Comments on draft Enforcement Guidelines for Illegal Trade Practices

Osler, Hoskin & Harcourt LLP welcomes the opportunity to comment on the Competition Bureau's draft *Enforcement Guidelines for Illegal Trade Practices: Unreasonably Low Pricing Policies under paragraphs 50(1)(b) and 50(1)(c) of the Competition Act* (the "Guidelines"). We applaud the Bureau's continuing efforts to clarify its enforcement policy with respect to various aspects of Canadian competition law through the publication of enforcement guidelines, information bulletins, press releases and other documents.

We recognize that enforcement guidelines are not binding on the Bureau and that the Bureau's enforcement policies and interpretation of the *Competition Act* (the "Act") will change in response to developments in economic theory, market conditions, judicial pronouncements and legislative amendments. The ongoing utility of the Bureau's enforcement guidelines depends on their regular review and updating, as necessary, to keep pace with such developments, and we agree with the Bureau's assessment that it would be appropriate to revise the 1992 *Predatory Pricing Enforcement Guidelines*. However, we note that the Competition Tribunal's decision in the upcoming *Air Canada* case may significantly affect the Bureau's interpretation and enforcement of the predatory pricing provisions in section 50(1) and that it may be prudent to await a decision in that case before issuing the Guidelines in final form.

We also note that the Industry Committee has recommended that paragraphs 50(1)(b) and 50(1)(c) of the Act be repealed and that predatory pricing be considered anti-competitive only as an aspect of abuse of dominant position.[1] It is possible that, in certain circumstances, below-cost pricing could be anti-competitive if engaged in by a firm that is not yet dominant (i.e., if there are barriers to entry and the below-cost pricing practice is likely to induce exit). However, we support the Industry Committee's conclusion that it is not appropriate to apply a criminal prohibition against unreasonably low pricing, since there is scope for considerable disagreement about what constitutes "unreasonably" low pricing and what the appropriate measures of costs and revenues should be in a particular case.

The Preface to the Guidelines indicates that transparency and certainty in the enforcement process are essential in the context of today's fast-paced, global economy. Certainty would be better achieved if the Bureau refrains from challenging conduct which adheres to the 1992 *Predatory Pricing Enforcement Guidelines* until such time as the new Guidelines are finalized. Once this occurs, the Guidelines should clearly indicate that, barring a ruling of the courts or the Tribunal to the contrary, the Guidelines will inform and reflect the Bureau's enforcement policy until such time as they may be amended following a period of public consultation.

Subject to the above and the Tribunal's decision in *Air Canada*, we offer the following general comments on the draft Guidelines. Comments relating to specific sections of the Guidelines appear below.[2]

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1 "A Plan to Modernize Canada's Competition Regime", Report of the Standing Committee on Industry, Science and Technology, April 2002, recommendation 21.

2 For ease of reference we have assigned paragraph numbers to the text in the body of the Guidelines (see attached) and refer to those paragraph numbers in these comments.

As recognized in the Introduction to the Guidelines, low pricing is generally not anti-competitive, and in fact is one of the principal objectives of maintaining competitive markets. While section 50 of the Act contains the phrase "unreasonably low pricing", in some cases the Guidelines refer to "low pricing" in a negative way. To avoid any suggestion that "low pricing" is presumptively or likely to be anti-competitive, this unqualified language should be avoided.

Although the Guidelines indicate in paragraph 13 that the courts have concluded that selling prices which are above costs can never be unreasonable, the distinction between "above cost" and "below cost" is not sufficiently well explained. In particular, the "avoidable cost" test that the Bureau indicates in the Preface will serve as the primary means of making this distinction is not further discussed or referred to in the body of the Guidelines until page 16. In our view, determining precisely what constitutes "below cost" is central to an analysis of predatory or unreasonably low pricing and warrants greater emphasis. In any event, the term "below-cost pricing" should be used instead of "low pricing" where reference is being made to an anti-competitive practice.

The Guidelines also refer in various places to a practice of strategically low pricing in order to deter entry. In our view, there is nothing improper or unlawful about such a practice. In establishing a price which is expected to maximize its profits, an incumbent firm is entitled to take into consideration the likely response to that price by actual and potential competitors. Such behaviour is lawful, economically rational and, to the extent it results in lower prices, beneficial to consumers. While an incumbent that reduces its prices below cost in response to a specific threat of entry may be engaged in predation, the Guidelines should not discourage incumbent firms from considering potential entrants when "strategically" establishing above-cost prices that are highly competitive.

Finally, in our view, the ability to recoup losses is an essential element of predatory pricing. The Guidelines should clearly indicate that, if a below-cost pricing strategy does not (or is not likely to) ultimately result in higher prices, lower quality or less choice, it is not harmful to consumers and will not be regarded as anti-competitive.

Part I: Introduction

The Introduction to the Guidelines recognizes the benefits of low prices stemming from legitimate competitive rivalry and the difficulty of distinguishing them from low prices resulting from anti-competitive behaviour. This is an important point and should be further emphasized. The Bureau should make it clear that it will err on the side of caution and pursue low pricing investigations only in the clearest of circumstances. Overzealous intervention may discourage the vigorous price competition that is a hallmark of competitive markets. If firms come to anticipate that every price cut may result in a competitor complaint and a detailed information request from the Competition Bureau they may be discouraged from cutting prices, resulting in greater price stickiness and increased conscious parallelism. Inappropriate intervention in the marketplace by the Bureau may have the unintended and perverse effect of encouraging higher prices and less price volatility.

The Introduction indicates that "unreasonably low pricing…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". This is different from the way the illegal trade practices are defined in section 50(1) of the Act.

The Bureau should clarify whether it is taking the position that intent ("design") to lessen competition substantially or eliminate competition is a prerequisite to enforcement activity.

Part 3: Enforcement Considerations

Paragraphs 11 and 12 suggest that the Bureau's low pricing enforcement activities are complaint driven. To provide some perspective on the extent to which a low price complaint is likely to result in a finding that the price is "unreasonably low", it would be helpful to include updated statistics on the number of complaints received by the Bureau and the number which have resulted in enforcement activity. This might also help to discourage unmeritorious complaints. If the Bureau engages in significant independent monitoring of pricing activity, this should also be described. Information on the factors considered by the Bureau in prioritizing its cases would also be helpful.

Paragraph 16 indicates that as a "threshold" matter, the Bureau assesses the likelihood that low-pricing behaviour "will harm competition, and therefore consumers and businesses". While it would certainly be inappropriate to continue an investigation into behaviour that will not likely harm competition, it should be noted that the prohibition in the *Act* relates to substantially lessening competition or eliminating a competitor. As noted by the Tribunal most recently in its redetermination of the *Superior Propane* case, not all lessening of competition is unlawful.

The safe harbour thresholds established for firms with market shares less than 35% and industries with low barriers to entry are relatively clear and will provide some certainty to certain businesses. However, the exception for a firm whose market share is less than 35% but "considerably greater than its rivals" is less clear. We suggest adopting a 35% safe harbour threshold in all cases, either without regard for the relative size of a firm's competitors or in conjunction with a 60% or 65% four-firm concentration threshold. Alternatively, it would be helpful to have some guidance on what is meant by "considerably greater" (e.g. a 10% gap, double the next highest share?) and whether a *de minimus* threshold will be applied (e.g., less than a 10% share).

The section on "preliminary examination" (paragraph 17) indicates that the Bureau considers the "duration, frequency, depth and pattern of the low-pricing behaviour". The Bureau should clarify whether price reductions of longer duration, greater frequency and greater magnitude are more or less likely to be considered anti-competitive. Also, it is unclear how the Bureau would have, at this stage of its investigation, credible information on the low-pricing firm's costs. We are concerned that at this stage the information provided by a complainant will be given too much weight by Bureau officials. The Bureau should be cautious and alert to strategic behaviour by complainants that may chill competitive rivalry.

Part 4: Elements of Unreasonably Low Pricing

2. Policy of Selling Products

Paragraph 36 refers to markets "where infrequent large tender calls constitute a significant portion of market transactions". The Guidelines should note that in such markets customers are likely to have significant countervailing power and it is unlikely that a low-pricing policy will have anti-competitive effects. In some jurisdictions, notably the European Union, "bid markets"

have been found to be competitive through the operation of such countervailing power even where the winning bidder may obtain a 100% market share.

Paragraph 37 seems more properly to belong in the section on "effect or tendency of substantially lessening competition" – perhaps after paragraph 44. It is also closely related to the discussion in paragraph 68, discussed below. Where paragraph 37 indicates that "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", this statement should be amended to state that, if the policy has not had an anti-competitive "effect" the Bureau will not take action unless the policy has a "substantially" anti-competitive "tendency" or "design".

3. Competitive Impact

The discussion of paragraph 50(1)(b) in paragraph 39 refers to "geographic markets". Although the *Act* refers to selling "in any area of Canada", we believe that the effects of any such policy should be evaluated with reference to relevant geographic antitrust markets, and the Guidelines should make it clear that this will be the Bureau's policy. (That is, eliminating a competitor in one "area" of a geographic market will not be regarded as having an impact on competition if there are no barriers to the expansion of competitors who are present in other areas of that market.)

(a) Effect or Tendency of Substantially Lessening Competition

Paragraph 44 suggests that the effect of a low pricing policy will be evaluated with respect to whether it prevents or lessens competition substantially, that is, whether it creates, preserves or enhances market power. Paragraph 46 then states that "the ability to engage in conduct which is predatory, exclusionary or disciplinary can itself be a good indication of the presence of market power." However, it cannot be concluded that a firm engaged in low pricing conduct has market power. Anyone can engage in a low pricing policy, yet this does not mean that (i) the person's intent is predatory, (ii) the person has market power, or (iii) the policy will be profitable. Only the ability to subsequently recoup lost profits is indicative of market power.

The sentence quoted above from paragraph 46 should be deleted from the Guidelines as it is likely to be misleading. The Guidelines should clearly indicate that low prices will not be considered evidence of market power.

The Guidelines should also refer to the more comprehensive discussion of the evaluation of market power and the delineation of relevant markets contained in the *Merger Enforcement Guidelines*.

Conditions of Entry and Exit – Behavioural Barriers

The reference to "excessive" investment in research and development or advertising in paragraph 58 should be explained or deleted, particularly since it is generally the policy of Industry Canada to encourage additional investment in research and development.

Paragraph 59 deals with natural/regulatory barriers to exit, not barriers created by firm behaviour. Accordingly, it should be moved to the section on "structural barriers" (after paragraph 56). The point that "barriers to exit…increase the prospects that competitors will

increase prices as opposed to exiting the market" is significant in that, in certain circumstances, a predatory pricing policy may substantially lessen competition without inducing exit.

Conditions of Entry and Exit – Reputational Barriers

The discussion in various places of "reputational barriers" refers to the effect of a reputation for "unreasonably low pricing". The Guidelines should not discourage firms from establishing a pattern of or reputation for low pricing as such behaviour will generally be pro-competitive. It would be helpful to emphasize in this section that pricing at or above cost, no matter how low, will never be considered anti-competitive.

Paragraph 63 should follow paragraph 51 as it is relevant to more than just reputational barriers. It should also be amended. Why would the time period set for evaluating the potential for new entry be shortened in cases where the industry is one "where only minimal investment and expertise is required and where there is a history of rapid effective entry"? A rational firm in such an industry is less likely to engage in predation given the diminished likelihood that costs could be recouped before entry is expected to occur. Adjusting the relevant time period based on the ease/history of entry in the manner described makes it more likely that predation will be artificially identified in industries where it is least likely to occur, and *vice versa*.

Conditions of Entry and Exit – Ability to Recoup Losses

The sentence which reads "a firm can recoup losses incurred in one market by exercising market power in another product or geographic market(s)" should be clarified to indicate that this can only occur as a result of reputation effects. Absent reputation effects, predation in one market will have no impact on a firm's ability to raise prices in another market, so there can be no "recoupment". While it is possible for a firm with market power to set off profits in market A against losses in market B, this behaviour is not economically rational unless the firm expects to recoup the losses in market B through bundling or future price increases.

The examples at the end of paragraph 64 (preserving long-term stability of an existing market structure, establishing an industry standard to exclude others or maintain market control) are examples of preserving market power through predation. Contrary to what the Guidelines indicate, they <u>are</u> examples of low-pricing behaviour motivated by the prospect of recoupment. However, such low-pricing behaviour is not necessarily unlawful if it is not intended to prevent or lessen competition or discipline or eliminate competitors.

In our view, the ability to recoup losses is an essential element of predatory pricing. Such recoupment need not always come in the form of higher prices – a firm that engages in predatory pricing and successfully eliminates some or all of its competitors may subsequently increase its profits through lowering expenditures on research and development or advertising rather than through instituting higher prices. While we appreciate that it may be difficult to demonstrate the likelihood of these effects and their impact on consumers in a court or the Tribunal, we believe it is very important for the Guidelines to clearly indicate that, if a below-cost pricing strategy does not (or is not likely to) ultimately result in higher prices, lower quality or less choice, it is not harmful to consumers and will not be regarded as anti-competitive.

(b) Effect or Tendency of Eliminating a Competitor

As indicated above, strategic low-pricing behaviour which deters entry is lawful and pro-competitive as long as the price is above an appropriate measure of cost. This section should be clarified.

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

Paragraph 68 indicates that a policy that is designed to substantially lessen competition or eliminate a competitor may contravene section 50 of the Act even if it is "entirely ineffective". We agree with the statement in paragraph 37 that a low-pricing policy with an anti-competitive "tendency" or "design" is subject to enforcement action even before it has had a noticeably anti-competitive impact. However, a policy that is unlikely to have or incapable of having an anti-competitive impact should not be subject to enforcement action regardless of the policy's design. A corporation with no market power and no prospect of attaining a dominant position should never be found to violate the unreasonably low pricing provisions of the *Act*, even if the corporation's marketing documents reflect a desire to "crush" the competition.

4. Prices Lower than Those Exacted Elsewhere in Canada

As indicated above in the discussion of paragraph 39, we believe that the effects of a policy of selling products at different prices in different areas of Canada should be evaluated with reference to relevant geographic antitrust markets, and the Guidelines should make it clear that this will be the Bureau's policy. Eliminating a competitor in one "area" of a geographic market will have no impact on competition if there are no barriers to the expansion of competitors in other areas.

5. Prices That Are "Unreasonably Low"

While it is important that the Bureau's analysis of whether a price is unreasonably low consider "more than just the amounts of the prices or their relationship to costs", it is equally important that the Guidelines provide sufficient certainty to avoid deterring vigorous and aggressive price competition. The Guidelines should emphasize (as the courts have indicated) that above-cost pricing will never be considered unreasonably low and that a price below an appropriate measure of cost will only be considered unreasonable if there is no valid business justification for it.

In particular, the statement in paragraph 73 that "a firm that charges a price insufficient to [cover its costs] without a legitimate business justification will not pass the Bureau's cost-based test" should be expressed in the converse (that is, a firm that covers its costs will pass the test). At the very least, explicit reference should be made to avoidable costs.

Apart from indicating that avoidable costs generally do not include sunk costs and may differ depending on the time period in question, there is very little guidance provided on the meaning of avoidable costs. In contrast, section 2.2.2 of the 1992 *Predatory Pricing Enforcement Guidelines* included specific examples of costs which would be considered variable. The discussion of avoidable costs in the draft *Enforcement Guidelines on the Abuse of Dominance in*

the Airline Industry is quite detailed. The Guidelines would benefit from such a discussion and, in particular, an explanation of how avoidable costs differ from variable costs.[3]

The Guidelines should also clearly indicate that the avoidable cost test has not been recognized by the courts and that, subject to any guidance obtained from the Tribunal in the *Air Canada* case, is only the Bureau's interpretation of the relevant measure of costs.

Why would "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" (paragraph 75) be different? Costs should only be considered avoidable if they are avoidable over the time period covered by the Bureau's examination. This time period should be sufficiently long to account for seasonal variations or fluctuations in demand, in addition to "random" fluctuations.

We agree that common costs incurred in the production of more than one product should ordinarily be considered unavoidable. The Guidelines should clarify whether this would still be the Bureau's position if a firm is not covering the variable costs of producing any of its products.

Part 5: Low Pricing Resulting From Market Expansion

The draft *Enforcement Guidelines on the Abuse of Dominance Provisions as Applied to the Retail Grocery Industry* indicate in section 5.2.2 that most large-scale retail grocery entrants incur losses in the first six months. While the reasonableness of a period of start-up losses will depend on industry-specific factors and market conditions, it would be helpful if this section provided some guidance on the length of a below-cost promotional period that will be considered by the Bureau to be reasonable.[4]

The third bullet in paragraph 82 should refer to the requirement in the Act that the conduct would substantially lessen competition or eliminate a competitor (not simply "would harm competition").

Part 6: Enforcement Outcomes

Paragraph 86 indicates that a fine may be imposed *in lieu* of a prison term for a violation of paragraphs 50(1)(b) or 50(1)(c). Since this penalty is not prescribed by the Act the Guidelines should indicate the authority for it (sections 734 and 735 of the *Criminal Code*?) and clarify that, for a person other than a corporation, a fine can also be imposed in addition to a prison term.

The discussion of other remedies should refer to the possibility of proceeding under section 79 of the Act.

Other Comments

- Interpretation: The statement that "These Guidelines supersede all previous statements of the Commissioner of Competition (the "Commissioner") or other officials of the Competition

[3] The avoidable cost of producing quantity Q of product X can be defined as the sum of the variable cost of producing Q units of X plus the fixed non-sunk costs attributable to only product X.

[4] According to the Industry Committee report, above, Amazon.com was founded in 1995 and has not yet priced above cost, but is not engaged in predatory pricing.

Bureau" should be narrowed to refer only to statements on the interpretation and enforcement of section 50(1) of the Act, including the 1992 *Predatory Pricing Enforcement Guidelines*.

- Paragraph 16: The first bullet should be changed to read: "…by the incumbent firm unless its market share is considerably greater than that of its rivals."

- Paragraph 20: There is a period missing from the end of the paragraph.

- Paragraph 35: There is a word or words missing from the first clause of the second sentence ("…the Court found that for any course of pricing action to be considered a "policy of selling"…").

- Paragraph 50: The last sentence indicates that "the Bureau usually will pursue cases where the low-pricing incumbent firm has a market share of more than 35%". The policy should be stated in the negative: "the Bureau will generally not pursue cases where the low-pricing incumbent firm has a market share of 35% or less".

- Paragraph 51: In the last sentence of the paragraph, change "will" to "may".

- Paragraph 56: Change the last sentence to: "Where sunk costs represent a significant part of the investment needed for entry or expansion, the investment is viewed by potential entrants as being of higher risk."

- Paragraph 65: Change "will continue to be" to "is".

- Paragraph 78: It is unclear how charging a low price would enable a firm to build inventory. This example should be deleted.

- As noted above, references to "strategic pricing behaviour" should be changed. All pricing decisions are strategic, and strategic pricing behaviour is not *per se* (or even presumptively) unlawful.