CFIG'S POSITION PAPER

ON

ENFORCEMENT GUIDELINES BY THE COMPETITION BUREAU FOR ILLEGAL TRADE PRACTICES: UNREASONABLY LOW PRICING

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THE CANADIAN FEDERATION OF INDEPENDENT GROCERS

LA FÉDÉRATION CANADIENNE DES ÉPICIERS INDÉPENDANTS

Position Paper of The Canadian Federation of Independent Grocers on Enforcement Guidelines for Illegal Trade Practices: Unreasonably Low Pricing

I. Introduction

Predatory pricing—what the Competition Bureau calls "unreasonably low pricing"—is a practice of low pricing which is intended to or has the effect of driving out competitors and competition. Such pricing is illegal under the criminal provisions of the Competition Act (paragraphs 50(l)(b) and 50(l)(c)) and also violates the abuse of dominance provisions found at Section 79 of the Act. Unreasonably low pricing has been a consistent concern of the Canadian Federation of Independent Grocers because of the substantial dominance exerted in this industry by a handful of large, integrated, manufacturer/wholesaler/retailer firms such as Sobeys and Loblaws. Unreasonably low pricing by dominant firms threatens the capacity of these independent grocers to compete and therefore threatens competition in the industry.

The new draft Guidelines alter the Bureau's approach to investigating predatory pricing allegations in three primary ways. In summary, they alter the definition of "cost" used to determine whether prices are unreasonably low, they eliminate

"ability to recoup losses" as the primary screening criterion for proceeding on complaints, and they address unreasonably low pricing in the context of market expansion. The introduction of new concepts and the change from previous concepts make it important that the Guidelines be clear and consistent.

II. INDUSTRY BACKGROUND

As explained in our comments on the draft guidelines on the Abuse of Dominance provisions as applied to the retail grocery industry, grocery retailing in Canada is highly concentrated. There are only 2 or 3 major players at the wholesale level of the Canadian grocery industry, and four firms account for 75% of total Canadian food store sales. This high level of market concentration is largely the result of increasing returns to scale in store operations and firm-wide economies enabled by information technology. The industry is also highly vertically integrated: all of the major retail chains supply their corporate and franchised retail outlets through their own wholesaling operations. The major retail chains also enjoy national or at least region-wide reputations, which along with the economies associated with vertical integration facilitate rapid expansion in newly entered local markets.

A consumer preference for making all core food purchases at a single location close to home drives many of the important strategic decisions made by retailers: location, product coverage, variety, reputation building, branding, and pricing are all influenced by this preference. Asymmetric information about quality and

consumer heterogeneity also drive important dimensions of competition. Because, as recognized by the Bureau, there is often a fine line between predatory pricing and aggressive competition, it is important that the Bureau have a good understanding of these market realities when investigating allegations of unreasonably low pricing in the grocery industry.

An important consequence of the demand side characteristics of the market and the significant economies of scale and scope enjoyed by major chains is that entry by smaller independents into local markets can be very difficult. It is therefore important that the Competition Act be enforced vigourously to ensure that the major chains do not unfairly drive out the competitors: once they do so, they may enjoy a dominant position in the market for a long time.

III. Screening Criteria

The Guidelines indicate that the Bureau will first conduct an initial assessment of a claim of unreasonably low pricing in order to determine whether certain thresholds are met (Part 3.1). Only if these thresholds are crossed will the Bureau continue with its investigation.

A. “Below cost” criterion

The first threshold appears to involve a comparison of prices with costs: the Guidelines state the Bureau will go on to define the relevant market only if “prices appear to be below cost”.

As set out in Part 4.5, the Bureau now considers avoidable cost, rather than average variable cost, to be the appropriate measure of cost to be used in determining whether prices are ‘unreasonably low’. While we agree that avoidable cost is the appropriate cost concept, measurement of avoidable cost can be time consuming, especially when the firm under investigation produces multiple products or sells bundles of products (as is effectively the case with large grocery retailers). Furthermore, in Part 3.2 the draft recognizes that “information about the low-pricing firm’s costs may be limited at this early stage of the analysis (ie. before a formal inquiry is commenced).

The Guidelines should explain whether the initial assessment will include a comprehensive comparison of prices with measured avoidable cost, and how this comparison will be made given that the available information is likely to be limited. If the Bureau does not intend to fully measure avoidable cost during the preliminary assessment, the Guidelines should explain how the Bureau will determine when prices ‘appear’ to be below cost. This is an important issue for grocery retailers since, as explained in our comments on the grocery guidelines, below cost pricing in the grocery industry can take on complex forms.

Our main concern is that when determining whether prices ‘appear’ to be below costs during its initial assessment, the Bureau will apply an under-inclusive cost measure. Accounting systems often report variable costs (or acquisition costs in the case of retailers), but avoidable costs may also include ‘common’ or ‘fixed’ costs, which are not allocated by these systems to specific products. There may therefore be a tendency--resulting from a desire to quickly complete the initial assessment--to simply assume that prices can be compared to reported variable costs. The danger is that credible allegations of predatory pricing will be dismissed during the initial stage, and predation will be allowed to continue, because avoidable costs are underestimated.

For example, in the grocery industry, the most easily measurable costs are acquisition costs, but these do not include other components of avoidable cost. In addition, when predation in this industry takes the form of below cost pricing on a number of sku’s (as is often the case), the common costs of supplying the entire bundle of potentially under-priced goods are properly considered to be avoidable, but are typically not reported as acquisition costs.The danger here is that a comparison of prices with acquisition costs in the initial assessment stage may lead to a false conclusion that prices are reasonable.

B. Market Definition Criterion

The initial assessment of a complaint also includes market share thresholds. A complaint will not be investigated further unless the alleged predator has more

than a 35% market share, or if its share is ‘considerably greater’ than the shares of its rivals. This criterion is inconsistent with Part 5 in the draft Guidelines, which indicates that, in some circumstances, a new entrant may be able to successfully charge unreasonably low prices even when its current market share is low.

Thus a new entrant into a local market, with considerable resources derived from activities in other markets, may not cross the draft Guidelines’ market share thresholds, yet may still have the ability and incentive to drive out local market incumbents. Established national or retail chains can leverage their reputations to gain quick consumer acceptance in new local markets; their entry is also facilitated by significant economies of scale in distribution, and economies of scope that are available because of their vertically integrated nature. The Guidelines should recognize that a new entrant can, because of these advantages, quickly reap the anti-competitive benefits of pricing below cost by driving out smaller competitors, notwithstanding the fact that its market share is currently low.

IV. EVALUATION CRITERIA

A. Market Definition

The Bureau has indicated that it will not pursue complaints unless the low-pricing firm has more than 35% market share or a share considerably greater than its rivals. In defining the relevant market for assessing market shares, the Bureau states that it will look at the functional characteristics of products, the views, strategies, and behaviour of sellers and buyers, and other factors when defining markets, but it does not explain *how* this information will be used to define relevant markets. This stands in contrast with the Bureau's Enforcement *Guidelines on the Abuse of Dominance* ("EGADs"), which explain that a modified 'hypothetical monopolist' test ("HMT") will be used to define markets.[1] The draft Guidelines on Abuse of Dominance Provisions as Applied to the Retail Grocery Industry and the Bureau's Intellectual Property Enforcement Guidelines ("IPEGs") also follow the Merger Enforcement Guidelines ("MEGs") in endorsing the HMT. Since all of these Guidelines, with the exception of the MEGs, also cover allegations of unreasonably low pricing, the lack of a detailed explanation in the current draft Guidelines of how the Bureau defines markets is bound to create confusion for business, complainants and the targets of complaints alike.

[1] A "hypothetical monopolist" test for relevant market asks whether, given a proposed market definition, a sole supplier of all the products in the candidate market would be able to profitably impose a small but significant (say, on the order of 5%) non-transitory (lasting, say, a year or more) increase in prices on consumers. If not, then that suggests

B. Relevant Cost Concept

Part 4.5 explains that "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."

We agree that avoidable cost is the correct cost concept for assessing unreasonably low pricing. Measuring avoidable cost, however, is a complex task, especially when the firm under investigation produces multiple products. Prompt resolution of claims of unreasonably low pricing would be facilitated if the Bureau described in the Guidelines the principles involved in measuring these costs. This would allow complainants to collect and present the kinds of information that the Bureau is likely to find useful in assessing a claim (this should be one of the primary purposes of any set of guidelines). Companies subject to an allegation of predation could similarly attempt to refute a claim by presenting only relevant information. The draft Guidelines currently contain no explanation of how avoidable costs are to be measured.

C. Anti-competitive Effect

Part 4.3 of the draft Guidelines discusses the Bureau's proposed approach to assessing the competitive impact of unreasonably low pricing. This represents a

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that there are close enough substitutes available that should be included in the the relevant market.

change from previous policy in that the Bureau is announcing in these guidelines that it will no longer screen cases on the basis of whether it appears that the low-pricing firm would be able to recoup its losses. While this is a welcome change, we are concerned that the Bureau's current approach is not sufficiently specific; in particular the Bureau has not identified what factors or analytical methods it will be using to determine when a low-pricing policy has the 'tendency' of substantially lessening competition or of eliminating a competitor. The draft indicates that the Bureau interprets 'tendency' as implying "more than the mere possibility that the policy will have 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".

The Bureau should clarify what it means by 'probably'. We are concerned that the competitive effects test will be applied too conservatively, as when unreasonably low pricing is found to be anti-competitive only when the probability that on-going predation will succeed approaches certainty. Such a policy could encourage dominant suppliers to employ potentially anti-competitive strategies that are low cost with limited probability of success. This is particularly troublesome when unreasonably low pricing has little business justification.

The Guidelines should also clarify how the Bureau will measure the likelihood that an unreasonably low-pricing strategy will substantially lessen competition or

eliminate a competitor. Is it sufficient, in the latter case, for the Bureau to have evidence that a competitor is likely to exit the market if the low pricing continues?

D. Market Power

Another difficulty with this Part is that the discussion of competitive impacts is limited to consideration of *existing* market power, which is proxied by a high share of a market with significant barriers to entry. However, below-cost pricing can harm competition even when the alleged predator does not possess significant market power before the predatory period. Predation should not be illegal only when it adds to existing market power. Again, this principle is recognized in Part 5 of the draft Guidelines, which deals with low pricing by new entrants. The Part of the Guidelines dealing with competitive impact should also explicitly recognize this principle. The Guidelines should also explain what factors, beyond current market share and barriers to entry, will be considered in an analysis that seeks to determine whether low pricing will substantially lessen competition or eliminate a competitor.

E. Barriers to Entry

The Bureau devotes considerable attention to the identification of potential barriers to entry. We believe there should be more attention to devoted to the barriers of scope and scale, as these are particularly significant in the grocery industry. Currently, this major source of barriers to entry is only mentioned in

passing on p. 11 in a paragraph that is principally devoted to formal regulatory and legal barriers.

In addition, it is important for the grocery industry to recognize the barrier to entry created by search costs. In order to compete effectively in the grocery industry, a firm has to communicate information about a huge array of products to its potential customers. The costs of advertising, and of obtaining sufficient market exposure to acquaint customers with the full range of prices and services offered by a potential competitor, is an important barrier to entry in the grocery industry which is not currently addressed in the Bureau's draft guidelines.

F. "Elimination" of a Competitor

The Bureau indicates that to conclude that a competitor has been eliminated, it "must be satisfied that a competing firm has, in fact, gone out of business or its otherwise no longer in a position to be an effective competitor in a particular market."

We are concerned that the Bureau's proposed approach will miss the elimination of competitors not by driving them from business entirely but by eliminating them from various lines or types of business. Grocery retailing is characterized by the bundling of many goods and services. Unreasonably low pricing could eliminate a competitor in selected lines or in providing particular services, even if the competitor continues to operate, albeit with a more restricted array of goods

and/or services. We believe the guidelines should recognize that the elimination of a competitor in this industry should be assessed at the level of goods and services, and not at the level of the existence or not of a firm.

G. “Temporary” or “Few Transactions” Low Pricing

Part 3.2 (“Preliminary Investigation”) indicates that “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.”

Below-cost entry into new geographic markets by dominant retail chains is a serious problem for independent grocers. Entrants often claim that their low pricing has a temporary ‘promotional’ purpose. However, even temporary low pricing can significantly harm smaller independents to the extent that they either exit the market or become less effective competitors. Consequently, a failure to address even temporary below-cost pricing can cause long term harm to competition. The Guidelines should therefore clearly state how the Bureau will determine whether on-going below cost pricing is temporary, and how it will ensure that such pricing does not cause competitive harm.

Part 4.2 states that "a particular price which applies to one, or relatively few, market transactions is unlikely by itself to constitute an unreasonably low pricing policy." This statement is ambiguous and we are concerned that it could be read to indicate, in the grocery industry, that prices on only a small number of products in a multi-product setting will not be evidence of a "low pricing policy."

In our comments on the draft *Enforcement Guidelines: Abuse of Dominance Provisions as Applied to the Retail Grocery Industry, we* expressed our concern that the Bureau had concluded that below cost pricing by a dominant grocery retailer on a small number of sku's would not violate the abuse of dominance provisions of the *Competition Act.* We explained that below-acquisition cost pricing on just a few products could result in substantial harm to competitors and competition. Since smaller grocers largely depend on the profits from a small number of 'core' products for their survival, low pricing of these products by dominant retailers could have a significant impact on the viability of independents. We also explained that even when a dominant retailer's prices for a small number of products are below acquisition cost, the revenues it earns on a wider range of products, essentially constituting a bundle that consumers purchase at a single outlet, may be below avoidable costs. The Guidelines should therefore clarify that the number of below-cost transactions sufficient to constitute an 'unreasonably low pricing policy' will be a function of the effects on competitor profitability of low pricing on particular transactions. Furthermore, the Guidelines should explain that the avoidable costs of a bundle of products will be

measured when this is appropriate. Otherwise, dominant firms may mistakenly conclude that by carefully targeting a small number of strategically important products, they are acting in conformity with the law.