Chapter Seven
Predatory Pricing

7.1 Introduction

In the previous chapter, we described how the Groceries Order operates both as a serious restriction on competition and as a serious interference in the freedom to trade and how, in our view, this can only be justified if clearly identifiable benefits accrue to all. Before drawing conclusions from this fact, it is necessary to examine whether or not such benefits might exist.

It has been suggested by virtually all those who support retention of the Order that one such benefit is the prevention of predatory pricing on the part of the country's largest retailers. This contention requires careful examination.

Among the positive benefits of competition in the economy are those of consumer choice and low prices. In a highly competitive market a business will be encouraged to lower prices in order to attract customers and gain market share. A perfect example of this is the low fare airline operators who have successfully built their business on the back of a no-frills, low fare promise to customers. Other airlines have been forced to enhance the efficiency of their operation so as to cut costs and try to match their competitors for price and value. That airline customers have benefited from this evolution in the marketplace is unquestionable.

Low prices are a good thing for consumers and are a consequence of greater competition. The difficulty arises in determining when we have had too much of a good thing – in other words when does a low price become a predatory price?

7.2 Submissions on Predatory Pricing

As indicated, it is a view universally expressed by those who wish to see the Groceries Order retained that one of its principal benefits is the prevention of predatory pricing. A very significant number of independent retailers, for example, have expressed the fear that their livelihoods may be at risk if the Groceries Order is removed or amended. They believe a change in the legislation may encourage predatory action on the part of large multiple supermarkets who will begin selling at super-low prices leaving smaller outlets unable to compete. Others have expressed views in the following terms:

RGDATA: (The removal of the Groceries Order) *"would also lead to the advent of predatory pricing without any effective control mechanism to prevent such activity by the multiples…It is a device that is not available to all retailers, but which allows those, which are the biggest, best resourced and most powerful, put competitors under unfair and unreasonable pressure."*

ADM Londis: *"The removal of the ban on below cost selling will…facilitate anti-competitive predatory pricing tactics by the multiples."*

BWGFL: *"The Groceries Order is good for consumer choice because it prohibits predatory pricing. Selling at below cost is a short term predatory pricing tactic aimed at putting competitors out of business. Concentration of the grocery market in a number of larger operators has a dramatic negative impact on consumer choice."*

IBEC: *"The thrust of the Order was to prevent the use of below cost selling/predatory pricing (financed by suppliers) by one or more parties from being used to cause other parties to exit the sector. The Order recognised that consumers can be misled into believing that deep discounting of Known Value Items (KVI's) applies to all products across the store. The reality is that the retailer's margin is recovered on other products in the shopping basket to which the shopper is less price sensitive."*

Joint Oireachtas Committee: *"Below cost selling, even where it is only for occasional promotional purposes, is an unfair trading practice. It is an artificial practice that does not take place in any other business sector. Banning the practice does not interfere with the market in grocery goods. It cannot be considered to be normal for a company to sell goods below the cost of purchase. Below cost selling can be used for predatory purposes with a view to putting competitors out of business. There is no law to prevent multiple retailers from reducing prices in individual stores so as to target competitors. After competitors have had to close, the multiple supermarkets can then increase prices."*

There are many assumptions in the foregoing submissions with which we take serious issue. Not least is the notion that all below cost selling is predatory. This is patently not the case.

7.3 What is Predatory Pricing?

Predatory pricing is a pricing strategy that is undertaken by business in order to damage or eliminate a competitor. The practice is generally taken to mean selling certain key products at a price that is below some measure of cost.

In a typical scenario, a large retailer engages in selling below cost on a persistent basis and in so doing he lures customers away from other, smaller or specialist, retailers that are unable to compete with the unreasonably low prices. This ultimately forces the smaller retailer out of business and the predator, left with the market to himself, can increase prices to whatever level he likes. The customer, with nowhere else to shop, has no choice but to pay up.

Furthermore, the predator must have some level of certainty that once the competitor has exited the market, he won't re-enter, or alternatively, that he won't be replaced with some new entrant.

The most celebrated victim of predatory pricing in the Irish grocery market is the H. Williams Group which, it is alleged, went out of business in 1987 as a result of a predatory pricing campaign waged by their competitors. It is H. Williams, we are told by many proponents of the Groceries Order, that caused the Order to be introduced in the first instance.

7.4 Below Cost Selling

There are a number of criteria that must be met before a retailer's pricing strategy can be considered predatory. Selling below cost is one such criterion and, therefore, finding an acceptable or agreed definition of "cost" is a critical factor.

"Below cost" is regarded by some as a price that is below cost plus a margin that reflects the need for all business to make a profit but we do not find this to be a commonly held view.

It is generally accepted, however, that "cost" is greater than simply the purchase price paid by the retailer for the product in question. It also includes the operating/overhead costs incurred by the retailer in actually bringing the product to the market. It is difficult, if not impossible, to apportion such costs to individual products on a retailer's shelves. Certainly, the UK Competition Commission's Report on the UK grocery sector found that the major UK multiples did not, in most cases, apportion operating costs or overheads to particular product lines.[1]

Professor Paul Dobson of Loughborough University defines below-cost selling as follows:[2]

> *"Pricing a good below its full economic cost in respect of the cost of purchase and resale."*

Professor Dobson goes on to comment that: *"Here cost of purchase should take account of the purchase price paid per unit along with any quantity discounts, rebates, over-riders and supplier's payments."* In other words, according to Professor Dobson's definition, purchase price should take account of all off-invoice discounts paid to the retailer.

The BWG Group in its submission has claimed that off-invoice discounts are an integral part of a retailer's margin. That is neither here nor there, in our view. Any form of income is part of the retailer's gross margin.

[1] "A Report on the Supply of Groceries from Multiple Stores in the United Kingdom" published in 2000 by the UK Competition Commission (this reference Para 7.154, Page 131)
[2] "The Economic Effects of Constant Below Cost Selling Practices by Grocery Retailers" by Professor Paul Dobson, The Business School, Loughborough University, July 2002 (Prepared on behalf of the The Federation of Bakers).

But BWG also claim that selling at a price representative of invoice cost less discounts (in other words, at a price less than the true purchase price of the product) would be a predatory tactic. We cannot agree with this assertion because, as we shall see, we consider that there are many legitimate reasons for selling a product below cost.

Furthermore, BWG believe that selling below invoice cost is predatory: *"To reduce prices below invoice cost for a sustained period can only be motivated by predatory tactics."*

It follows from what we have been saying that we cannot agree with this view either. However, in this case there is a further false premise in the argument because the invoice price is exclusive of discounts. Thus, it is not a reflection of true purchase price and has no relationship to cost whatsoever. The whole idea flies in the face of any accepted definition of predatory pricing that we have seen.

The logical conclusion of the BWG argument is that off-invoice discounts are somehow to be equated with operating costs, and that one should be offset against the other. If that is what is being suggested, then we reject it as a completely arbitrary notion that hugely distorts economic principles and should not be allowed to form the basis of the regulation of below cost selling.

In our view, any starting point for the calculation of cost must be the actual purchase price of the product and this must take account all discounts paid by the supplier regardless of when paid. This obviously would require finding some means to apportion such payments across different product lines but no other definition meets a simple logic test.

7.5 International Approach

Whatever the measure of cost, the practice of selling below cost is rarely considered sufficient on its own to justify a charge of predatory pricing.

A report prepared for the Ministry of Economic Affairs in the Netherlands and published in June 2005,[3] defines predatory pricing in the following terms:

> *"A predatory pricing strategy usually means that the predator:*
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> - *must be pricing below cost;*
> - *has an intent to eliminate specific competitors;*
> - *has market power (or dominance) to eliminate competitors;*
> - *is able to sustain future market power to recoup earlier losses.*

In a paper prepared for the Swedish Competition Authority[4] by Professor William J Baumol of New York University, predatory pricing is described as

[3] "What is the Impact of a Minimum Price Rule?" Report prepared for the Ministry of Economic Affairs of the Netherlands by Oxera Consulting Ltd, UK. Published June 2005.

"…the adoption of prices whose only logical purpose is the elimination of a competitor or prospective competitor." According to Professor Baumol there are three essential prerequisites for meeting a definition of predatory pricing. Initially, the strategy must (a) threaten competition and (b) have no legitimate business justification. Additionally, the predator must have what US Courts refer to as the "dangerous probability of recoupment" that is the ability, having eliminated the competition, to raise prices high enough and for long enough to recover the losses sustained in commission of the predatory act.

Similar definitions of predatory pricing are to be found in other organisations and jurisdictions.

The Organisation for Economic Cooperation and Development (OECD)

"The predator, already a dominant firm, sets its prices so low for a sufficient period of time that its competitors leave the market and others are deterred from entering. Assuming that the predator and its victims are equally efficient firms, this implies that the predator as well as its victims has incurred losses and that these losses are significant. For the predation to be rational, there must be some expectation that these present losses (or foregone profits), like any investment, will be made up by future gains."[5]

Competition Bureau of Canada

"The predatory pricing provisions address situations in which a firm engages in a policy of selling products below cost for a sufficiently long period of time to eliminate or deter rivals as competitors, and subsequently raises prices or otherwise harms the competitive process."[6]

Australian Competition & Consumer Commission

"The intention of the price cutting must be to eliminate or substantially damage a competitor, prevent the entry of a person into the market or deter or prevent a person from engaging in competitive conduct in a market.

It is this clear purpose that turns price cutting by a company with substantial market power into predatory pricing. Once competitors are

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[4] "The Pros and Cons of Low Prices" by William J. Baumol, Professor of Economics, New York University, and Professor Emeritus, Princeton University. Prepared for the Swedish Competition Authority.
[5] "Predatory Pricing", OECD, 1989.
[6] Competition Bureau of Canada, Glossary of Terms in the Canadian Competition Act, http://www.competitionbureau.gc.ca

eliminated the likely results are that the company can raise its prices, recoup its losses, and exploit consumers."[7]

7.6 Dominance

Predatory pricing is a tactic undertaken by a firm which is dominant in its market.

John Vickers, Chairman of the Office of Fair Trading in the UK puts it succinctly:

> *"Competition Law is unconcerned with low pricing by non-dominant firms."*[8]

Section 5 of the Competition Act, 2002 is modelled on Article 82 of the EU Treaty and is designed to prevent the abuse by an undertaking of a dominant position in the market: Section 5 (1) of the Act provides that:

> *"Any abuse by one or more undertakings of a dominant position in trade for any goods or services in the State or in any part of the State is prohibited."*

Section 5 (2) provides that such abuse may include:

> *"…directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions."*

There is European case law supporting the use of these provisions to establish predatory pricing. European jurisprudence in the matter is based on the so-called AKZO case involving the Dutch multi-national chemical company of that name. In December 1985 a fine was imposed on the company for a predatory abuse of a dominant position. The European Court of Justice rejected an appeal by AKZO in July 1991.[9]

RGDATA in their submission assert that the Competition Act, 2002 is not capable of preventing predatory pricing in the grocery trade. They state:

> *"RGDATA believes that reform of the Competition Act is required in a number of key areas before the fears of many supporters of the Order can be assuaged.*
>
> *Most importantly the…Act should be amended to provide a more realistic mechanism for a finding of predation by an undertaking that is not dominant but which has sufficient local or national market power."*

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[7] "What is Predatory pricing", Australian Competition & Consumer Commission, http://www.accc.gov.au/

[8] "Abuse of Market Power", Speech to the 31st Conference of the European Association for Research in Industrial Economics, Berlin, 3 September 2004.

[9] Judgment of the Court of Justice of 3 July 1991 in case C-62/86, AKZO Chemie BV v Commission, European Court reports 1991, page I-03359.

We see it as beyond the scope of this Report to provide a definition of dominance. This is an issue that provokes debate whenever and wherever anti-trust experts gather and there is no common approach across all jurisdictions. There is a wide body of European and international literature and jurisprudence that can be drawn on for those who wish to delve further. However, it is worth acknowledging that market share is often regarded as an important criterion in assessing dominance.

Based on some case studies we have examined, it seems unlikely that a firm will be considered to be dominant in a market if it holds less than 35% market share. On that basis no grocery retailer would be considered dominant in the national Irish market.

This would seem to us to be the essence of the RGDATA concern as expressed above.

However, the matter is more complex than this.

In the first instance, single firm dominance is not the only approach and there are circumstances in which one or more firms acting in concert might be considered to be abusing a jointly dominant position.

Neither does it have to be assessed on a national scale. Even a small retailer might be considered dominant in a small rural town if the structure of the market is such that consumers are unlikely to travel beyond its boundaries to buy groceries.

Market definition is, therefore, a factor in determining dominance and this is recognised in the 2002 Act when it refers to:

> "…abuse by one or more undertakings of a dominant position in trade for any goods or services in the State or in any part of the State is prohibited."

There is certainly evidence of the Competition Authority's willingness to consider dominance in local markets particularly in the context of the exercise by the Authority of their merger control functions. It has happened in the pharmacy sector and was also a feature of recent decisions of the Authority in the retail hardware sector.

The Authority also considered the issue of local market dominance in the case of alleged predatory pricing by the Drogheda Independent (DIC) in a decision published in February 2005. In this case, the Authority identified the relevant market in which the DIC competes as the market for advertising in local newspapers in the greater Drogheda area. [10]

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[10] The Authority held in this instance that DIC was not dominant, although it held a market share of between 65% and 75%, because of low barriers to entry and expansion, low customer switching costs, and the relative size of the DIC's rival, the Drogheda Leader, which constrained the ability of the DIC to

Frankly, we do not believe that RGDATA's concerns in this regard are well founded and it is our view that the terms of the 2002 Act are adequate protection against predatory action according to the accepted international anti-trust definition of the term.

7.7 Other Characteristics of Predatory Pricing

There is a long held view that the entire notion of predatory pricing is completely implausible; the idea that any business, no matter how powerful, would willingly and knowingly sell goods at a loss for a prolonged period of time in the hope that some day they will recoup those losses many times over, is nothing short of ludicrous. This theory would hold that predatory pricing is so expensive and the prospect of success is so uncertain that no business with any self-respect or survival instinct would engage in it.

There is also the view that predatory pricing is no more than the legitimate manifestation of vigorous competition. Why is it different, for example, than a large multi-national deciding to use its financial muscle to invest heavily, and at a loss, for a period of time in research and development activity? It might be motivated to do this because it believes it will come up with better and bigger products than its much smaller rivals and thus, ultimately, put them out of business.

Such theories may not have much credibility in practice and it is generally accepted that predation can take place in a modern economy. However, because it is expensive, there has to be some certainty that the losses incurred in predation can be recouped. One of the great fears of a predator is that having succeeded in eliminating the competition, other, bigger predators will be attracted into the market by the high margins that the predator is able to command as a result of his success.

Consequently, the existence of barriers to entry into a market place, while not a prerequisite for predation, can act as an encouragement to a prospective predator. Where such barriers exist, a predator can be more confident that others may be discouraged from entering such a protected market. Indeed it could be argued that the Retail Planning Guidelines currently in force might act as an encouragement to predatory tactics in the Irish retail market.

Great care needs to be taken to distinguish between legitimate competition and apparent acts of predation.

It is almost self-evident that inefficient firms will have their existence threatened by vigorous competition.

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profitably raise the price of advertising in its newspapers. Neither was its behaviour an abuse because it was indicative of intense competition in the market and benefited consumers as a result of permanently low prices.

The US Federal Trade Commission has pointed out that although predatory pricing is illegal*, "…the US Supreme Court has taken great pains to ensure that antitrust law is not used to prevent pro-competitive price cutting. It is axiomatic that the antitrust laws are intended for 'the protection of competition, not competitors'."*[11]

The FTC continued:

> *"…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."*

The corollary, supported also by the FTC, is that competition will encourage greater efficiency and allow resulting cost savings to be passed on to the consumer in the form of lower prices.

Professor Baumol in his paper for the Swedish Competition Authority[12] argues that *"…the great resemblance between predation and vigorous competition constitutes an open invitation to inefficient firms to attempt to subvert the antitrust agencies into granting them protection from the competition that they are incapable of meeting in the market…"*

It follows that unwarranted protection from vigorous competition encourages inefficiencies.

7.8 H. Williams

Equally, the existence of inefficient competitors might also encourage intense price competition that might have the effect of driving them out of the market.

Many submissions have referred to the fact that the Groceries Order was introduced in the wake of the demise of the H. Williams Group in the latter part of 1987. In fact, history does not necessarily confirm this theory.

The Restrictive Practices Commission recommended the introduction of a ban on below cost selling in its Report submitted to the Minister for Industry & Commerce in January 1987. That Report made no reference to H. Williams by way of justification for its recommendation.

The Minister accepted the recommendation and signed the 1987 Groceries Order in May 1987. H. Williams ceased trading the following autumn. We can find no evidence to suggest that the difficulties being experienced by the supermarket chain figured in the thinking of either the RPC in recommending

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[11] Federal Trade Commission letter dated February 2002 to House of Delegates, Virginia on the subject of below cost sales of motor fuels (and quoting Brown Shoe Co. v. United States, 370 U.S. 294, 320 (1962)). Letter to be found at http://www.ftc.gov.be/V020011.htm

[12] "The Pros and Cons of Low Prices", op. cit.

the ban, or of the Minister in accepting that recommendation and agreeing to sign the Order.

It is a fact that the Order was only confirmed by an Act of the Oireachtas in December, 1987 and it may well be that the closure of H. Williams contributed to the political will that existed at the time to confirm the Order. However, we have examined the Oireachtas debates of the time and find that the Minister for Industry & Commerce, Albert Reynolds, made only a passing reference to "the recent appointment of a receiver to one of the major multiple groups" when moving Second Stage of the Confirmation Bill in the Dáil[13] and no reference at all in his speech to the Seanad.[14]

Contemporaneous media reports would suggest H. Williams had been experiencing financial difficulties for some time before it ceased trading. It had gone from making a profit of £0.54m in 1976 to a loss of £0.6m in 1980 and Checkout Magazine reported in 1981 that: *"We feel sorriest for the H. W. workers who have a very dismal looking future as the company is again facing continuing losses.*[15]

The RPC in its review of the 1987 Order in 1991 stated that a number, but not all, witnesses to its enquiry had testified that the *"…demise of H. Williams was due to management deficiencies rather than being primarily caused by below cost selling."*[16]

Buisness and Finance reported: *"The best estimates available a week after the Bank of Ireland appointed Laurence Crowley* (as Receiver) *show a serious financial shortfall that could not have arisen in the few weeks since Ben Dunne cut his prices."* [17]

The Oireachtas debates on the Bill, confirming the order are also interesting, as the following selection of contributions will show:

> ***Mr. Cullen:*** *There has been mention here today of the problems surrounding H. Williams. I do not believe that group went to the wall on account of below-cost selling only. It might have been one factor involved in the business of operating a multiple chain supermarket. One must remember that other companies have been extremely successful, have grown, survived, have been in a better financial position. Perhaps the operations of the H. Williams chain were not properly thought out in financial terms, in terms of the products they carried, presentation and so on. I believe all of those factors were involved in the collapse of that chain.*
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> \- *Dáil Éireann - Volume 374 - 29 October, 1987*

[13] Dáil Éireann - Volume 374 - 29 October, 1987, Restrictive Practices (Confirmation of Order) Bill, 1987: Second Stage.
[14] Seanad Éireann - Volume 117 - 02 December, 1987, Restrictive Practices (Confirmation of Order) Bill, 1987: Second and Subsequent Stages.
[15] Checkout Magazine, November, 1981.
[16] FTC 1991 Report of Review of the 1987 Groceries Order, op. cit., Para. 7.119, P.83
[17] Business & Finance Magazine, 1 October, 1987

Mr. Leonard: *The recent failure of H. Williams must raise serious questions, not only for the suppliers but for the financial institutions who allowed this over expenditure. We heard that this firm failed because of competition from another multiple, but it is very hard to accept that because a firm does not fail overnight. The financial background of all these multiples should be closely monitored.*

- Dáil Éireann - Volume 374 - 29 October, 1987

Mr. Keating: *Very serious questions arise in the wake of the H. Williams break-up and they have not been answered. I refer to questions about how that company was run, about how the cash throughput was managed and about the role of the banks.*

- Dáil Éireann - Volume 374 - 29 October, 1987

Proinsias De Rossa: *Indeed, I wonder to what extent the H. Williams collapse is as much the result of their failure to respond to market demands and needs as it is to the question of a price war. Certainly questions must be asked in relation to the management of that company but, given that we are in a private enterprise society and the weakness of company law in the State, directors of private and public companies have virtually a free hand in running their companies and in choosing to develop them.*

- Dáil Éireann - Volume 374 - 29 October, 1987

It seems that following the demise of the Group, the other two big multiples in the market at the time, Dunne's Stores and Quinnsworth, acquired many of their better stores.[18]

On the other hand, if it is alleged that either or both of these multiples were instrumental in forcing H Williams out of the market, then it is perhaps illustrative of the risks associated with predation that one of the principal beneficiaries of the demise of H. Williams was the independent Musgraves franchise, SuperValu, which acquired 15 of the 33 H. Williams stores that became vacant at the time. There is little doubt that SuperValu acquired a national image as a result.

Furthermore, it is obvious that whatever price war took place between Irish supermarkets around that time, it does not seem to have harmed the independent retailer. The 1991 Report of the RPC records the growth of the SuperValu franchise operation during the 1980s. It grew from 30 stores to 80 stores between 1980 and 1987.[19]

[18] Source: FTC 1991 Report of Review of the 1987 Groceries Order, op. cit., Para. 2.78, P.22.
[19] FTC 1991 Report of Review of the 1987 Groceries Order, op. cit., Para. 2.79, P.23

The quoted evidence would suggest that the H. Williams collapse is consistent with the theory that intense competition is likely to impact negatively on competitors only when those competitors are already weak and vulnerable.

One of the more interesting submissions we have received came from Mr Finbarr Holland. Mr Holland paid more than £4m to acquire a majority stake in H. Williams in May 1982 and still controlled the company when it went out of business.

Mr Holland urges the complete abolition of the Groceries Order which he describes as *“virulently and highly anti-consumer.”*

Finally, even if it is accepted that a price war precipitated the downfall of H. Williams, there is an assumption that below cost selling was involved, that it was predatory in intent, and that the price war was initiated by the company’s competitors.

There is little evidence for any of the foregoing assumptions. Certainly, there is no evidence that higher prices resulted from the exit of H. Williams from the market.

There is no definition of predation that would support the notion that permanently low prices, no matter how low, are predatory.

7.9 Responding to the Threat of Predatory Pricing

The Groceries Order is our response to the threat of predatory pricing. Proponents of the Order say that if it is repealed, the door will be open for large multiple retailers to engage in predatory practices to eliminate smaller competitors. Such an argument ignores the protection afforded by the Competition Act, 2002.

As outlined earlier, be that as it may, one of the accepted criteria for establishing predation is that it must involve pricing below some measure of cost.

In this respect, the use of the net invoice price as employed by the Groceries Order is arbitrary and unscientific. The value placed on the invoice does not, either in theory or in practice, have to bear any relationship to cost and can be chosen at random to suit the circumstances of any sale. It then becomes the minimum resale price of that product regardless of what its actual cost is.

The Groceries Order, therefore, does not provide any measure of cost and cannot validly be used to determine if predation exists.

It is our view that for the purposes of determining predation in the retail grocery trade, that cost should be defined as the actual purchase price of the

products in question – including all rebates, allowances, discounts and supplier payments whenever paid.

We recognise that this excludes the cost of resale. However, defining such cost and apportioning them across perhaps 40,000 products on supermarket shelves is always going to be, at best, problematic.

Furthermore the choice of actual purchase price is based on widely accepted economic reasoning which we explain briefly as follows:

The Areeda-Turner Test is a cost based standard for predatory pricing that was first proposed in an article published in the US in 1975 by Philip Areeda and Donald F Turner.[20] The test proposed that prices below marginal cost be considered predatory and prices above marginal cost be considered non-predatory.[21] Areeda –Turner recognised, however, that marginal cost might be difficult to prove in certain circumstances and so they proposed that pricing below Average Variable Cost be used instead. [22]

The Areeda-Turner test is supported by a ruling of the European Court of Justice as the yardstick for determining predatory pricing.[23]

According to Areeda-Turner, the preferred measure of cost is marginal cost – in other words the additional cost of one additional unit of production. Marginal cost in the retail trade is the cost to the retailer of selling one additional unit of a product. In the case of the retail grocery trade, the marginal cost of any single product on a supermarket's shelves is, we suggest, close to, if not identical to, the purchase price of that product. Put another way, actual purchase price is the closest measurable quantification of marginal cost and thus largely meets the Areeda-Turner test.

The logic of the test is that the loss the retailer incurs by selling a product below cost is the difference between the actual purchase price of the product and the below cost selling price.

This is the threshold established in international law as a measure of predation. Anything above this level can be considered to be legitimate, vigorous, pro-competitive pricing from which consumers should be allowed to benefit.

Net invoice price, on the other hand, provides no measure of cost and is so far above the threshold for establishing predation, that it eliminates virtually all prospect of price competition in the retail grocery trade. It is a hugely disproportionate response to any threat of predation.

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[20] "Predatory Pricing and Related Practices Under Section 2 of the Sherman Act", Harvard Law Review, 88: 697-733. 697 (1975)

[21] An economic definition of marginal cost in the grocery trade is the additional cost incurred by the retailer in selling one additional unit of a product.

[22] AVC is determined by dividing total variable costs by total units sold. Variable costs are costs which are not fixed and which will increase if output increases.

[23] The AKZO ruling – see Paragraph 7.6 above.

7.10 Pricing Strategies that are not Predatory

Not all sales near, at or below cost can be regarded as predatory.

The Report prepared for the Dutch Ministry of Economic Affairs draws a distinction between different retail pricing strategies as follows:

> *"Retailers apply various pricing policies that may involve pricing below the purchase price. The most relevant of these fall into four categories:*
>
> - *Short-run price promotions;*
> - *Loss-leading;*
> - *Price wars;*
> - *Predatory pricing."*[24]

In a footnote to this, the Report describes other valid reasons for selling below cost as follows:

> *"For example, in some cases, a firm may introduce a new product to the market at a loss making price in order to build up a sufficiently large customer base to allow it to achieve and benefit from economies of scale, at which point the price would become profitable. Products may also be sold at below cost if they are perishable or as a result of unanticipated shocks."*

The UK Competition Commission Report into the UK grocery trade in 2000 also recognised various legitimate reasons for selling below cost, for instance on lines that have been de-listed, have reached their sell-by date or which the retailer no longer intends to stock and the Commission took the view that *"such occasional selling below cost is unlikely to damage competitors."*[25] It was for this reason that the Commission confined their comments in their Report to what they described as "persistent" below cost selling.

7.11 Promotional Pricing

Many proponents of below cost selling argue that it is a valid promotional tool designed to attract customers in the same way as advertising, free car-parking or free delivery.

One of the contradictions in the 1987 Order is that it confines a prohibition on selling below cost to the retailer. Many price promotions in Irish supermarkets are financed by the supplier – for example, a two for one offer on a packet of washing powder. Such an offer – effectively half price - may or may not involve the supplier selling to the retailer at below cost. Whether it does or

[24] "What is the Impact of a Minimum Price Rule?" , op.cit. 2005.
[25] UK Competition Commission Report, 2000, Para.2.378, P.83

does not is not the point. The point is that the law does not prevent it. Therefore, at some level, this type of promotion is regarded as entirely valid. It is only against the law if it is financed by the retailer.

At this point, we should recognise a point made in the submission by IBEC that a retailer is selling someone else's product and that this creates a different dynamic when selling below cost. IBEC state:

> *"…when an airline such as Ryanair sells below cost, they are selling their own product and balancing their own risk. When a retailer sells below cost it is not selling its own product and is funding risk either through recapturing margin on other products or through forcing suppliers to underwrite the risk."*

In the first instance, we do not believe that all promotional selling that is financed by suppliers, is forced on them by retailers, as implied by the IBEC submission. It is obvious from the packaging employed in many promotional schemes (extra size packs, buy-one-get-one-free and so on) that these are financed by either the manufacturer or the supplier.

Be that as it may, a survey of the independently owned grocery sector in Ireland suggests that only half of all independent retailers (62% of symbol members) <u>always</u> run the promotion obtained from their supplier whereas 20% say that they sometimes run the promotion and 13% say they always keep the margin i.e. they never run the promotion.[26]

Secondly, we simply pose the question as to whether or not it should be any less reasonable for a retailer to finance a product promotion than for a supplier to do so. This is particularly so if a retailer is trying to improve his competitive position in a market by promoting sales of particular product lines in a way that is not damaging to competitors.

Professor Dobson[27] recognises the validity of product promotion when he states:

> *"…it is important also to consider the time dimension involved* (in below cost selling) *since there is likely to be a considerable difference in the economic effects between short-term <u>temporary</u> discounts (which can promote competition) as opposed to <u>persistent</u> or <u>constant</u> below-cost selling (which can impede and distort competition)."*

The Joint Oireachtas Committee has submitted, as already indicated, that: *"Below cost selling, even where it is only for occasional promotional purposes, is an unfair trading practice. It is an artificial practice that does not take place in any other business sector."*

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[26] Irish Symbol and Independent Retailing Tracker 2005, Insight Research, UK.
[27] "The Economic Effects of Constant Below Cost Selling Practices by Grocery Retailers" by Professor Paul Dobson, op.cit.

We actually believe that the opposite is the case and that various types of below cost selling take place across business sectors for a variety of legitimate reasons. We do not accept, for instance, that when a budget airline either advertises or sells a seat for €1 it is doing so at other than below cost. The traveller will be encouraged to visit the airline's website with a promise of low fares. If the traveller finds that all promotional offers have been snapped up, he may be offered the option of purchasing a more expensive product. This is a free choice that results from a perfectly valid marketing tactic on the part of the airline.[28]

When free samples of shampoo are given out to shoppers at a local supermarket, this is certainly at below cost and shoppers are lured away from a competitor's product.

It is not unusual for firms in a start-up situation to forecast losses in the initial period of operation as start-up costs are absorbed. Clearly prices and charges are nothing like sufficient to meet costs in these circumstances.

One well-known high street retailer in Dublin was recently offering 70% off a line of gent's clothing. Similar winter or summer sales are commonplace and many involve the sale of product at prices less than cost. The Competition Authority has observed in its submission that many of these promotions would be illegal if the ban on selling below invoice price was extended to the retail trade generally.

Similarly, industry might sell below cost when test marketing new products, when seeking to dispose of old stock that won't otherwise be sold or when it is necessary to match a competitor's prices.

There are many legitimate reasons for below cost selling and a general policy that prohibits the practice is, in our view, anti-competitive. If the situation was otherwise, then such a ban should apply in all sectors of the economy.

7.12 Loss-Leading and Cross-Subsidy of Product Prices

Losses incurred as a result of selling below cost may be recouped in ways other than through the elimination of competitors. This is achieved when loss-making products are cross-subsidised by other lines on which the retailer takes a higher margin.

In such a scenario, a grocery retailer will reduce the prices of certain well-known products to uneconomic levels in order to attract customers to its store. The sort of products that would be priced down in this way include those for which the customer is most likely to know the price as they are the products which are most purchased. These are called "Known Value Items" or KVIs. The customer is thus fooled into thinking that everything in the store is cheaper than he might be able to buy it elsewhere.

[28] Of course, an issue may arise in the context of consumer law if the offer of low fares was in any way misleading.

This may not be the case and, having lured the unsuspecting customer away from the competition, the retailer can recover lost margin by increasing the prices of other items on his shelves. The unsuspecting customer loses out by paying more in the long run for his shopping basket than he would if he went elsewhere.

There is an almost universal assumption in submissions received in support of retaining the 1987 Order that loss-leading below cost has no legitimate motivation and is driven only by a desire to damage competitors.

This view is not supported by modern economic thinking, which has demonstrated that the practice does not have to be predatory in intent and can be a natural outcome of competition, particular in a multi-product retail business where consumers have imperfect information in regard to the prices of all products in a store.[29]

There are many classic examples of loss leading. Restaurants often attract the customer with attractively priced main meals only to make up their margin on the trimmings. Basic model motorcars are sold cheaply with expensive "extras". Gentlemen's razors are virtually given away but sales of replacement blades are very profitable.[30] Inkjet printers are cheap but replacement cartridges cost almost as much as the machine itself. Software developers give away "freeware" in the hope of attracting customers to other products in their portfolio. Cinemas give away cheap seats but charge high prices for popcorn and soft drinks. Internet based music vendors will supply cheap music for which you need their proprietary music player to listen to it.

A particularly interesting example of loss-leading is when newspapers give away free CD's and books. This is obviously supplied to the reader below cost but is unlikely to result in overall losses for the newspaper. Advertising revenues alone would probably mean that some newspapers could pay the customer to read their product and still make money. The theory of the practice is that sales increase, advertising revenues increase, and the consumer suffers no detriment. It is unlikely that single product promotions of this sort will distort the market or disadvantage competitors.

Whether or not the practice of loss-leading in the grocery trade impacts in a negative way on consumers depends on a number of factors. Principal among these is whether or not consumers are likely to be influenced to shop in a particular outlet because of the prices of individual products or because of the overall value of their weekly shopping basket.

There is a general perception that consumers in Ireland are price insensitive, in other words that their knowledge of prices is likely to be limited to a small number of key products which they buy on a regular basis. They will not be

[29] Loss Leading and Price Intervention in Multiproduct Retailing, by Patrick Paul Walsh and Ciara Whelan, published by the International Review of Law and Economics, 1999

[30] A practice developed by the American businessman, King Gillette,which gave rise to what is known as the 'razor and blades' business model

familiar with the prices of a broader basket of goods that make up their weekly shop. Such price insensitivity may well heighten the negative impact on consumers of loss leading tactics.

On the other hand, many consumers, even those who are insensitive to the prices of products they purchase less often, are likely to have a broad idea of whether or not their overall weekly shopping basket represents value for money. Such consumers are less likely to be fooled by loss-leading tactics.

Consumer price sensitivity will vary across different sections of the community and consumers who spend a higher proportion of household income on the weekly grocery shopping are likely to be more price-sensitive. Thus, cross subsidisation is likely to impact positively on less well off sections of the community who will find cheaper prices for the Known Value Items that make up the bulk of their shopping basket. There is an argument to be made that loss leading on popular grocery lines is an effective mechanism for redistribution by which those on higher incomes subsidise those on lower incomes.

For another large number of consumers price is simply not a factor in deciding where to shop. Such consumers will shop based on convenience, store location, overall shopping environment, product availability and so on and are unlikely to be influenced by loss-leading tactics.

Furthermore, there is some evidence that cross subsidisation of product lines is not just a feature of the multiple supermarket trade. Convenience stores rely heavily on trade in what are called “traffic builders” – the products that attract customers in the first instance.

Independent research suggests that among independent retailers, the most important manufacturers’ representatives visiting their stores are Gallagher (42%), Coca-Cola (41%), John Player (34%), C&C (31%), and Cadbury (28%). Additionally, deli food is considered by 23% of independent retailers to be their most important category of sales, 21% say confectionery and 18% say minerals.[31]

Thus products such as confectionery, chocolate, carbonated drinks and, in some cases, basics such as bread and milk are likely to be competitively priced in convenience stores.

Nonetheless, these products will often be cross subsidised by higher margins on top up items such as cereals or washing powder which are not normally bought in convenience stores.

Grocery stores are unlikely to engage in loss-leading tactics unless they perceive some benefit to themselves. Such practices may actually benefit some consumers, or, at worst, have a completely neutral impact on their shopping habits.

[31] Irish Symbol and Independent Retailing Tracker 2005, Insight Research, UK.

The economic model developed by Walsh and Whelan in 1999[32] demonstrated that loss leading in the retail industry can have a competitive outcome, in other words it is a practice that is unlikely to distort the market or result in any consumer detriment.

In so far as the practice may impact negatively on some, a proportionate response would seem to be to encourage consumers to be more price sensitive and aware of the cost of their overall basket of goods. Indeed, building consumer awareness is likely to be a key strategy of the new National Consumer Agency.

Notwithstanding the foregoing, it is possible to conceive of rare examples of persistent below cost selling that have no predatory intent but which may have a negative impact on market structures and place certain participants at a disadvantage. In so doing such practices may act against the broader interests of consumers.

Unfortunately, the ban on selling below net invoice price as exists in the Groceries Order is a blunt and absolute instrument that provides no measure of cost, recognises no exceptions to the rule (other than products excluded from its scope) and is incapable of distinguishing such examples from instances of pro-competitive pricing that benefit consumers.

We believe that it is a disproportionate response to any threat of harm to the public interest as a result of instances of persistent below cost selling in the grocery trade.

7.13 UK Competition Commission Report

A number of submissions have referred to the Report of the UK Competition Commission on the grocery trade, published in 2000 and already quoted above.

The Joint Oireachtas Committee on Enterprise & Small Business notes the Commission's finding that *"…the practice of below cost selling when conducted by …those parties with market power….operated against the public interest."*

The Commission's definition of cost in this respect is sale below the cost of purchase, i.e. at a negative gross margin.[33] This obviously does not include the cost of resale i.e. operating/overhead costs.

However, and most importantly, the Commission also say that:

[32] Loss Leading and Price Intervention in Multiproduct Retailing, by Patrick Paul Walsh and Ciara Whelan, published by the International Review of Law and Economics, 1999, op.cit.

[33] Para.7.153

"When identifying instances of below cost selling, allowance has to be made for discounts, over-riders and similar payments that may have the effect of rendering an apparent case of below-cost selling profitable."[34]

It is clear, therefore, that the Commission was concerned with sales below actual purchase price and their findings must be considered in that context.

The Commission acknowledged the difficulty in attributing such supplier payments to individual product lines.

And neither did the Commission concern themselves with instances of temporary, legitimate below cost selling:

> *"Similarly, below-cost selling may arise when multiples try to dispose of end-of-line stock (for example, if a product has been de-listed, or to clear seasonal stock), and to clear products near their sell-by date. We considered that such distress purchases were by their nature short term and relatively unimportant, and therefore that any adverse consequences would be limited. There was some evidence that there could be a seasonal pattern to below-cost selling. Iceland said that Christmas turkeys were used as loss leaders to tempt people into stores. Some seasonal products were promoted below cost, such as* suntan lotions. *In general it was unusual for promotions to be run at a negative gross margin (as they usually had substantial supplier support), and by their nature such promotions are short term. Therefore, we concentrated on instances of persistent below-cost selling."*

It is also important to record that the Commission reported that they had received no direct evidence that the major supermarkets had pursued below cost selling as a predatory tactic.[35]/[36]

> *"We did not find any evidence that multiples had engaged in short-term inter-temporal predatory behaviour, i.e. supermarkets selectively lowering and then raising prices in response to the presence and subsequent exit of local competitors"*

Apart from temporary below cost selling for legitimate reasons (which we have already identified above), the Commission found, in effect, that below cost selling came about because of intense competition in the marketplace – in effect, the need to match, or maintain differentials with, competitors:

> *"…margins may be squeezed to very low levels and the parties may be forced into below-cost selling, particularly if their costs are high."*[37]

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[34] Para.7.155
[35] Para.2.380, P.84
[36] Para 7.167, P.132
[37] Para.2.378, P.84

Also the Commission found that below cost selling may be particularly prevalent over certain periods such as Christmas when products might be used as loss leaders to tempt customers into stores.

However, the Commission went on to acknowledge that their principal concern was the element of cross-subsidy inherent in below cost selling and concluded that the ability of multiples to engage in such tactics, while it might not be predatory in intent, did put their smaller competitors at a disadvantage. Furthermore, they suggested that if the practice was to damage smaller independent and convenience retailers, this could impact adversely on those elements of the community, notably the elderly, the disabled and the less mobile, who rely more heavily on such outlets.

Consequently, and as previously indicated, the Commission concluded that the practice of persistent below cost selling operates against the interest of consumers.

The Commission considered a number of possible remedies in relation to the practice of persistent below cost selling and concluded that such remedies would *"…require monitoring and intervention that would be disproportionate to the adverse effects they were designed to remedy. Therefore we make no recommendations for remedial action."*

7.14 Conclusions

Predatory pricing is anti-competitive and operates against the interests of consumers. However, the practice, as defined by generally accepted principles of anti-trust law, is already prohibited by the Competition Act, 2002.

Loss-leading is a legitimate business practice which operates in many business sectors and can be a highly pro-competitive outcome of market forces at work. It is a practice that can operate without distorting the market and without producing any consumer detriment.

The practice of <u>persistent</u> below cost selling of grocery products, when operated in a manner that does not meet the definition of predatory pricing, is not prohibited by the Competition Act. It is possible to conceive of rare instances in which the practice might act against the public interest if its effect is, or is likely to be, an alteration in market structure resulting in less choice for consumers.

However, we consider the provisions of the 1987 Order, and in particular those set down in Articles 11, 12 and 13, to be a disproportionate response to the threat of both predatory pricing and such persistent below cost selling for the following reasons:

- Article 11 acts against the interests of consumers by taking no account of legitimate, pro-competitive reasons for selling below cost;

- There is no test to determine whether or not the practice of below cost selling is likely to distort the market or be harmful to the public interest in any given circumstance;

- It does not provide any valid measure of cost and is incapable of distinguishing between genuine acts of predation and legitimate and vigorous pro-competitive pricing from which consumers should be allowed to benefit;

- No account is taken of discounts, rebates or other allowances, paid by suppliers to retailers;

- The Articles limit the freedom of retailers to decide whether and how such discounts should be passed on to the consumer;

- Consequently, the Order places an artificial floor under the price of grocery goods that has no relationship to either purchase price or cost and prevents downward pressure on prices that might be expected to result from normal competitive forces in the market;

- We have been unable to identify any benefits accruing to the public interest that would justify such a fundamental restriction in the freedom to trade.

- Neither Article 11 nor Article 13 are operating in the manner intended when the Order was introduced and, together, they encourage off-invoice discounting, a practice prevalent in the trade, and which, according to the Director of Corporate Enforcement, may not be advantageous from a company law perspective.

- The impact of Articles 11 and 13 is that a form of resale price maintenance operates in the Irish grocery trade, an anti-competitive practice which is actually prohibited by the Order as well as by the Competition Act 2002 (see Paragraph 6.6 above);

- The 1987 Order seriously limits price competition in the grocery trade market and this in turn is driving increased concentration in the market at symbol/convenience store level.

- Article 11 limits the ability of smaller retailers to compete with legitimate lower cost selling by larger competitors. This is because it would be against the law for a small retailer - whose wholesale price is greater than that of his competitor - to reduce his prices to the levels charged by his competitors if the effect of such a measure was to mean that the smaller retailer would be selling below cost.

- Article 11 also limits the ability of even the largest retailer to compete in certain circumstances. For example, if supermarkets in Northern Ireland engage in below cost selling during the Christmas period

(something for which there is ample anecdotal evidence), all retailers in this jurisdiction, regardless of size are placed at a competitive disadvantage.

- The combined effect of the Articles is to limit competition and thus the incentive to find efficiencies in the distribution chain from which consumers might benefit in the form of lower prices.

We consequently conclude that Articles 11, 12 and 13 of the Restrictive Practices (Groceries) Order, 1987 should be repealed in their entirety.