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Organisation de Coopération et de Développement Economiques
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DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE

1. Types of Predatory Foreclosure.

1. For the purpose of this discussion, we will define predatory foreclosure as a unilateral act in which one firm seeks to impose costs on its rivals with the aim of reducing competition. The instruments chosen by a firm to accomplish this may or may not involve its own price. A wide class of predatory foreclosure strategies involves acts that lose money, in some relevant sense, in the short term. The classical example of this is, of course, predatory pricing, which involves setting price below marginal cost, at least conceptually. The presumed goal of doing so is to induce rivals to exit, making the market less competitive and allowing the "predator" to more than recoup the short-term losses associated with its predatory conduct.

2. To prove a predatory pricing claim, the plaintiff must be able to show that the defendant firm has priced below a good estimate of marginal cost. In addition, a predatory pricing claim must pass the recoupment test. The need for a recoupment test may not be self-evident, yet it serves as a valuable safeguard against confusing aggressive, pro-consumer competition with anticompetitive conduct. The recoupment test demands, in effect, that the plaintiff demonstrate that predation is plausibly a rational strategy. In particular, if the plaintiff cannot demonstrate that the short-term losses associated with its actions will be recouped by supracompetitive pricing in the long run, we are left with several unanswered questions, none of which bode well for the plaintiff. Among these questions are the following: Does the plaintiff's theory imply that the defendant firm is irrational, losing money in the short run for no apparent long run gain? Is the measure of cost presented by the plaintiff flawed? Is the plaintiff's theory of the case

7. In the mid-1990's, American Airlines ("AA") had a large hub at the Dallas-Fort Worth, Texas airport ("DFW") and, the Division contended, substantial power to set rates on at least 30 city-pair routes. Competition from so-called low-cost carriers ("LCCs") began to surface. LCCs can pose a competitive threat to dominant carriers, such as AA at DFW, because they have significantly lower operating costs than the major airlines. For example, when ValueJet created a mini-hub in Atlanta, Georgia, Delta Airlines lost $282 million in annual revenue from its Atlanta hub. Delta's experience in Atlanta so worried AA that it created an internal Task Force to develop a strategy to make LCCs unprofitable at DFW. The Task Force concluded that any such strategy would be very expensive in terms of AA's short-term profitability because it would include adding capacity to significantly reduce the amount of traffic an LCC could capture. Nonetheless, because AA had determined that a successful LCC hub at DFW would jeopardize at least $252 million of AA's annual DFW revenues, AA went ahead and added significant extra capacity on routes threatened by nascent LCC competitors.

8. The Division's investigation concluded that, in five separate episodes, AA added excess capacity in order to drive a competing LCC off the route. AA overrode its own capacity planning models and added at least 3 - and in some cases as many as 5 - seats for each additional passenger that AA gained on these routes. And in each case, after the LCC exited the route, AA reduced capacity and increased its prices. Using AA's accounting system data, the DOJ staff was able to determine that the cost of the

expected this strategy to prove successful. Moreover, AA knew that this process would be very costly in the short run, but that the losses on the five routes where foreclosure occurred (which were quantified at $41 million) were acceptable because AA was protecting $250 million in annual revenue.

13. Although the court of appeals affirmed the district court, it did not disagree with DOJ's theory. It agreed with the DOJ's broad position that although courts should continue to approach predation cases with caution, they should not treat them with the incredulity that once existed. In making this proclamation the court relied on recent literature that explains predatory pricing can make sense in a multi-market scenario. The court also rejected outright the district court's holding that route-wide AVC is the only appropriate cost measure, because in certain circumstance a market-wide approach could mask a particular predatory scheme (as we had argued it did in the AA case). The court also recited uncritically the Division's incremental cost test and then proceeded to consider whether each of the proposed cost tests were valid as a matter of law. Ultimately, it affirmed the district court on the narrow ground that all of our cost tests were factually flawed because they relied on cost allocations and, therefore, were not "precise" in computing AA's "actual" cost of adding the challenged capacity.

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14. Significantly, the court did not address the Division's recoupment theory at all. The court easily could have affirmed if it agreed with the disi th5o3(.)1.4(e9(tf)e)1 Ar(f)-1.(tf)'(f)-7.3(s)10.in-u.9((rm)19.a7(

able to restrict entry into a regulated industry merely by filing objections to applications by potential entrants, this can be virtually costless, but highly effective. Moreover, it can be much cheaper for incumbents to object than for entrants to surmount the objection, and the mere fact of the objection creates a very powerful barrier to entry. Also, if a standards setting organization is powerful and is respected, its standard may define a relevant market, so that a firm that is able to manipulate the process may gain market power at small direct cost to itself. This is especially true given the potentially large costs of changing a standard once an industry is locked into it.

4. Additional Comments.

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