. In assessing whether price matching is anti-competitive, the Bureau will examine each situation on a case-by-case basis to determine all facts and circumstances relevant to establishing whether the low-pricing policy can be justified on legitimate business grounds. One factor which the Bureau will consider is whether there is a qualitative difference between the products being offered by the rival companies. Where one product is superior to another in terms of quality or service, matching prices would, in effect, be 'undercutting'. If the pricing results in a situation where the matching firm is below its avoidable cost, the Bureau may take enforcement action under the section. In addition, the Bureau will consider the length of time the low prices are available in the market, and whether there is evidence to indicate that the matching firm is taking steps to reduce its own costs in order to remain competitive. The Bureau also considers the ability of the alleged low-pricing firm to compete through innovation or methods other than pricing below avoidable cost.

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[7] *R. v. Consumers Glass Co.* (1981), 33 O.R. (2d) 228. Also see *Boehringer Ingelheim (Canada) Inc. v. Bristol-Myers Squibb Canada Inc.*, Ontario Court of Justice (General Division), October 9, 1998, unreported, a private action brought under section 36 of the *Competition Act.*

PART 5: LOW PRICING RESULTING FROM MARKET EXPANSION

Most of the concern regarding unreasonably low pricing relates to an established firm trying to protect or extend its market dominance by deterring or disciplining new entrants. However, there may be circumstances in which a well established firm expands into a new market and attempts to advance its market position by engaging in unreasonably low pricing. While this is unlikely to happen if the new entrant's market share is relatively small and it lacks operations elsewhere, it becomes more feasible when the firm operates similar businesses in other markets, has "deep pockets", and has behaved in an aggressively competitive, and possibly anti-competitive, fashion in other markets. Such an entrant could finance its low-pricing strategy from its earnings in other markets, a parent with deep pockets or superior access to financing, and consequently be able to enter a new market and sustain losses for an extended period of time.

Understandably, a new entrant is initially likely to engage in some form of promotional pricing by offering products in the new market at prices lower than in its other markets. In determining whether low pricing is a concern, the Bureau will consider the length of the promotional period, the relative sizes of the price differences in relation to its other markets, whether and for how long the new entrant has achieved a foothold in the new market and the competitive conditions in the new market.

In the event of a complaint about alleged unreasonably low pricing by a new entrant, the Bureau applies the analysis described above. Unreasonably low pricing by a new entrant is more likely to occur, or to have occurred, when the Bureau finds that:

- the pricing behaviour satisfies the criteria outlined in these guidelines;
- there is no reasonable alternative explanation for the conduct;
- the conduct would harm competition in the market; and
- the entrant's prices are lower than prices it charges elsewhere for the same products under similar competitive circumstances.

When examining alternative explanations for the observed conduct, as well as its effects, the Bureau assesses whether the new entrant is more efficient than the incumbent firm, offers more or less variety, is more or less attractive to customers, and can cover its avoidable cost with the incumbent firm still in the market.

When evaluating the impact of the new entrant's conduct, the Bureau seeks to determine whether the entrant's continuing operation will likely lead to the elimination of multiple competitors, whether the entrant's behaviour will result in higher prices and other consumer costs (e.g., transportation costs), and whether the entrant's costs are similar to, or higher than, those of existing firms. If these criteria

are substantiated, the Bureau will probably conclude that the low-pricing policy would have an adverse impact on competition in the market.

PART 6: ENFORCEMENT OUTCOMES

When a preliminary examination proceeds to the formal inquiry stage, a range of potential outcomes is possible. These outcomes are listed below, including the Bureau's Program of Advisory Opinions which is designed to provide advice on whether proposed business conduct is likely to raise an issue under the *Competition Act*.

1. Prosecution

If the Commissioner concludes that an offence has been committed, evidence may be referred to the Attorney General with a recommendation that criminal charges be brought. The Attorney General will then decide whether or not to follow that recommendation. A person found guilty of an offence under paragraph 50(1)(b) or 50(1)(c) may be imprisoned for a maximum of two years. A fine may be imposed in lieu of a prison term.

2. Other Remedies

The remedies for anti-competitive conduct are not limited to those resulting from a prosecution before the courts or proceedings before the Competition Tribunal. Under section 34 of the *Competition Act*, the Attorney General may apply for a prohibition order for a period of up to 10 years, to stop behaviour that constitutes, or is directed toward, the commission of an offence. In urgent circumstances, the Attorney General may apply for an interim injunction under section 33 to temporarily halt such behaviour pending a prosecution or the completion of proceedings under subsection 34(2).

In lieu of formal proceedings under the Act, the Commissioner has the discretion to pursue alternative means of resolution. These less-formal remedies are described in the Bureau's *Conformity Continuum Information Bulletin*.

3. Discontinuance

If the Commissioner concludes that the evidence does not establish the elements of paragraphs 50(1)(b) or 50(1)(c), the inquiry is discontinued. The Commissioner then produces a formal report for the Minister of Industry, indicating the information obtained and the reason for the discontinuance. Following this, the target of the inquiry as well as the complainant(s) are notified in writing of the status of the inquiry.

4. Right of Civil Action

A right of private action also exists under section 36 of the Act. This remedy is available if there has been a violation of the criminal provisions of the Act, or a failure to comply with an order of the Tribunal or court. Anyone who has suffered losses or damages as a result of conduct that is contrary to section 50 may sue those who engaged in the anti-competitive behaviour. Recovery can be equal to the loss or damage, if proof is provided by the person bringing the action.

5. Program of Advisory Opinions

If a business is not sure whether an activity, if entered into, would contravene the Act, it can submit a proposed plan or practice to the Bureau, which may then provide an opinion on whether the situation described raises competition concerns. Parties are not bound by the advice and are free to adopt their plan or practice even in the face of a negative advisory opinion. Similarly, the Bureau may re-examine the activity if the facts change. If Bill C-23 is enacted, advisory opinions will be binding on the Commissioner provided the subject fact situation is unchanged.