ANTITRUST INTERVENTION AS A REAL OPTION: LONG-PURSE REVISITED

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LONG ABSTRACT

Entry deterrence by dominant firms is more likely to occur in markets characterized by high entry fixed costs and/or a high rate of technological innovation. When entrants are financially constrained, incumbents may succeed in deterring entry or inducing exit through a policy of aggressive rebates (financed by the "long-purse" or "deep pocket"). The implicit assumption behind that is that credit market fails to sustain a potentially efficient competitor (McGee, 1958; Telser, 1966). Because aggressive competition by the incumbent increases the likelihood of competitors' exit, investors refuse to finance those entrants exposed to incumbents' predation (hereinafter, IP). Indeed, lenders evaluate corporate projects by looking at their net present value (NPV), especially when financing is made against cash flows and is staged. Because of IP strategy, however, entrants' projects might have a negative NPV. As a result, they might well go unfunded. (Tirole, 2005).

In our view, this situation would result in a problem of adverse selection, at least in some circumstances. With high entry fixed costs, incumbents may find rationale to start predatory strategies against those competitors who appear to be potentially more dangerous in challenging dominant positions. Thus, a war price would reveal to the market the potential market success of entrants rather than their weakness in fighting back IP. Put different, IP would act as a signal of the entrant's virtues. For this reason, it should attract rather than inhibit new investments.

We also argue that, when the IP economic signal is too weak to be given adequate consideration by investors, an antitrust intervention may provide a stronger, institutional signal. Thus, when investors include competitive dynamics and antitrust policy in their analysis, incumbents' predation or deterrence strategies may produce a countervailing effect. They may induce investors to finance entrants' effort to replicate incumbents' prices. In turn, we show how antitrust authorities play a crucial role in enhancing market competition. Not only do they contrast market abuses, but also they may provide valuable information to investors on entrants' ability to succeed against dominant firms.

In light of the above, we suggest that real option analysis should be preferred over traditional corporate projects' valuation techniques, such as the NPV test, in evaluating insurgents' projects. Pursuant to the former kind of analysis, investments are evaluated by looking at them as including hidden options on timing, expansion, closing, flexibility, etc, and their payoffs are discounted accordingly. Thus, if evaluated through the real option technique, even investments with a negative NPV may be profitable.

This becomes of crucial importance in the insurgents-incumbents context to avoid the adverse selection problem that follows the undertaking of IP strategy. By applying the real option analysis in such a context, lenders should evaluate insurgents' projects not only by looking at the price war between the parties, but also at the investment's hidden option, that is, the possible antitrust intervention. More specifically, we suggest that lenders should consider two variables in valuing this hidden option: (i) the probability of the antitrust authority's intervention; i.e., the option's *vega*; and (ii) whether this intervention is likely to be in favor or against the insurgent; i.e., the option's *delta*. If the antitrust intervention is probable and likely to be in favor of the insurgent, even projects with a negative NPV would become profitable and, therefore, fundable. This, in turn, would avoid the exclusion of potentially efficient competitors.