

Wilmer Cutler Pickering Hale and Dorr LLP

Wilmer Cutler Pickering Hale and Dorr Antitrust Series

Year 2003

Paper 27

United States v. AMR Corp.: Non-Traditional Cost Measures and Expanding Predatory Pricing Exposure

Robert Bell*

Lee Greenfield†

Veronica Kayne‡

William Kolasky**

Jim Lowe††

Doug Melamed‡‡

Thomas Mueller§

Ali Stoeppelwerth¶

*WilmerHale

†

‡

**

††

‡‡

§

¶

This working paper is hosted by The Berkeley Electronic Press (bepress) and may not be commercially reproduced without the permission of the copyright holder.

<http://law.bepress.com/wilmer/art27>

Copyright ©2003 by the authors.

United States v. AMR Corp.: Non-Traditional Cost Measures and Expanding Predatory Pricing Exposure

Robert Bell, Lee Greenfield, Veronica Kayne, William Kolasky, Jim Lowe, Doug Melamed, Thomas Mueller, and Ali Stoeppelwerth

Abstract

Historically, industries with low average variable costs (AVC) have been as a practical matter largely immune from predatory pricing claims. The reason is simple. Predatory pricing claims require the plaintiff to establish, among other things, that the defendant priced below an appropriate measure of cost. Because marginal costs are notoriously difficult to measure, courts have commonly compared the defendant's prices to AVC (total costs that vary with output/units of output). Consequently, in industries where average variable costs are very low, plaintiffs are unlikely to be able to prove that defendants have priced below AVC, even when defendants have drastically slashed prices. Airlines are a classic example of such an industry.



WILMER, CUTLER & PICKERING

Antitrust and Competition Law Update

JULY 11, 2003

United States v. AMR Corp.: Non-Traditional Cost Measures and Expanding Predatory Pricing Exposure

Historically, industries with low average variable costs (AVC) have been as a practical matter largely immune from predatory pricing claims. The reason is simple. Predatory pricing claims require the plaintiff to establish, among other things, that the defendant priced below an appropriate measure of cost. Because marginal costs are notoriously difficult to measure, courts have commonly compared the defendant's prices to AVC (total costs that vary with output/units of output). Consequently, in industries where average variable costs are very low, plaintiffs are unlikely to be able to prove that defendants have priced below AVC, even when defendants have drastically slashed prices. Airlines are a classic example of such an industry.

A recent appeals court decision may give companies with low AVC new reason to worry about predatory pricing claims. In *United States v. AMR Corp.*, No. 01-3202 (10th Cir. July 3, 2003), the Tenth Circuit accepted in principle the Justice Department's argument that, in some predatory pricing cases, measurements other than AVC that more directly reflect the specific incremental costs associated with alleged predation may be the most appropriate benchmark of the defendant's costs.

The Decision in *AMR*

Between 1995 and 1997, several low cost carriers entered certain airline routes between Dallas/Fort Worth Airport and other cities that American Airlines serves and undercut American's fares. American responded to the new competition by lowering prices and increasing capacity by adding flights or using larger planes, in both cases drawing planes from other purportedly profitable routes. In each instance, American's conduct allegedly forced the low cost carrier to either move its operations to different routes or cease competing altogether. After the low cost carriers had exited the routes, American generally reduced capacity and raised prices to levels roughly comparable to those before the low-fare competitors entered. The government alleged that American designed its actions to drive the low cost carriers from the markets and, more broadly, build a reputation for predatory pricing to defend its monopoly on other routes between its Dallas/

Fort Worth hub and other cities. The district court granted AMR's (American's parent) motion for summary judgment on all antitrust claims.

To understand the government's argument in *AMR* it is helpful to recall the purpose of comparing price and cost. Doing so helps the court to determine whether the defendant made sales that were unprofitable and thus made no economic sense apart from their anticompetitive purpose. It also helps to ensure that predatory pricing claims do not (perversely) chill the very bare-fisted price rivalry that the antitrust laws are designed to preserve. As noted above, courts have widely adopted the defendant's AVC in the relevant market as a proxy for marginal cost.

The Justice Department argued that applying an AVC test — measuring variable costs over the defendant's entire market output — was inappropriate here because the Department's claim was directed against well-defined,

WILMER, CUTLER & PICKERING

measurable incremental conduct, namely adding capacity while cutting prices. The Department therefore asked the court to forgo market-wide AVC and instead measure the costs specifically associated with American's capacity additions. According to the Justice Department, relying on market-wide AVC would obscure American's predatory strategy: although American may have priced above its market-wide AVC, an analysis comparing the incremental revenues and costs of its capacity additions would have shown a loss.

The government argued that since American's cost of adding capacity exceeded the revenues generated by the capacity additions, its conduct would have been economically irrational but for its exclusionary effect. According to the government, the district court erroneously believed that an airline's cost of serving additional passengers is always close to its route-wide AVC. In essence, the Justice Department argued that the proper measurement of cost is that associated with bringing more or bigger planes on to the route; and the district court erred by holding the amount of capacity on the route as a given, fixed cost and classify as variable only those costs directly associated with putting one more passenger on a flight (*i.e.*, a bag of peanuts and a soft drink).

Citing recent scholarship challenging the premise that predatory pricing schemes are implausible and irrational, the Tenth Circuit said it approached the predatory pricing claim with "caution" rather than "incredulity." It accepted the government's basic legal theory that measures of cost other than AVC may be necessary properly to evaluate predatory pricing claims, although it nonetheless affirmed the grant of summary judgment in favor of the defendants. The court found that sole reliance on market-wide AVC might, indeed, obscure the nature of a predatory scheme.

The court also made clear, however, that when a plaintiff seeks to use marginal cost as the relevant measure, the calculation of marginal cost must be accurate and reliable in the circumstances of the case. On the particular facts in *AMR*, the Tenth Circuit found that the Department had failed to offer an alternative test that accurately measured incremental costs. Specifically, according to the court, the four alternative tests that the government offered were invalid as a matter of law either because they lumped fixed with marginal costs, adopted an impermissible short-run profit-maximization test, or included variable costs attributable to American's broader opera-

tions that were not specifically associated with adding capacity to the routes at issue. The court's rejection of the government's tests reinforces why AVC, rather than marginal cost, has been the customary touchstone for predatory pricing analysis: plaintiffs trying to rely on marginal costs to prove predatory pricing face difficult — and sometimes insoluble — conceptual and practical problems.

Implications of *AMR*

AMR does not signal a change in the basic law of predatory pricing. Indeed, it reconfirms the basic premise that marginal cost — rather than the more common proxy of AVC — may be an appropriate cost measure in predatory pricing cases. This option was left open by the Supreme Court in *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993), when it declined to endorse AVC as the only appropriate cost measure. The Tenth Circuit's opinion does suggest, however, that post-Chicago School economic scholarship may be influencing courts to take a less hostile view towards predatory pricing claims than that reflected in *Brooke Group* and other cases. More particularly, *AMR*'s focus on the potential decision making advantages of using marginal cost rather than AVC in some circumstances could have far-reaching consequences.

As long as courts rely only on AVC, firms with low AVC in the relevant market (such as airlines and software firms) are virtually immune from predatory pricing claims. In light of *AMR*, however, even firms with very low AVC should be more cautious and examine proposed new pricing schemes carefully. Of course, plaintiffs still face the difficult challenge of devising tests to measure these incremental costs accurately, without including fixed costs or other variable costs not attributable to the specific conduct in question. Nevertheless, after *AMR*, even very low AVC is no longer a guarantee that a defendant will prevail in a predatory pricing action.

Please contact us if you would like further information about the *AMR* case or would like information about any other issue of US or foreign antitrust or competition law.

Robert Bell
Lee Greenfield
Veronica Kayne
William Kolasky

Jim Lowe
Doug Melamed
Thomas Mueller
Ali Stoeppelwerth

