UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

Commonwealth of Virginia
House of Delegates
Richmond, VA

Dear Delegate McDonnell:

The staff of the Office of Policy Planning and the Bureau of Competition of the Federal Trade Commission welcome the opportunity to submit this letter in response to your request for comments on Senate Bill No. 458, "Below-Cost Sales of Motor Fuels."(1)

Proponents of Senate Bill 458 suggest that the legislation is necessary to prevent large retail and convenience store chains from slashing gasoline prices below cost, driving independent service stations out of business, and then raising prices to monopoly levels once the competition has been eliminated.(5) However, such anticompetitive below-cost pricing ("predatory pricing") is already illegal under federal antitrust laws.(6)

The federal antitrust laws are fundamental to national economic policy. We, as a nation, have determined that the economic needs of the American people are best served by competitive markets. Under our free market system, the wants and desires of consumers, as expressed by their dollar votes in the marketplace, determine what gets produced, how much gets produced, and who gets the reward from that production. The antitrust laws are instrumental to our free market system because they ensure that markets remain competitive, efficient, and dynamic.

The antitrust laws have performed exceptionally well ever since the enactment of the Sherman Act in 1890. The U.S. economy is the most competitive and the most vibrant economy in the world, and indeed is the envy of the world. The antitrust laws and their enforcement are a major part of that success.

Under these laws, both the Federal Trade Commission and the Antitrust Division of the United States Department of Justice may bring enforcement actions against predatory pricing. The federal government has launched several predation investigations and cases during the past several years. Notable examples include *American Airlines*, *Intel*, and *Microsoft*.(7) In addition, private plaintiffs and state attorneys general have the right to bring predatory pricing cases. Under Section 4 of the Clayton Act, any person who has been injured in his business or property as a result of conduct forbidden by the antitrust laws can seek treble damages for that injury.(8) State attorneys general, acting as parens patriae, may also bring such actions.

Although predatory pricing is illegal, the United States Supreme Court has taken great pains to ensure that antitrust law is not used to prevent procompetitive price-cutting. It is axiomatic that the antitrust laws are intended for "the protection of competition, not competitors."(9) That is, the federal antitrust laws are intended to promote and maintain legitimate, vigorous price competition, irrespective of how individual competitors may fare in the face of such competition.(10) Vigorous price competition forces producers to minimize costs and prices and to increase quality. Through this dynamic, consumer welfare is maximized because consumers reap the benefits of lower prices, greater variety, and higher quality goods and services. Indeed, the Court, in several important antitrust decisions, has been absolutely clear that consumer welfare is the linchpin of the antitrust laws, and that low prices, as a general matter, are "a boon to consumers."(11)

Indeed, the Court has spoken directly and definitively to the lawfulness of low pricing strategies. In *Brooke Group*, the seminal case that originated here in the Fourth Circuit, the Supreme Court left no doubt that a decrease in a plaintiff's profits from a reduction in the defendant's prices, by itself, is not unlawful under the antitrust laws. "Low prices benefit consumers regardless of how those prices are set."(12) Rather, to be unlawful, the low prices minimally must be predatory. "[S]o long as they are above predatory levels, [low prices] do not threaten competition. ... We have adhered to this principle regardless of the type of antitrust claim involved."(13) "[W]e have rejected elsewhere the notion that above-cost prices that are below general market levels or the costs of a firm's competitors inflict injury to competition cognizable under the antitrust laws."(14)

The Court has defined predatory pricing, in turn, as "pricing below an appropriate measure of [the defendant's] cost for the purpose of eliminating competitors in the short run and reducing competition in the long run."(15) Although the Court has not stated what the appropriate measure of cost should be, prominent antitrust scholars and several federal circuit courts have concluded that the price-cutter's marginal costs, or a close proxy such as average variable costs, should be the yardstick.(16)

It is important to keep in mind that, whatever cost measure is chosen, the pertinent comparison is to the price-cutter's cost, not the costs of its rivals. If the *price-cutter* has lower costs, and thus is more efficient, than its rivals, no predatory pricing occurs when it prices above its own costs, irrespective of whether those prices are below its rivals'

costs. "To hold that the antitrust laws protect competitors from the loss of profits due to such price competition would, in effect, render illegal any decision by a firm to cut prices in order to increase market share."(17)

Below-cost pricing by itself, however, is insufficient under the antitrust laws to constitute a violation. Consumers are not harmed by below-cost pricing unless they will see sustained above-cost prices later on:

[T]he short-run loss is definite, but the long-run gain depends on successfully neutralizing the competition. Moreover, it is not enough simply to achieve monopoly power, as monopoly pricing may breed quick entry by new competitors eager to share in the excess profits. The success of any predatory scheme depends on maintaining monopoly power for long enough both to recoup the predator's losses and to harvest some additional gain.(18)

Thus, even if a below-cost pricing strategy succeeds in temporarily reducing the number of competitors, the price-cutter must be able to find a way to keep competitors from returning after it tries to raise prices again. Otherwise, the below-cost pricing strategy, which requires that the firm incur losses on every sale, will not succeed. When a firm is unable to recoup short-run losses (from sales at below-cost prices) in the long-run, consumers enjoy a windfall. And, without harm to consumers, an antitrust violation does not occur. "The second prerequisite to holding a competitor liable [under the federal antitrust laws] for charging low prices is a demonstration that the competitor had a dangerous probability of recouping its investment in below-cost prices. ... Evidence of below-cost pricing is not alone sufficient to permit an inference of probable recoupment and injury to competition...That below-cost pricing may impose painful losses on its target is of no moment to the antitrust laws if competition is not injured."(19)

Given the strong stance of the Supreme Court in favor of the benefits of low prices and the care it has devoted to explaining what types of price cutting are illegal under the antitrust laws, it is doubtful that new legislation is necessary to prevent the same harms to consumers.

III. Scholarly studies and court decisions suggest that anticompetitive below-cost pricing rarely happens.

To assess whether this bill is necessary, Virginia legislators may find it helpful to consider the extensive scholarship and court decisions on anticompetitive below-cost pricing. In an exhaustive discussion of the topic, Judge Frank Easterbrook of the U.S. Court of Appeals for the Seventh Circuit noted that "[s]tudies of many industries find little evidence of profitable predatory practices in the United States or abroad. These studies are consistent with the result of actual litigation; courts routinely find that there has been no predation."(20)

More recent analyses largely confirm Easterbrook's conclusion. A leading textbook on industrial organization economics notes, "Given all the problems in identifying predatory pricing, it is not surprising that economists and lawyers have found few instances of successful price predation in which rivals are driven out of business and prices then rise. Although predation is frequently alleged in law suits, careful examination of these cases indicates that predation in the sense of pricing below cost usually did not occur."(21) Predation sometimes occurs(22), but not nearly as frequently as claimed.

Because it is difficult to profit from anticompetitive below-cost pricing, the Supreme Court, in keeping with scholarship on this point, has found that "there is a consensus among commentators that predatory pricing schemes are rarely tried, and even more rarely successful."(23) Therefore, the Court has emphasized the need to take great care to distinguish between procompetitive price cutting and anticompetitive predation because "cutting prices in order to increase business often is the very essence of competition..."(24) "To hold that the antitrust laws protect competitors from the loss of profits due to ... price competition would, in effect, render illegal any decision by a firm to cut prices in order to increase market share. The antitrust laws require no such perverse result."(25)

In short, the proposed legislation appears to address a problem that not only is already covered under federal antitrust law, but also is relatively unlikely to occur in any event.

IV. Past studies show that anticompetitive below -

Anticompetitive price-cutting is already illegal under federal antitrust laws. Senate Bill 458, however, would outlaw more types of pricing behavior than federal antitrust laws do, and so it runs the risk of penalizing procompetitive price-cutting that benefits consumers.

Under the bill, a retailer must "cease and desist" upon notification by the Commissioner of the Department of Motor Vehicles that the retailer sold fuel below cost and does not qualify for any of the exemptions listed in the bill. The Commissioner can also impose a civil fine of $5,000 for

Sincerely,

Ted Cruz, Director
Jerry Ellig, Deputy Director
Office of Policy Planning

Joseph Simons, Director

and Means Committee, Other Taxes and Revenues Subcommittee, South Carolina House of Representatives (May 12, 1989).

5. Dina ElBoghdady, "The High Price of Cheap Gas," Washington Post, February 1, 2002, p. E01.

6. Predatory pricing claims are brought under Section 2 of the Sherman Act, 15 U.S.C. § 2. Plaintiffs can also claim anticompetitive predation under the Robinson-Patman Act, 15 U.S.C. § 13(a) (as amended).

7. *United States v. AMR Corp*., 2001-1 Trade Cas. (CCH) ¶ 73,251 (D.Kan. 2001); *In re Intel Corp*., No. 9288 (FTC Aug. 3, 1999); *United States v. Microsoft Corp*., 97 F.Supp.2d 30 (D.D.C.), judgment entered, 97 F. Supp.2d 59 (D.D.C. 2000), No. 00-5212 (D.C. Cir. June 13, 2000).

8. 15 U.S.C. § 15.

9. *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 488 (1977) (quoting *Brown Shoe Co. v. United States*, 370 U.S. 294, 320 (1962)).

10. Many state antitrust statutes require that state courts follow federal precedent in state antitrust cases. Virginia's antitrust law does not specifically say this, but it does read, "Nothing contained in this chapter shall make unlawful conduct that is authorized, regulated or approved...by an administrative or constitutionally established agency of this Commonwealth or of the United States having jurisdiction of the subject matter and having authority to consider the anticompetitive effect, if any, of such conduct." Code of Virginia, 1950, Title 59.1 Ch. 1.1, § 59.1-9.4(b). This provision appears to say that Virginia courts cannot declare illegal under Virginia's antitrust law any conduct that U.S. courts have declared legal.

11. *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp*., 509 U.S. 209, 224 (1993); *Atlantic Richfield Co. v. USA Petroleum Co*., 495 U.S. 328 (1990); *Matsushita Elec. Indus. Co. v. Zenith Radio Corp*., 475 U.S. 574 (1986).

12. *Brooke Group*, 509 U.S. at 223.

19. *Brooke Group*, 509 U.S. at 224, 226.

20. Frank H. Easterbrook, "Predatory Strategies and Counter-Strategies," 48 U. of Chicago L. Rev. 313 (1981).

21. Dennis W. Carlton and Jeffrey M. Perloff. Modern Industrial Organization 342 (Addison-Wesley, 2000).

22. Jeffrey Church and Roger Ware, Industrial Organization: A Strategic Approach 659 (Irwin McGraw-Hill, 2000).

23. *Matsushita Elec*., 475 U.S. at 589.