Predatory Pricing: The Combines Investigation Act-Subsection 34(1)(c), a Violation in Search of a Standard

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PREDATORY PRICING:
THE COMBINES INVESTIGATION
ACT—SUBSECTION 34(1)(c),
A VIOLATION IN SEARCH
OF A STANDARD

By GERALD F. HAYDEN, JR.*

I. INTRODUCTION

In 1980, a Canadian court was required for the first time to determine the legal standard for a “price unreasonably low” under subsection 34(1)(c) of the Combines Investigation Act in order to ascertain when a price charged by a firm becomes predatory. A predatory price is one calculated to exclude or foreclose an equally efficient competitor from the market. In 1981, the Ontario High Court was again faced with the same issue, but this time a different standard was adopted. As a result of these two recent cases, there are now two very different legal standards of predatory pricing within the meaning of subsection 34(1)(c).

The purpose of this paper is to determine an appropriate legal standard for predatory pricing cases. Both cases will be discussed and the legal standard adopted in each will be considered in light of American case law and legal literature. Finally, a manageable legal standard will be proposed in order to provide the necessary degree of predictability in predatory pricing cases.

Predatory pricing behaviour involves a reduction of the price of a product in the short-run so as to drive competing firms out of the market or to discourage entry of new firms in an effort to gain larger profits via higher prices in the long-run. As well, the dominant firm in a market may engage in predatory pricing as a way of disciplining its competitors. Generally, predatory pricing, if successful, is not beneficial to consumers in the long-run since the predator will earn monopolistic profits.

There is no empirical evidence to suggest that predatory pricing is a serious problem in Canada. Since the proclamation of the Act, there has been only one reported case wherein the Crown was successful in obtaining a conviction. And even in that case, consumers actually benefitted from the

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1 R.S.C. 1970, C-23, as am. by S.C. 1974-75-76, c. 76, s. 16(1)(c), [hereinafter Act].
predatory pricing activity. Linden J. commented that "[m]ost Canadians would probably wonder why the defendant was prosecuted at all for what it did. The potential ill effects of predatory pricing is not a problem that concerns very many Canadians. Predatory pricing is not a business tactic that is widely used in this country to eliminate or reduce competition."

Some commentators have argued that predatory pricing is so rare that it should not be an important aspect of competition policy. Professor Bork would go so far as to say that it would be unwise to construct rules about a phenomenon that probably does not exist or which, should it exist, would present the courts with grave difficulties in distinguishing it from competitive pricing behaviour. According to Bork such rules "would do more harm than good." Other commentators, such as Professors Williamson and Baumol, have developed such elaborate schemes to detect predatory pricing behaviour that the courts would essentially become public utility regulators. The complexity of their schemes would suggest that predatory pricing behaviour is a problem serious enough to justify an enormous cost to society in order to distinguish it from competitive behaviour.

Since Parliament has made predatory pricing an offence under subsection 34(1)(c) of the Act, it is important for the courts or Parliament to develop a standard to distinguish competitive behaviour from predatory behaviour. Presumably, such a standard should be one that is clear and manageable so that:

1. there is not a considerable cost to society in litigating cases unnecessarily; and
2. businessmen, in setting prices for their products, are able to determine when their price will be considered predatory.

While predatory pricing may be unusual in Canada, it is likely to become more widespread if Parliament adopts a stricter and more effective merger policy. Professor Posner argues that, given the stricter American merger laws, predatory pricing may be a cheaper mode of monopolization than acquisition because it is more difficult to detect. If the Supreme Court of Canada allows a private right of action in the Act, competitors will be able to bring an action against the predator to force it to increase its price. In a market where there is a dominant firm, the other competitors will be able to harass the dominant firm by threatening a predatory price action. Without any clear standard to determine when the courts will consider a price predatory, society may be

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9 Under s. 31.1 of the Combines Investigation Act, private actions for damages are permitted for Part V offences. Subsection 34(1)(c) is a Part V offence. The constitutionality of s. 31.1 has been challenged with conflicting results. In Henuset Bros. Ltd. v. Syncrude Canada Ltd., [1980] 6 W.W.R. 218, the provision was held to be valid federal legislation, whereas in Seiko Time Canada Ltd. v. Consumers Distributing (1980), 29 O.R. (2d) 221, it was held to be ultra vires. The issue is currently before the Supreme Court of Canada.
worse off if inefficient competitors are able to successfully dissuade efficient firms from lowering their prices.

II. LEGISLATIVE HISTORY OF SUBSECTION 34(1)(c)

Prior to 1960 predatory pricing was considered an offence under subsection 412(1)(c) of the Criminal Code. The statute provided that:

Everyone engaged in trade, commerce or industry who
(c) engages in a policy of selling goods at prices unreasonably low, having or designed to have the effect of substantially lessening competition or eliminating a competitor,
is guilty of an indictable offence and is liable to imprisonment for 2 years.

The Code did not define "goods".

In 1960 subsection 412(1)(c) was repealed and a similar provision was added to the Combines Investigation Act. Subsection 33A(1)(c) stated:

Everyone engaged in a business who
(c) engages in a policy of selling articles at prices unreasonably low, having the effect or tendency of substantially lessening competition or eliminating a competitor, or designed to have such effect,
is guilty of an indictable offence and is liable to imprisonment for two years.

"Article" and "business" were defined as follows:
(i) "article" means an article or commodity that may be subject of trade or commerce.
(ii) "business" means the business of manufacturing, producing, transporting, purchasing, supplying, selling, storing or dealing in articles.

It would appear that this provision was not substantially different from the Criminal Code provision. In 1976 subsection 34(1)(c) was further amended to increase the scope of the meaning of "articles" and "business". The amended section, currently in force, states:

Everyone engaged in a business who
(c) engages in a policy of selling products at prices unreasonably low, having the effect or tendency of substantially lessening competition or eliminating a competitor, or designed to have such effect,
is guilty of any indictable offence and is liable to imprisonment for two years.

"Products" and "article" are defined as follows:
(i) "product" includes an article and a service.
(ii) "article" means real and personal property of every description including
(a) money,
(b) deeds and instruments relating to or evidencing the title or right to property or an interest, immediate, contingent or otherwise, in a company or in any assets of a company,

10 S.C. 1953-54, c. 51, s. 412(1)(c).
11 S.C. 1960, c. 45, s. 21.
13 S.C. 1960, c. 45, ss. 1(1)(a), (aa).
14 S.C. 1974-75-76, c. 76, s. 16(1).
(c) deeds or instruments giving a right to recover or receive property,
(d) tickets or like evidence of right to be in attendance at a particular place at
a particular time or times or of a right to transportation, and
(e) energy, however generated.\[^{15}\]

The definition of "business" was amended to include services:

"business" includes the business of
(a) manufacturing, producing, transporting, acquiring, supplying, storing and
otherwise dealing in articles, and
(b) acquiring, supplying and otherwise dealing in services.\[^{16}\]

The section would now appear to cover those selling services, stocks, futures,
and tickets.

Essentially, all the amendments to date have served to enlarge the applica-
tion of the predatory pricing section from "goods" to an expanded definition
of "products".

If predatory pricing does become a serious problem, Parliament may then
consider amending subsection 34(1)(c) to make it an offence to attempt to
engage in predatory pricing. Under the current section the predator must ac-
tually engage in a policy of predatory pricing. But one drawback of expanding
the provision in this manner is the resulting effect on consumers. If the
predator fails to lessen competition, it can be argued that consumers will ac-
tually benefit through lower prices.

III. CANADIAN CASE LAW

There have been only three reported cases in Canada involving predatory
pricing. The two leading cases, \textit{R. v. Hoffmann-La Roche Ltd.,}\[^{17}\] and \textit{R. v. Consumers Glass Ltd.,}\[^{18}\] addressed the issue of what constitutes an
unreasonably low price. The third case, \textit{R. v. Producers Dairy Ltd.,}\[^{19}\] decided
earlier, distinguished intent to meet the competition from intent to lessen the
competition.

A. \textit{R. v. Producers Dairy Ltd.}

Producers Dairy was in the business of selling dairy products, including
milk, in the Ottawa area. The same market was served by four other suppliers:
Borden's Dairy, Clark's Dairy, Capital Dairy, and National Milk Co. When
one of the supermarket chains opened a new store, it was standard practice for
its milk suppliers to give the store special discounts. In keeping with this prac-
tice, Clark's offered a two-for-one deal for two days to the customers of a new
store opened by one of the chains, Steinberg. However, Clark's extended this
discount to all of the Steinberg stores in the Ottawa area. Producers reacted by
reducing its prices to Steinberg along with the rest of its wholesale customers.
Borden's then offered the same deal to its wholesalers.

\[^{15}\] Id. ss. 1(4), (1).
\[^{16}\] Id. s. 1(2).
\[^{17}\] Supra note 3.
\[^{19}\] (1966), 50 C.P.R. (2d) 265 (Ont. C.A.). This case was decided in 1966 but it was
not reported until 1981.
The trial judge found that, although Clark's, Capital and National were adversely affected by Producers' price-cutting over the two-day period, Producers did not have the requisite intent to lessen competition and, therefore, did not violate subsection 33A(1)(c) [now 34(1)(c)]. The Ontario Court of Appeal dismissed the Crown's appeal on the ground that Producers was not involved in a "policy" of selling milk at unreasonably low prices. Neither court, however, addressed the issue of what constitutes an unreasonably low price. This issue was the focus of the next two cases, both of which adopted different standards.

B. *R. v. Hoffmann-La Roche Ltd.*

The issues involved in this case were not only substantive, but also constitutional and procedural. The only aspect of interest for this paper is that involving proof of the offence.

Hoffmann carries on business in Canada manufacturing and selling pharmaceutical products. Included among these products are two tranquilizers sold under their trade names, librium and valium. When they were first introduced in Canada, Hoffmann had a monopoly over their sale by virtue of its patents. Hoffmann was the leading ethical drug company in the hospital and drugstore markets in 1969 when the federal government amended the *Patent Act* in an attempt to reduce the high cost of drugs. The amendment reduced the royalty paid by compulsory licensees for the use of the patentee's licence from fifteen to four percent. As well, provincial governments adopted legislation allowing druggists to substitute cheaper generic drugs for brand-name drugs. In Ontario this substitution programme was known as Parcost. The overall effect was to create "an atmosphere of vigorous competition in the drug field." Because of Hoffmann's success with valium and librium, competitors began entering the market. In 1968, Horner entered the librium market and offered its product at prices below Hoffmann's. Hoffmann reacted by introducing a two-for-one deal on the librium sold to hospitals, thereby reducing its effective price below Horner's and its other competitors. In fact the Crown showed that the sales were made below cost. Hoffmann also tendered a bid of $1 on three government tenders, which was also found to be below cost.

In 1970, Horner entered the valium market as well. It organized a massive promotional programme in an attempt to convert doctors and hospitals from Hoffmann's product to its own. The hospital market is extremely important because doctors prescribe the brand names of the products they are familiar with to their patients. In response, Hoffmann gave away valium to hospitals for a one-year period, forcing Horner to withdraw from the hospital market for that period. The Court, however, found that Horner "did not suffer thereby."

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20 *Id.* at 267.
21 *Id.* at 270-71.
23 *Supra* note 3, at 13 (D.L.R.), 172 (O.R.).
24 *Supra* note 4, at 283 (D.L.R.), 465 (O.R.).
Hoffmann was subsequently charged with predatory pricing under subsection 34(1)(c) for the librium tenders and the one-year give-away of valium.

Linden J. stated that there are four elements to a subsection 34(1)(c) offence and the Crown has to prove each element beyond a reasonable doubt. Here, the Crown had to show that:

(1) Hoffmann was engaged in a business;
(2) Hoffmann was engaged in a "policy" of selling articles;
(3) Hoffmann's price was "unreasonably" low; and
(4) the effect or tendency of the "policy" was to substantially lessen competition or eliminate a competitor or that it was designed to have such an effect.  

Before examining whether each of these elements was satisfied, it is necessary to examine how Linden J. defined the relevant market and the products' prices. Hoffmann argued that the market should be defined so as to include the total institutional and consumer demand for its products. Since the hospital market is essential to success in the retail market, the relevant market should be both the retail and hospital markets put together. With valium, for example, when a doctor prescribes a mild tranquilizer for a patient for use outside the hospital, it is important for Hoffmann that the doctor use the brand name "valium" instead of its generic name. If the relevant market includes both the retail and the hospital segments, the valium give-away looks more like a buy-one-get-one-free situation. Accordingly, price would be calculated as:

\[
\text{Revenue obtained in the retail market and the hospital market for the one year give-away period} \\
\text{Number of valium pills sold in the retail market} + \text{number of valium pills given away during the one year period.}
\]

However, Linden J. did not agree with Hoffmann's definition of the relevant market and held that it included only the hospital segment. Accordingly, Linden J. held that the price of valium pills during the one year give-away was zero.

The first two elements of the offence were easily satisfied. It is clear that
The Crown argued that the price was unreasonable because it was below cost. While "cost" was not specifically defined, it was to be exclusive of overhead. The Crown's economist testified that in economic terms a price below cost is unreasonable except in two instances: where the goods are perishable or obsolete, or where the seller is overstocked or is giving away new products. Linden J. flatly rejected that view in stating that "economic theory cannot control the legal determination of reasonableness," but he did agree that it was relevant in determining whether the price was unreasonably low. According to Linden J., whether a price is unreasonable depends on all the circumstances. Even if something is sold for a zero price, that does not necessarily mean that it is being sold at an unreasonably low price.

While Linden J.'s approach is rather vague and uncertain, he does provide us with a list of factors that a court should consider in determining whether a price is unreasonably low:

(a) **Cost:** Was the article sold above cost? If so, the price can never be held unreasonable. If it is sold below cost, the price may or may not be reasonable. Linden J., however, fails to define what measure of cost he is using. It is not clear whether he means variable or full costs. At least we now know that whatever "cost" is, the price will not be unreasonable if it is above it.

(b) **Length of Time:** For how long did the seller price his product at the questionable level? The only guidance Linden J. gives us is that "if articles are sold below cost for a day or a week, this is less likely to be unreasonable than if it is done for a month, six months or a year." So it appears that the line will be drawn somewhere between a week and a month.

(c) **The Circumstances of the Sale:** Was the price-cutting a defensive strategy designed to counteract a competitor's price-cut or was it an offensive move? This seems more relevant to the question of intent, which is really the fourth element of the offence.

(d) **Effect:** Are there any external or long-term economic benefits that will accrue to the seller by virtue of the price reduction? Linden J. gave as an example a manufacturer who wants to keep his business going, his customers supplied, and his employees employed during difficult economic periods, even though he cannot do so profitably. Again, this factor seems more relevant to the question of whether the predator had the necessary intent to lessen competition or to eliminate a competitor rather than to the reasonableness of the price.

By setting out the circumstances or factors that the courts should consider in taking his approach, Linden J. has not reduced any of the uncertainties. Factor (a) is too imprecise to apply because we do not know the definition of "cost". In defining the relevant market to include only the hospital segment,

27 Id. at 15 (D.L.R.), 174 (O.R.).
28 Id. at 38 (D.L.R.), 197 (O.R.).
29 Id.
30 Id. at 42 (D.L.R.), 201 (O.R.).
31 Id. at 41-42 (D.L.R.), 200-201 (O.R.).
Linden J. did not have to concern himself with a precise definition of "cost" for the valium pills because whichever way it was measured, it had to be greater than the zero price.

Factor (b) is only relevant to the interpretation of element (2): whether the seller was engaged in a "policy". Factors (c) and (d) seem to be relevant only to the issue of intent, which is the fourth element of the offence.

The fourth element of the offence focuses on the alleged predator's pricing policy. The Crown can satisfy this element by proving either that the "policy" actually had the necessary effect or that the predator intended for it to have that effect. Linden J. held that the "documentary evidence demonstrates a continuing state of mind of the accused which is disclosed by the various letters, memoranda and minutes of its various employees, committees and officials." Linden J. was somehow able to separate phrases in the documentary evidence that suggested Hoffmann wanted to make it difficult for existing competitors from those that suggested Hoffmann was attempting to exclude potential competitors. Apparently, the necessary intent under this element is satisfied if the evidence suggests that the predator is attempting to exclude potential competitors.

The documentary evidence presented, found in employees' letters and internal memoranda concerning the give-away programme, apparently reflects an unacceptable intent:

(1) It will serve as "notice to all present and future parasites that we mean business." 32
(2) It is "a device for 'loading the hospitals' and 'filling the pipelines'." 33
(3) "It is our feeling that this tactic will not only abort Horner's efforts but serve as a warning to others who seem to be showing an interest in this product." 34

Such statements, however, could also be those of a vigorous competitor. They may simply be "colourful jargon of the market-place," or indicative of a "macho spirit" or of "enthusiastic participation in a contest." 35 The difficulty in distinguishing statements of predatory intent from those of a vigorous competitor, as illustrated in Hoffmann, suggests that the intent requirement for a subsection 34(1)(c) offence may be difficult for the courts to manage.

Ultimately, Hoffmann was convicted under s. 34(1)(c) for the one year valium give-away but was not convicted for the $1 librium tenders because they "were not sales at unreasonably low prices in all of the circumstances." 36

At the end of the day, Linden J. leaves us with a standard so vague and imprecise that it is of little value in predicting future outcomes. We know only that a price above cost is per se not unreasonable. Yet we do not know what

32 Id. at 50 (D.L.R.), 209 (O.R.).
33 Id. at 15 (D.L.R.), 174 (O.R.).
34 Id. at 48 (D.L.R.), 207 (O.R.).
35 Id.
36 Id. at 49 (D.L.R.), 208 (O.R.).
37 Supra note 3, at 44 (D.L.R.), 203 (O.R.). Linden J. found there was no risk that the librium tenders would have any impact in lessening competition. Consequently, he was not convinced beyond a reasonable doubt that the librium tenders were for unreasonably low prices.
Predatory Pricing constitutes "cost" except that it excludes overhead. What we are left with is a standard which suggests that a price below cost may be unreasonable, depending on the circumstances of the particular case.

Hoffmann appealed the conviction on the basis that the trial judge erred in his determination of the relevant market and in interpreting the words in the documentary evidence to mean something other than simply the "'jargon' of the market-place." The appeal, however, was dismissed.

Several months after the Hoffmann case, the Ontario High Court was again confronted with the issue of predatory pricing. This time the Court enunciated a much clearer standard of what constitutes an unreasonably low price.

C. R. v. Consumers Glass Ltd.

Portion Packaging Ltd., a wholly-owned subsidiary of Consumers Glass Ltd., produced and sold small plastic lids. Prior to 1975, it was the only supplier for the Canadian small lid market. In 1975, Amhil Enterprise Ltd. entered the market and began selling identical lids at lower prices. Portion reduced its prices by approximately sixteen per cent in October, 1975 and another five per cent in December, 1975 in order to retain its large market share. This pricing strategy was not completely successful, however, as Portion's market share fell to sixty per cent by December, 1976, and to thirty per cent by February, 1978. Portion finally dropped out of the market in 1979.

The evidence indicated that in 1974, before Amhil had entered the small lid market, Portion had decided to leave the market. Portion thought it would be more profitable to manufacture drinking cups, which would require it to maintain part of its lid-making capacity.

O'Leary J., in reviewing all of the documentary evidence, found that Portion did not intend to drive Amhil out of the market through its price-cutting activities. Portion "cut prices to retain as much of the market as it could so as to minimize the losses it realized it was going to suffer because of the entry of a competitor into the market." While O'Leary J. recognized that "[b]acked by Consumers, Portion could have dropped prices so low as to force Amhil out of the market," he found that Portion's pricing decisions in 1975, were nothing more than attempts by them [Consumers and Portion] to retain as much of the small lid market as possible at prices that would result in the largest possible contribution being made towards fixed overhead.

O'Leary J. was not prepared to decide this case on the basis of lack of intent. While it was fairly clear that Portion did not have any predatory intent, O'Leary J. shared Schnacke D.J.'s concern, expressed in Transamerica Computer Co. v. Int'l Business Machines Corp., that "[u]nless some objective,

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39 The trial judge did not err in defining the relevant market as the hospital market for the purposes of s. 34(1)(c). The hospital market was separate from the retail market. Further, the trial judge did not err in his finding that the accused had the relevant intent to eliminate a competitor.

40 Supra note 18, at 291 (D.L.R.), 245 (O.R.).

41 Id.

42 Id. at 284 (D.L.R.), 238 (O.R.).
understandable standard is established for the guidance of businessmen, they must either forego competitive price decreases or risk punitive damages that might turn on some careless word once spoken in a boardroom. Businessmen must have notice of what is violative of the law." A cost-based standard, developed by Professors Areeda and Turner, was considered by O'Leary J. He concluded that "where chronic excess capacity exists, an accused cannot be said to have sold at unreasonably low prices, regardless of its intent, if at all times it sold at prices above its average variable cost. . . ." Since Portion was at all times selling its lids above average variable costs, it was not selling at a price unreasonably low. Therefore, Portion was not engaged in any predatory pricing activity.

So it appears that the Consumers test for "unreasonably low prices" is strictly a cost-based rule. As long as a businessman prices above his average variable cost, he cannot be said to be engaging in predatory pricing activity even if he has the necessary predatory intent. In Hoffmann, Linden J. refused to accept such a rigid standard. Under the Hoffmann rule a price could be below average variable cost and not be considered unreasonable. While O'Leary J. wanted businessmen to have notice of where the courts were prepared to draw the line between competitive pricing behaviour and predatory pricing behaviour, the state of the law under subsection 34(1)(c) is no clearer now than it was before Hoffmann and Consumers. What makes it even more confusing is that O'Leary J. indicated it was not necessary for him "to decide whether the Areeda and Turner proposal [the average variable cost rule] is an appropriate one for the Court to accept in all predatory pricing cases." It seems O'Leary J., in Consumers Glass, limits the application of the AVC rule to situations where chronic excess capacity exists in the industry.

The next two sections of this paper deal with the Areeda and Turner proposal and the subsequent criticism of it by commentators. The important issues to keep in mind throughout the following discussion are: (i) is a cost-based test appropriate for establishing a standard for distinguishing predatory pricing behaviour from competitive pricing behaviour? (ii) if it is appropriate, how should "cost" be defined? and, (iii) should the same cost-based test apply in all situations?

IV. THE AREEDA AND TURNER PROPOSAL

The Areeda and Turner article represents the first attempt in the legal literature to develop a legal standard per se distinguishing predatory pricing behaviour from competitive pricing behaviour, based solely on a cost-price analysis as suggested by economic theory.

It is important at this point to define some of the economic terminology which will be used:

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43 (1979), 2 Trade Cases 79, 618 at 79, 637.
44 The leading American article on predatory pricing written by Areeda and Turner will be discussed in the next part of this paper.
45 Supra note 18, at 300 (D.L.R.), 254-55 (O.R.).
46 Id.
According to Areeda and Turner, the classic rationale for engaging in predatory pricing behaviour is to enjoy monopolistic profits in the long-run by sacrificing short-term profits in order to eliminate one's competitors. According to economic theory, a firm in a competitive market will maximize its profits, or minimize its losses, by producing at the point where its MC equals price. A monopolist, on the other hand, will maximize its profits by producing at the point where its MC equals its marginal revenue. Areeda and Turner view MC as being economically sound for distinguishing competitive from predatory pricing behaviour. Yet, they conclude that MC is impractical as a legal standard. Since MC is not an accounting cost, it cannot be determined from conventional business records. Therefore, administrative reasons necessitated the finding of a surrogate cost base which approximates MC. Areeda and Turner chose AVC as their cost base because it can be determined from business records and it approximates MC most closely in the middle range of production. At low levels of production MC will be less than AVC, and at high levels it will be greater than AVC.

Areeda and Turner propose the following legal standard for distinguishing predatory from competitive pricing behaviour:

(1) a price at or above AVC should be conclusively presumed lawful, and
(2) a price below AVC should be conclusively presumed unlawful.

The Areeda and Turner standard relies entirely on an examination of the alleged predator’s price-cost relationship. The AVC rule, they argue, is manageable by a court and provides businessmen with a clear indication of what will be considered a predatory price. American courts have generally accepted the Areeda and Turner rule for predatory pricing. In Hanson v. Shell Oil Co., the 9th Circuit Court held that the plaintiff, in order to demonstrate predation, had to adduce "evidence that Shell was selling its gasoline at or below marginal costs or, because marginal cost is often impossible to ascertain, below average variable costs." In International Air Industries Inc. v. American Excelsior Co., the 5th Circuit Court held that in order to establish a case of predatory pricing, the plaintiff had to show that the predator’s price was either below average variable cost (AVC rule) or below ATC, and that there were extremely high barriers to entry.
Chillicothe Sand and Gravel Co. v. Martin Marietta Corp., the 7th Circuit Court accepted the marginal, or AVC rule to determine predatory pricing behaviour.\(^{57}\) However, the 10th Circuit Court in Pacific Engineering & Production Co. of Nevada v. Kerr-McGee Corp. refused to adopt a purely cost-based test.\(^{58}\) In order to establish a predatory pricing case the plaintiff had to show not only that price was less than AVC, but that there were other factors or circumstances to indicate that, in the long-run, the predator's conduct was anti-competitive.\(^{59}\)

Many economists have criticized the Areeda and Turner proposal and have suggested alternate formulations of the legal standard for distinguishing predatory from competitive pricing behaviour. It is worthwhile to examine these criticisms and proposals in assessing whether a cost-based test is sensible for a subsection 34(1)(c) offence, and whether the Consumers Glass test is an appropriate legal standard.

V. CRITICISM OF THE AREEDA AND TURNER RULE

A. Scherer (1976)\(^{60}\)

Professor Scherer's main criticism of the Areeda and Turner rule (hereinafter A-T rule) is that it is possible for a firm to engage in predatory price-cutting without being detected under the rule.\(^{61}\) The following diagram illustrates Scherer's point.

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\(^{57}\) 615 F. 2d 427 at 432 (7th Cir. 1980).
\(^{58}\) 551 F. 2d 790 at 797 (10th Cir. 1977).
\(^{59}\) Id. at 798.
\(^{60}\) Scherer, Predatory Pricing and the Sherman Act: A Comment (1976), 89 Harv. L. Rev. 869.
\(^{61}\) Id. at 869-71.
If a monopolist is faced with entry by a new firm, it can deter entry by expanding its output to $Q_M^*$ and reducing its price to $P_M^*$. The monopolist will produce at a point where MC exceeds the market price. Since this price is below MC, the monopolist is engaging in predatory pricing behaviour. Yet, according to the A-T rule, the monopolist is not engaging in predatory pricing behaviour because its price is above ATC and, hence, above AVC.\(^6\) Scherer warns that "[c]ourts that attempt to substitute simple cost rules for such analyses of effect and intent in alleged predation cases are likely to reach economically unsound decisions."\(^6\)

In a reply to Scherer's criticism, Areeda and Turner acknowledged that Scherer’s argument has merit.\(^6\) However, Areeda and Turner are prepared to tolerate the possibility of a predator pricing below MC but above ATC for practical reasons. They believe that significant anti-competitive consequences are unlikely in this situation. Presumably, the reason is that at an output of $Q_M^*$ the firm is likely to be expanding its plant capacity. The reason for such a great divergence between MC and AVC at $Q_M^*$ is that fixed costs are increasing. Normally one would not expect a predator to invest in plant expansion if its intention is to reduce its output once the competitor(s) has been driven from the market. Increased output is supposed to be only temporary in a predatory pricing situation. Plant expansion activity would suggest some permanency to the output increase. Consequently, in most situations, one would expect plant expansion activity to be inconsistent with predatory pricing activity.

Scherer develops an alternative test for detecting predatory behaviour based on long-run welfare maximization.\(^6\) While the A-T rule focuses on the short-run, Scherer argues that long-run profit maximization calls for the monopolist to price below MC in order to drive its rivals out.\(^6\) Therefore, according to Scherer, the A-T rule may penalize monopolists for pricing below MC when it is perfectly consistent with long-run profit maximization. Presumably, this would occur in a natural monopoly situation. According to Scherer’s test, the courts would have to consider the following variables before determining whether the price charged by the alleged predator is contrary to long-run welfare maximization:

- the relative cost positions of the monopolist and fringe firms,
- the scale of entry required to secure minimum costs,
- whether fringe firms are driven out entirely or merely suppressed,
- whether the monopolist expands its output to replace the output of excluded rivals or restricts supply again when the rivals withdraw,
- whether any long-run compensatory expansion by the monopolist entails investment in scale economy-embodied new plant.\(^6\)

Clearly such a test has no operational utility and is certainly not manageable by a court.\(^6\) In a reply by Scherer to Areeda and Turner’s criticism of his long-run test, he concedes that a court could not perform the kinds of analyses he contemplates.\(^6\)

\(^{61}\) Id. at 871.
\(^{62}\) Id. at 890.
\(^{63}\) Areeda and Turner, Scherer on Predatory Pricing: A Reply (1976), 89 Harv. L. Rev. 891.
\(^{64}\) Supra note 60, at 880.
\(^{65}\) Id. at 882.
\(^{66}\) Id. at 890.
\(^{67}\) Supra note 64, at 897.
\(^{68}\) Scherer, Some Last Words on Predatory Pricing (1976), 89 Harv. L. Rev. 901 at 903.
B. **Williamson (1977)**

According to Professor Williamson, we should not be concerned about the possibility of firms engaging in predatory pricing in competitive markets because they have no incentive to do so — only a dominant firm in an industry has an incentive to exclude or eliminate rivals. This makes sense because a firm which does not have the necessary market power (that is at least a forty per cent share of the market) would be committing suicide by engaging in predatory pricing behaviour. Williamson's basic criticism of the A-T proposal is that it does not distinguish predatory pricing behaviour in response to entry from predatory behaviour among established firms. Williamson seems to be concerned about new firms entering the market which may be more efficient in the long-run than the dominant firm. The new firm may, in the long-run, have lower costs than the dominant firm. Consumers will benefit with the new firm through lower prices because it will consume less resources to produce its product. If the dominant firm has lower costs than the new firm (in the new firm's initial stages of production), it is possible for the dominant firm to drive the new firm out of the market by reducing its price and expanding its output without pricing below its AVC. Therefore, Williamson proposes an output-limiting rule. This would involve prohibiting the dominant firm(s) from expanding its output when a new firm enters the market. Areeda and Turner, in a reply to Williamson, find his proposal inappropriate because it would encourage inefficient firms to enter the market. If the new firm's costs will be significantly above those of the dominant firm in the long-run, then society will be worse off by not allowing the dominant firm to lower its price and expand its output in order to drive the new firm out of business. Under the Williamson proposal, consumers will pay higher prices in the long-run by allowing a new, less efficient firm to remain in the market. Professor McGee argues that this rule would penalize competitive behaviour that is completely innocent of any predatory purpose or effect. Williamson, in a reply to Areeda and Turner's criticisms, argues that his output-limiting rule is workable, theoretically sound, and more appropriate than the A-T rule where the dominant firm is keeping entrants out.

Williamson must, therefore, feel that the increased cost to consumers in allowing a new entrant to remain is worth the risk that the new firm may, in the long-run, be more efficient. Yet it may be more appropriate for the new entrant to convince its creditors that it will be more efficient in the long-run and that they should carry it through its initial stages of losses, rather than to convince a court that it should interfere with the competitive process.

C. **Joskow and Klevorick (1979)**

Essentially, Professors Joskow and Kelvorick's criticism of the A-T rule is that it does not catch all predators. They propose a two-tiered legal standard.

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70 Williamson, *supra* note 7.
71 *Id.* at 292.
72 *Id.* at 331.
74 *Supra* note 5, at 315.
76 *Supra* note 2.
77 *Id.* at 214-16.
Tier one of their test involves a structural analysis of the industry to determine whether the alleged predator has market power. If the alleged predator does not have market power, its price can never be held to be predatory. This is premised on Williamson’s theory that competitive firms have no incentive to engage in predatory pricing. If Joskow and Klevorick’s test was applied to the facts of the Consumers Glass case, the case would have been dismissed since Portion was found not to have had market power. Tier two of Joskow and Klevorick’s test involves three cost-based rules:

(1) If price is below AVC: predatory.
(2) If price is between AVC and ATC: presumed predatory.
(3) If price is above ATC: presumed legal unless price cutter reverses price within reasonable time after cut, then presumed predatory.

Joskow and Klevorick’s second cost-based rule would appear to be in response to Scherer’s concern. However, as previously indicated, in Scherer’s situation the alleged predator is likely to be engaging in plant expansion activity, which would explain the great divergence between MC and AVC. Since ATC includes the fixed costs of the expansion, it would make more sense to presume that the alleged predator is engaging in competitive pricing behaviour. It would be a rare case where a predator would invest in plant expansion if it only intended to temporarily increase its output.

D. Baumol (1979)

Professor Baumol’s concern is with situations in which a new firm enters the market and the established firm seeks to deter entry. His worry is that the new firm will not have the economies of scale that the established firm has because of high barriers to entry. In the long-run, society may benefit from having the new firm if that firm will be just as efficient, or more so, than the established firm. To protect this benefit in the event that the entrant exits the market, Baumol suggests that once an established firm cuts its price it should not be allowed to increase the price again unless it is in response to changes in cost or demand. But such a test turns the court into a regulatory agency. If the entrant has the potential to be equally or more efficient than the established firm, it should be able to convince either the banks or the capital markets to pull it through the initial years of losses.

Despite the limitations of the A-T rule, the practical difficulties in proving the existence or absence of predatory pricing require some relatively arbitrary rules in order to minimize the administrative difficulties. Any legal standard for predatory pricing must be manageable in a court, and the only proposal thus far which is both theoretically and administratively sound is the A-T proposal.

VI. WHAT IS WRONG WITH THE CONSUMERS GLASS TEST?

In Consumers Glass, O’Leary J. was not prepared to decide whether the A-T rule was appropriate in all predatory pricing cases. He limited his AVC test to situations where chronic excess capacity existed in the industry. Since

78 Id. at 245-49.
79 Id. at 249-55.
80 Baumol, supra note 7.
81 Id. at 2.
82 Id. at 4-9.
Portion was producing in what may be characterized as the middle range of its production, its AVC closely resembled its MC. O’Leary J. was correct in applying the A-T rule in this situation.

O’Leary J. seemed to be concerned about the accuracy of the A-T rule in situations where the firm was producing beyond its middle range of production. By limiting the A-T rule to situations where there is chronic excess production capacity, O’Leary J. was responding to Scherer’s concern that there could be situations where a firm is pricing below MC but above AVC and, thereby, engaging in predatory pricing that would not be detected under the AVC test. But the AVC test is not an appropriate one for predatory pricing in a Scherer situation. As discussed earlier, the reason for a Scherer-type situation is that the firm is expanding its plant capacity. Since the fixed costs of expansion will be included in MC, there will be a large disparity between AVC and MC. In this situation, it is possible, but highly unlikely, that the firm is engaging in predatory pricing by pricing above its AVC. Without the new expansion cost component in MC, AVC will still closely resemble MC. Therefore, AVC will still be a good proxy in a Scherer-type situation. Consequently, the A-T rule should not be limited to excess production capacity situations, but should be applied in all predatory pricing cases to determine whether the price charged by the alleged predator is unreasonably low.

Under the Consumers Glass test, O’Leary J. seems to imply that intent becomes relevant if price is below AVC. Areeda and Turner would argue that an inquiry into intent is not likely to provide any illumination. The problem with intent is evident in the Hoffmann case, where the documentary evidence Linden J. relied upon was equally consistent with a conclusion of vigorous competitive intent. Yet, Linden J. held that the evidence indicated predatory intent. To avoid this problem of where to draw the line between vigorous competitive intent and predatory intent, it would make more sense not to have intent as a requirement for a subsection 34(1)(c) offence, but to allow for affirmative défences.

Another problem with the Consumers Glass test is in determining which costs should be considered variable. Bork contends that “true average variable costs cannot be reconstructed adequately from business records in a firm of any complexity.” Areeda and Turner recognize that “[t]here are no doubt disputable questions as to: (i) which costs should be included in variable costs; (ii) proper accounting valuation of inventories; and (iii) allocations of costs in multi-product enterprises.” Areeda and Turner believe that these are all resolvable questions. Certainly in Consumers Glass, the Court was able to resolve the issue of how much of Portion’s manufacturing overhead was fixed and how much of it was variable. Some commentators have suggested that variable costs should be defined so as to include all those costs that are “avoidable” if the alleged predator ceased production. With the aid of accountants, this issue of which costs are variable is not likely to cause the courts much hardship.

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83 Supra note 18, at 300 (D.L.R.), 254-55 (O.R.).
84 Supra note 64, at 897.
85 Supra note 6, at 154.
86 Supra note 73, at 1346.
87 Supra note 18, at 300-301 (D.L.R.), 255 (O.R.).
VII. CONCLUSION

The most difficult elements of a subsection 34(1)(c) offence are: 1) what is an unreasonably low price? and, 2) did the alleged predator have the necessary intent? The legal standard for what is considered to be an unreasonably low price must be clear and it must be manageable by a court. The test in Hoffmann provides no predictability. Businessmen, in developing pricing strategies, will be reluctant to reduce their prices under the Hoffmann test because they are not sure where the courts are prepared to draw the line between predatory pricing and competitive pricing behaviour. A cost-based test provides the necessary predictability. The Consumers Glass test draws the line quite clearly at AVC. The A-T rule, while criticized, is the only standard proposed in the legal literature that is manageable by a court and theoretically sound.

While Consumers Glass adopted an AVC test, its application was limited to situations involving chronic excess capacity. There does not seem to be any sensible argument for not extending its application to all predatory pricing cases.

The design or intent element of the offence should be eliminated because of the problems in distinguishing between predatory intent and vigorous competition, as illustrated in the Hoffmann case.

I would propose a three step analysis for dealing with the elements of unreasonably low price and intent in a subsection 34(1)(c) offence. Firstly, a court would be required to assess the structure of the industry to determine whether the alleged predator has any market power. If the alleged predator had more than a forty percent (40%) share of the market, then presumably it would have market power. If the alleged predator did not have a significant market share then it should be acquitted. Secondly, a court would be required to perform a cost-price analysis. If the alleged predator's price is at or above AVC, then it should be acquitted. If its price is below AVC, then it is per se unreasonable. A court should not, in either situation, consider intent as being relevant. Finally, assuming the alleged predator has market power and is pricing below AVC, a court would be required to allow for certain affirmative defences where: (i) the alleged predator was liquidating excess, perishable, or obsolete merchandise, or (ii) the cost of keeping the plant open is less than the cost of existing and re-entering where there is a temporary downturn in demand.

This type of three step analysis will improve upon the present state of affairs because predictability will be greatly enhanced. Businessmen in developing pricing strategies will be aware that if they have market power and price below AVC that they will be engaging in predatory pricing unless they can bring themselves within one of the affirmative defences. A more certain legal standard for an unreasonably low price should promote more competitive pricing. Businessmen will not be as reluctant to lower their price where a clearly articulated legal standard exists for distinguishing a predatory price from a competitive price.