ANTITRUST INTERVENTION AS A SIGNAL:

LONG-PURSE REVISITED

by
Antonio Nicita & Simone Maria Sepe

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Summary

- Long debate on the economic nature and rationale for predatory strategies: (i) mechanisms and (ii) functioning
- LP-Long pursue (deep pocket) theory refers to (ii).
- Recent LP theories focus on contractual failures between financiers and new entrants (ex-ante market failure) as an explanation for LP predatory strategies
- We suggest a sketch of a new theory based on ex-post market failure (financiers inability to receive the right information signal embedded in predatory pricing)
- We suggest that antitrust intervention - when appropriate - may generate positive information externalities into the market which enhance the mechanisms of the competitive process

The mistery of predation

- three main approaches: (i) behavioral (incumbent's rationality); (ii) effect-based (what predation is); (iii) the functioning and sustainability of predatory pricing
- two main views:
  - Chicagoans: the Easterbrook test
  - the Edlin approach (above cost predatory pricing)
- In both cases the essence of predation refers to an asymmetry: entrants' inability to (credibly) match incumbent's strategy on prices at any level

Our focus

- Our focus here is not on the conditions which determine whether or not an incumbent price strategy is predatory and hence anti-competitive

- We focus rather
  - (a) on the origin of the market failure according to which an equally efficient entrant is not able to face a price war
  - (b) on the role that antitrust institutions and policies might play in order to solve (or to generate) that market failure

The Long Purse Story

"A large firm might drive a small competitor out of the market by waging a price war that gives losses to both.

But the small competitor has limited resources ("a small pocket") and will therefore be unable to survive such losses for a long time.

Sooner or later, it will have to give up and leave the industry, allowing the large firm to increase prices and recoup losses."

M. Motta , 2004

Economic Critique

McGee (1958) criticized the LP idea:

- Large firms also incur in great losses
- When they increase price ex-post entry will start again (unless entry fixed/sunk costs)
- Asymmetric pockets are assumed rather than explained
- Predation should be not only feasible but also profitable (Easterbrook test)

Developments

Focus on imperfect information, uncertainty and beliefs (Motta, 2004)

- Reputation models: actual predation as a signal to future entrants (chain-store game)to endogenously raise barriers to entry
- Signalling models: incumbents set prices to signal their efficiencies to entrants
- Imperfect financial markets: focus on asymmetric information between financiers and the entrant

Signalling Models

- Milgrom&Roberts (1982): lower prices deter entry (only efficient incumbents may survive at lower prices)
- Harrington (1986): incumbent might deter entry by setting a high price, because this would signal the existence of high costs
- Fudenberg&Tirole (1986): "signal-jamming predation"

Imperfect financial markets/1

- Deep pocket theory of predation assumes limited access to financial market by the entrant: how to explain that ? (Benoit, 1984; Holmstrom&Tirole, 1997; Cestone, 2001)
- "*predation affects the perceived risk of lending money, thereby reducing financial sources available to the prey*"
- this is due to imperfect information on the side of lenders (principals) with respect to the activity of the agent (entrant)

Imperfect financial markets/2

two economic explanations:

- due to imperfect financial markets the entrant can only recur to self-finance to start a project and thus it has limited resources to face a price war
- due to imperfect financial markets, the lender can only rely to post-entry market performance to make a decision on whether to continue to finance or not; price war reduces expected profitability

in both cases: aggressive behaviour by the incumbent endogenously reduces the funds available to the rival (at least when commitment is not credible)

The Paradox
(what the literature neglects)

- the literature neglects that price war is a signal also for lenders in imperfect financial market in an opposite way
- incumbent would accomodate inefficient entrants while deterring efficient ones (at least when there are positive entry fixed costs)
- a price war should signal that entrants are potentially able to push incumbents out of the market: price war is a relevant information for lenders on the quality of the entrant

Information biases/ I

- Financiers that neglect the previous argument would be biased in their financial decisions. After entry:
  - they would (continue to) finance entrants which result to be 'accomodated' by incumbents (because inefficient in the long term)
  - They would refuse (to continue to) finance entrants which result to be faced by incumbents (because deemed as efficient in the long term)

Information biases/2

- The paradox here is that entrant's financiers behaviour would reinforce predatory strategy but in a way which is rather different than the standard literature has focused with
- We focus here not on ex-ante transaction costs of signing a contract, but on the ex-post transaction costs faced by financiers to fully understand the meaning of a price war as a signal about entrant's quality when taking a decision on extending of not their financial support after entry is observed

Sketch of a model/1

- period 1: incomplete contract between lender and an equally efficient new entrant which finances entry costs
- period 2: post-entry observation by lender, other things being equal, if a price war starts, decision to continue to finance
- period 3: two possible equilibria (entrant is the new monopolist or duopoly)

Sketch of a model/2

- the signal provided in period 2 could be biased if the incumbent has imperfect information on the quality of the entrant (it can start a price war against an inefficient entrant and accomodate an efficient one)
- when this occurs, lenders could not rely on predation as an information revealing outcome
- we introduce the assumption that an antitrust intervention against anti-competitive predation may restore the reliability of the information signal

Sketch of a model/3

for any definition of predation (Easterbrook or Edlin tests):

- anti-competitive predation is defined as predation by the incumbent against an equally efficient entrant when there are fixed entry costs in the industry

- An appropriate antitrust intervention is defined as an alleged abuse of dominance when anti-competitive predation is detected in the market

Sketch of a model/4

- we thus reformulate our conclusions in such a way
- when an antitrust agency is capable of adopting an appropriate antitrust intervention over an anti-competitive predation, then its intervention can restore the signal of predation for the lenders
- Thus antitrust intervention if appropriate has not only a 'punitive' role against abuse of dominance but also an informational role on the market

Wrong antitrust action and trade-offs

However when the signal provided by the antitrust agency is biased (not appropriate) two inefficiencies may affect the market:

a. inefficient punitive damages against efficient incumbents

b. inefficient financial aid to inefficient entrants

- On the other hand, the antitrust approach to predatory prices affects not only incumbent's strategy but also market structure (barriers to entry)

Conclusions/1

- We outlined a paradox: with rational agents predation is rational when the entrant is efficient
- We then provided a theory of LP predation based on the inability of lenders to evaluate the signal of predation
- An appropriate antitrust intervention may correct the information bias
- Antitrust agency play a comprehensive role: not only punishing illegal behaviour, but also providing information to the market.

Conclusions/2

- predatory prices are not generated by a market failure (incomplete agency contracts between lenders and entrants) as suggested by main literature

- rather they are generated by another institutional failure: antitrust authorities' ability to select appropriate intervention (to identify predation against efficient entrants)