

Selective Price Discounts  
by a dominant player:  
the RDB case

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Recent Developments in the Enforcement of Art. 82  
Rome, April 9th 2010

# The beginning

- Italgasbeton (ITGB) is a small company (turnover 5 mln €) producing and distributing AAC (more later) under its own proprietary technology
- In sep. 2005 ITGB complained to AGCM the aggressive pricing policy adopted by RDB, the dominant player in the market, designed to exclude ITGB from the market
- To achieve this goal ITGB claimed that RDB was offering below cost prices to Italgasbeton best customers

# The Product - 1



Autoclaved Aerated concrete (AAC), or Autoclave Cellular Concrete (ACC), is a lightweight, precast building material providing structure, insulation, fire and mold resistance in a single material. AAC products include blocks, wall panels, floor and roof panels

# The Product - 2

Produced for more than 70 years, AAC offers considerable advantages over other construction materials:

- light weight (five times lighter than concrete)
- high insulating capability (high thermal efficiency, reduction of space for heating and cooling in buildings)
- low environmental impact in all phases of its life cycle (from processing of raw materials to the disposal of AAC waste)
- quick and easy installation (easily cut to size on site using conventional carpentry tools)

# AAC - The Market - 1

Very substantial variation in the price differential between AAC and aggregate blocks through time: it is unlikely that they are close substitutes for each other

- At current prices a small but significant rise in the price of AAC would not lead to significant switching to other products
- Existence of significant switching costs: there is little or no ability (in the short term) on the supply side to switch from the production of AAC to aggregate blocks, or vice versa
- The evidence, both on the demand and supply side, was consistent with the finding that AAC is the relevant market

# AAC - The Market - 2

RDB is the dominant player in AAC market:

- market share 70% and growing in the last four years
- RDB realized several acquisitions, consolidating its market position: in 2000 and 2004 acquired two producers located in the same area in which traditionally ITGB operated
- RDB has a strong brand, “*Gasbeton*”, with high reputation for quality
- Market is growing (7% in the previous 4 years; 3-4 times the average rate for similar products, i.e bricks, etc.)

# The working of the market

- The market process is decentralized
- Each producer operates through a distribution network of retail agents
- The commercial terms are set client by client
- The clients are mainly resellers with low bargaining power:  $\approx 9000$  buyers; each single order does not exceed 5000-10000 m<sup>3</sup>

# Competition Authorities need to be careful - 1

- Competition requires that efficient rivals drive out their less efficient counterparts
- But the elimination of rivals may be associated with an increase in monopoly power if there are entry barriers
- The same methods are required to eliminate socially efficient rivals as inefficient ones
- The boundary between exclusionary conduct and legitimate competition is fuzzy and controversial:
  - Type I error or false positives, diagnosing as anticompetitive a genuine competitive action
  - Type II error or false negatives, in which companies engaging in welfare-reducing anticompetitive actions are not found to have violated the antitrust laws



# Competition Authorities need to be careful - 2

- It may be exceedingly difficult to tell which has occurred
- Exclusionary Conduct. Which test ?
- Equally efficient rival test – a conduct should be condemned if it is capable of excluding an equally efficient firm
- In a world of incomplete information, smaller rivals need to be persuaded of their “*inefficiency*” if they are to be convinced that they should exit
- Simple legal rules often fail to do the job

# Before to start: efficiency and intent

C. Shapiro : “*Exclusionary Conduct*”, 2005

- *The claim that a practice is “efficient” because is profitable for the firm employing it is clearly too broad: all profitable practices employed by dominant firms would be “efficient” by this argument*
- *Evidence regarding intent is only relevant to the extent that it is informative regarding likely effects... Executives ... understand the .... markets in which they operate far better than judges or juries so their more specific language regarding aims...may be highly informative regarding the likely effects on competition and customers*

# The anticompetitive story: selective price cuts

- In 2004-5 RDB planned a predatory strategy with the ultimate goal:
- **”to buy the last competitor (ITGB) in the italian market“** - *Source*: RDB Strategic Plan, March 2005
- Action: Selective price-cutting to the most significant ITGB clients
- Six files containing names of ITGB clients ( $\cong$  300) internal documents all called *“Azione contro Italgasbeton”* (source: docs. n.177, 178, 89, 88, 25, 26)

# The Plan against ITGB: an example

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Aggiornamento del 05/04/05

**Azione contro Italgasbeton**

Nominativo Cliente	Prov.	mc/annul	Status	€/mc	
Balzano	NA	4.000	Acquisito	60	
Bondatti	RM	1.000	Acquisito	57	*
Domi	NA	2.500	Acquisito	63	*
Edil Lamberti	SA	700	Acquisito	59	*
Edil Romeo	NA	800	Acquisito	63	
Edilnovit	NA	6.000	Acquisito	60	*
Ediltutto	CB	700	Trattativa	-	
Fiorentino	NA	2.000	Trattativa	-	
Fin Beton	BS	2.000	Trattativa	-	
Sarifer	RM	3.000	Acquisito	57	*
Semprebuono	NA	2.000	Trattativa	-	
Valerio	IS	700	Trattativa	-	
Vinaccia Maria	NA	1.500	Acquisito	60	
Vinaccia Srl	NA	1.500	Acquisito	60	
Edil Cem	NA	700	Acquisito	63	*
Andrea & Gildo Russo	SA	700	Acquisito	62	
Edilizia Amoroso	CE	800	Acquisito	61	

\* Primi ritiri già effettuati

**Totale Acquisito**      30.000 mc

# The anticompetitive hypothesis - 1

- Using the (conservative) “*equally efficient rival test*” AGCM found that ITGB was an efficient competitor:  
unit production costs  $\cong$
- Selective price cuts are a form of price discrimination, based on the following characteristics:
- The customer belongs or is shared with the targeted competitor
- “Exclusionary” selective prices target primarily at competitor’s best customers

# The anticompetitive hypothesis - 2

- With ITGB equally efficient rival, RDB behaviour is anticompetitive if:
- **1:** the frequency of invoices with prices below ATC is higher for common clients than for RDB-only-clients
- **2:** the RDB margin is lower for common clients than for RDB-only-clients
- **3:** in estimating the margin, once controlled for firm, client and market characteristics, the sign of the dummy variable for common clients is negative and significant

# The data

- AGCM analyzed over 40.000 invoices issued by RDB to its clients during 2005
- Each invoice contained the quantity and price of the order and additional information (i.e. the name and the geographical area of the client)
- AGCM estimated fixed and variable costs using the consolidated accounts of the AAC division of RDB

**1. the frequency of invoices with prices below ATC is higher for common clients than for RDB-only-clients**

<b>Pricing</b>	<b>RDB only clients</b>	<b>Common clients</b>
<b><math>P &lt; ATC</math></b>	<b>5%</b>	<b>11%</b>
<b><math>P &gt; ATC</math></b>	<b>95%</b>	<b>89%</b>
<b># Invoices</b>	<b>[40.474]</b>	<b>[2.066]</b>



**2. the RDB margin is lower for common clients  
than for RDB-only-clients**

<b>Pricing</b>	<b>RDB only</b>	<b>Common clients</b>	<b>Target Clients (The Plan)</b>
<b><math>P &lt; ATC</math></b>	<b>4%</b>	<b>15%</b>	<b>18%</b>
<b><math>P &gt; ATC</math></b>	<b>96%</b>	<b>85%</b>	<b>82%</b>
<b>Av. Size (m<sup>3</sup>)</b>	<b>[134]</b>	<b>[124]</b>	<b>[177]</b>
<b>Index margin (euro/m<sup>3</sup>)</b>	<b>[100]</b>	<b>[81]</b>	<b>[67]</b>

**2: the RDB unit margin is lower for  
common clients than for RDB-only-  
clients – More on the Plan**

<b>N<sup>^</sup>. doc.</b>	<b>Date</b>	<b># Clients in the Plan</b>	<b>Price &lt; ATC</b>
<b>doc. 177</b>	<b>05/04/2005</b>	<b>12</b>	<b>100%</b>
<b>doc. 178</b>	<b>19/04/2005</b>	<b>15</b>	<b>93,3%</b>
<b>doc. 89</b>	<b>23/05/2005</b>	<b>30</b>	<b>73,3%</b>
<b>doc. 25</b>	<b>31/10/2005</b>	<b>47</b>	<b>61,7%</b>
<b>doc. 26</b>	<b>17/11/2005</b>	<b>30</b>	<b>73,3%</b>

### 3: in estimating the unit margin, the sign of the dummy variable for common clients is negative and significant

**Table 3 – Econometric analysis**

<b>Dependent variable: margin over total costs, p-ATC</b>				
Method: Least Squares				
Observations: 43.273				
White Heteroskedasticity-Consistent Standard Errors and Covariance				
Variable	Coefficient	Std.Errors	t-Statistics	Prob.
<b>Constant</b>	20.690	0.125	166.13	0.000
<b>Common</b>	-0.830	0.112	-7.405	0.000
<b>Subtracted</b>	0.134	0.158	0.842	0.399
<b>Wholes./final user</b>	0.796	0.086	9.295	0.000
<b>Regional dummies</b>	significant at less than 1%			
<b>Plant dummies</b>	significant at less than 1%			
<b>AAC varieties</b>	significant at less than 1%			
R-squared	0.416	Mean dep. variable		24.728
Adjusted R-squared	0.416	S.D. dependent variable		6.553
S.E. of regression	5.010	F-statistics		993.70
Sum squared resid.	1085241.0	Prob(F-statistics)		0.000

Source: Case A372\_RDB, Decision, p.80.

# What the data show ? - 1

## The characteristics of the common customers

- In 2005 common customers were three times those of 2004
- The size of common customers was larger than average ITGB customer
- Size distribution of common customers with  $P < ATC$  was heavily skewed towards bigger clients
- In a fast growing market targeting at competitor's customers with  $P < ATC$  is at odds with a “*competitive tale*”

# What the data show ? - 2

## The effects on ITGB

- In 2005 ITGB lost  $\cong$  20% of its 2004 turnover
- Half of the loss is accounted by the clients in the *“Azione contro Italgasbeton”*
- In 2005 the competitor EBITDA declined  $\cong$  20%
- RDB was successful: the damage to ITGB more than proportional to the cost (actual and expected)

# Facts in search of a model-1

G. Saloner: *Predation, mergers, and incomplete information*, RJE 1987

- Predation to merge. Saloner (1987):
- Price-cutting can simultaneously serve two purposes: a predatory and a limit-pricing function
- Predation models produce “pooling” equilibria in which inferences by entrants are prevented or delayed, i.e. it convinces the rival to sell out on favorable terms
- Signaling models typically produce “separating” equilibria in which observations of the incumbent’s actions allow immediate inferences by entrants, i.e. the incumbent might have incentive to fight in order to build a reputation that signals to potential entrants that entry is unprofitable

# Facts in search of a model-2

G. Saloner: *Predation, mergers, and incomplete information*, RJE 1987

- Here the main purpose of the dominant player was to engage in a strategic price-cutting to improve the takeover terms
- Value of the firm =  $f(\text{FCF}+, \Delta\text{FCF}+, \text{WACC}-)$
- A preemptive price-cutting strategy lowers the value of ITGB
- With  $P > \text{ATC}$  such pricing cannot be considered "predatory" in the generally accepted interpretation of the term
- The elimination of the rival can occur even without the an unlawful price-cutting and the anticompetitive behavior can go undetected and undeterred

# The end of the story

- Here the story is different.
- ITGB was an efficient competitor
- The RDB price-cutting was a selective discounts pricing strategy with  $P < ATC$  to common clients shared with ITGB
- Hence the cost-effective exclusionary behaviour of the dominant player was unlawful
- BUT...
- With a more prudent pricing policy the story will be different.... and the consequences too