Policy Brief UMBC Policy Brief No. 2 – January 2007

Department of Public Policy, University of Maryland, Baltimore County
1000 Hilltop Circle, Baltimore, MD 21250

Six Recommendations for Reframing Monopolization Law

by Timothy J. Brennan

About the Author

Timothy J. Brennan is a Professor of Public Policy and Economics at UMBC. Professor Brennan was selected to serve as the 2006 T. D. MacDonald Chair in Industrial Economics for the Canadian Competition Bureau, the first academic from the U.S. to be named to this prestigious post.

This paper is adapted from Dr. Brennan's June 22, 2006 remarks before a joint public hearing held by the Department of Justice and the Federal Trade Commission on whether and when specific types of single-firm conduct may violate the antitrust laws, in particular, Section 2 of the Sherman Act. The specific focus at that hearing was "predatory buying;" a concern that a firm would drive out its rivals by paying too much for an input they need, in order to depress the price that firm has to pay in the future for those inputs once its competitors are eliminated. The purpose of his remarks was to suggest that "predatory buying" is unlikely to offer a better framework to assess the practices a firm might use to exclude its competitors. His remarks reflect his own opinions and do not represent those of UMBC, the Canadian Competition Bureau or any of its staff.

Issue

Antitrust laws, in the U.S. and around the world, focus on three types of practices that prevent the public at large from benefiting from a competitive economy. Two of those classes of practices—collusion (e.g., agreements to fix prices rather than compete in the market), and mergers eliminating significant competitors—often present difficult factual questions, but the fundamental principles behind them are widely accepted. The third class involves practices under which a single firm allegedly acts to create or maintain a monopoly by excluding competitors. This type of practice, known as "monopolization" in U.S. law and "abuse of dominance" in most of the rest of the world, has long been controversial because consumers generally benefit when a firm is a tough competitor, even when that also hurts its rivals.

Competition agencies around the world are currently looking at single firm conduct to see if better legal standards can be developed to separate tough competition from harmful exclusion. Accordingly, the U.S. Department of Justice (DOJ) and the Federal Trade Commission (FTC) are reviewing the appropriate antitrust approach under Section 2 of the Sherman Act, the part of the law that covers monopolization. Among the many practices they plan to examine under the monopolization rubric is what they call "predatory buying." As exemplified by a recent case, *Ross-Simmons v. Weyerhaeuser*[1] (currently on appeal to the Supreme Court), predatory buying involves paying too much for something a business needs (e.g., trees sawed by lumber mills) to drive competitors out of business, enabling the "predator" to drive down the price it pays in the future.

My concern, shared by others at the hearing,[2] is that standards appropriately designed to make predatory cases difficult to bring would be excessive in most exclusion cases that involve making it harder for competitors to obtain what they need to compete effectively. The two broad categories of monopolization practices—exclusion and predation—are essentially different; recognizing those differences is crucial for sound antitrust policy. Six recommendations, which follow from recognizing these differences, can support Section 2 jurisprudence and reconcile it with less controversial, more accepted frameworks for prosecuting cartels and evaluating horizontal mergers.

Predation and Exclusion: Understanding the Distinction

As just noted, the basic premise behind my recommendations is that monopolization entails two essentially different types of practices. For shorthand, one could be called "predation," and the other "exclusion." The most succinct distinction is that predation cases involve doing too much of a good thing to bring about a bad result later. There, the understandable concern is that a firm will deter energetic competition in the future by charging low prices, adding product features, and the like in the present.

Exclusion cases, on the other hand, involve doing a bad thing now. One way or another, exclusion comes down to acquiring control and effective market power over supply or access to what economists call complements, which in this context are inputs or services a firm needs to compete. The most explicit way to acquire such control would be through a series of exclusive contracts with the complement's suppliers. It also may involve overbuying inputs through explicit purchase or, as I'll suggest below, bundling, rebates, or other forms of "leaving money on the table." Whichever form it takes, I call the

practice of excluding through acquiring control of goods and services competitors need "complement market monopolization," or CMM.

The major problem with single-firm conduct law is the failure to recognize the essential differences between these two types of conduct, leading to the counterproductive imposition of predation standards on exclusion cases. Perhaps this failure arises from a presumption that one statutory provision, the Sherman Act's Section 2, must imply one principle. Or, it may follow from the persistent belief that Section 2 must be premised on harm to rivals. Since competition also harms rivals, Section 2 law is thus driven by fear of over-deterrence.

Regardless of the underlying cause of this failure, exclusion cases should be seen as different from predation cases. Realizing the differences between these two types of cases has many implications for developing appropriate legal standards. The remainder of this brief provides six specific recommendations that follow from recognizing the differences between exclusion cases and predation cases. Perhaps most fundamentally, genuine predatory buying cases—where the purpose is to drive down input prices in the future—are rare. In most cases, the anticompetitive effect will be exclusionary, obtaining control over an input or other complement that directly leads to higher prices. In those cases, we can apply familiar tools, rather than predation screens, to delineate and protect complement markets.

Recommendations

1. Genuine predatory buying cases will be rare; if they occur, validate necessary assumptions.

Although the panel was nominally about "predatory buying," "exclusionary buying" would be a more apt topic, because the leading cases involve creating market power over complements. The recent DOJ/FTC *certiorari* petition in *Weyerhauser v. Ross-Simmons* illustrates an exception that proves the rule.[3] The setting is unusual, in that the concern is not that a timber processor would acquire so much control over a relevant market in uncut trees to be able to raise their effective price. Rather, according to the petition, the allegation is that a mill would pay too much for trees to drive out other buyers, with subsequent recoupment by cutting prices paid for trees in the future.

I have little to say about which market power, price-to-cost, and recoupment tests are appropriate for preventing over-deterrence in these rare predatory buying cases. I do, however, suggest that such tests are necessary, but not sufficient, to establish that predatory buying has occurred. Courts should also examine whether specific assumptions behind strategic models are satisfied, i.e., that the alleged predator either has a reputation for non-profit maximizing behavior to protect or benefits from identified failures in capital markets. Theoretical possibility alone does not make a practice harmful.

2. For exclusion cases, the first and crucial step is to delineate a complement market being monopolized using the DOJ/FTC Horizontal Merger Guidelines (HMGs).[4]

Market power is often characterized not just as the ability to raise price but also as "the ability to exclude." This is a mistake of imprecision. The ability to raise the price of product X depends on entry barriers or other impediments to competition, but those do not depend upon the price of that product. Higher prices for product X would, if anything, encourage entry. Rather, the ability to exclude depends upon control over the prices of complements Y, Z, and W, or something else needed to produce and sell X.

Delineation of the relevant complement market should therefore be the first step in all exclusion cases. In the *Dentsply* case, for example, the case rested on the premise that the national distributors constitute what in merger contexts would be regarded as a relevant market, in this case for the distribution of teeth to dental labs.[5] The HMGs provide the useful framework for testing this premise. They ask whether teeth manufacturers would turn to other distributors, or distribute themselves, in response to a "small but significant non-transitory increase in the price" (SSNIP) of using such dealers.

I do not know the facts of that case and thus the answers, but the HMGs ask exactly the right questions. Cases eventually turn to evidence of entry or substitution into the complement market, but they do not make such concerns central. The best indicator would be the continued identification of the relevant market as that in which the alleged monopolizer is already dominant, not the market over inputs or services competitors need to compete. Control over such a complement market is not only sufficient to raise competitive concerns; it is necessary for anticompetitive exclusion.

(continued on reverse)

Hence, plaintiffs should focus on identifying that complement market and showing that the practices at hand cover enough of that market to raise the complement's price. In effect, the relevant question is whether one would be troubled if the complement providers covered by the alleged exclusionary practice merged. Unlike usual characterizations of monopolization cases, this is a question we know how to answer: use the HMGs. If the answer is no, stop; if the answer is yes, go to the next step.

3. Having delineated the relevant complement market, the second step should be to establish the price effect in that market.

A firm cannot raise barriers to entry and impede competition by any more than the extent to which the firm can raise the price of the complement. Sometimes this higher price will be explicit; sometimes it will be only an inferred higher price. At a recent conference, Professor Dennis Carlton usefully called this a "shadow price," defined as the implicitly higher prices brought about when an exclusionary practice so ties up the complement market that only higher priced substitutes, including self-provision, are available.[6]

Explicit exclusive dealing contracts offer one such standard: firms wanting to use those dealers would have to cover the cost of breaching the contract. Other alleged exclusionary practices, such as bundle discounts or loyalty rebates, may increase the price competitors have to pay to obtain the input or complement. Whether this increase is competitively significant depends on whether the contracts, bundles, or rebates cover enough of a properly delineated complement market to give the alleged monopolist the power to raise prices overall.

4. The appropriate standard for assessing the exclusionary effect of a bundle or rebate is not whether an incremental price is below incremental cost, but its effect on the price of the complement.

Following the last point, one could ask whether bundling, a rebate, or other program has to increase the effective price of the complement as much as would explicit contracts. I have no reason to believe it should. Were we to follow the HMGs, as we should for complement market delineation, we might only establish that the practice leads to a SSNIP of the complement.

This tells us that whether a bundle is anticompetitive has nothing to do with a predation-like test. It does not depend on whether the incremental price of adding a good to a bundle, or of supplying more of a product given a discount, is less than some measure of marginal or average variable cost. Rather, it depends only on the extent to which such practices create market power in order to raise the price others must pay for the services provided by retailers, distributors, or other complement providers getting the discount.[7]

5. Predation case screens—profit sacrifice, equally efficient competitor, and prior dominance—do not belong in exclusion cases.

Even for predation, some commentators have noted that some or all of these screens need not increase competition and consumer benefit. Nevertheless, they may be appropriate to prevent over-deterrence of competition through low prices or added features. However, in exclusion cases, controlling a monopoly share of complement markets is not presumptively pro-competitive, and thus need not have high bars for its protection.

The profit sacrifice or "no business sense" test—the two are equivalent if one assumes that "business sense" means "maximize profits"—substitutes concern with intent and tactics for concern with effects, as if determining whether someone has been murdered depends on the price paid for the gun. Others have noted that the profit sacrifice test creates an absolute efficiencies defense, in that a penny of gain from a practice excuses untold anticompetitive harms. As fellow panelist Rick Warren-Boulton and others have said, the test is notably inappropriate when regulated monopolists do the excluding.[8]

Although I have criticized "raising rivals' costs," mostly for its emphasis on "rivals," Professor Salop on the panel deserves enormous credit for pointing out long ago that predatory sacrifice and recoupment are unnecessary to carry out tactics that raise those costs.[9] My difference is that I would focus directly on the complement market.

Ironically, the test also ignores that once upon a time, profit sacrifice implied previously unobserved efficiency, not anticompetitive harm. We learned that exclusive territories, exclusive dealing, tying, and even resale price maintenance must generate efficiencies because they reduce demand, making even monopolists worse off otherwise. That realization

gradually reformed most vertical restraint law. Assuming now that a profit sacrifice must be anticompetitive neglects antitrust history and invites us to repeat mistakes that have not been fully undone after nearly a century.

On equally efficient competitors, I point out what should be obvious: inefficient competitors may still hold down price. Complement market monopolization leading to their exclusion can raise price and harm consumers.

Having gone after two sacred cows, I may as well finish off the herd: The *Grinnell* prior possession of a monopoly test also can impede meritorious exclusion cases.[10] It distracts attention away from the complement market, focusing instead on the characteristics of who monopolized it. Prior dominance could even be a defense, but once complement market monopolization is shown, it should be up to a defendant to claim it has no consequence because of monopoly elsewhere in the production chain.

Moreover, this test is counterproductive. Proving the cost, demand, and entry barriers necessary to establish prior dominance undercuts the argument that the alleged exclusionary practices make a difference. Using Richard Posner's phrase, the monopoly should be "fragile" at worst. An exclusion case will be strongest if the sector would be competitive, but for the practice under scrutiny.

To understand the inappropriateness of these tests, ask whether we would apply them to mergers. Should all mergers be legal unless one could show they would be unprofitable but for anticompetitive harm? Should any merger, including to monopoly, be legal if a more efficient firm buys and eliminates a less efficient competitor? Of course not. Even prior dominance may make the incremental effect of a merger less troubling. If these tests would gut merger law, and if exclusion cases are akin to acquisitions in the complement market, they do not belong on this side of Section 2.

6. Consider share-based rather than "all or nothing" remedies.

In typical Section 2 cases, either a practice is acceptable, or it is not and should be stopped. Analogy to mergers, where they are allowed in a market up to a point but not beyond, opens the door to more creative remedies for exclusion. In particular, a share-based approach may be appropriate. Exclusive dealing contracts, bundles, or other alleged monopolizing practices might have efficiency benefits. The problem is not the practice per se, but its scale: the practice pre-empts so much of the complement market that it raises its price significantly. Rather, defendants should be allowed to retain the practice, but only over a non-dominant share of the complement market, e.g., 35 percent, 50 percent, or some appropriate number. If the practice is actually efficient, it will be kept. If it serves only to exclude, this remedy would lead to its discontinuance.

Conclusion

About two years ago, I gave a talk at the FTC on these ideas, entitled "Saving Section 2." As I began, an economist there, reflecting the widespread controversy associated with these cases, asked, "Why should anyone want to save Section 2?" My answer may not have satisfied him, but in short, it is that Section 2 can and should be saved. Were all Section 2, single-firm conduct cases about protecting a monopolist's rivals by drawing vague or impossible lines between competing just enough and too much, I might have shared the questioner's skepticism. However, exclusion cases are not about maintaining monopolies but creating new ones. In focusing on complement market monopolization, such cases can and should be no more controversial than merger and collusion cases are today.

For a longer treatment of some of these issues, see Brennan, T., "Saving Section 2: Reframing U.S. Monopolization Law," in Ghosal, Vivek and Johan Stennek (eds.), The Political Economy of Antitrust (Amsterdam: North-Holland, forthcoming 2007). A version of this chapter is available from the AEI-Brookings Joint Center for Regulatory Studies at ***http://www.aei-brookings.org/publications/abstract.php?pid=1002.***

Footnotes

1. Ross-Simmons Hardwood Lumber Co. v. Weyerhaeuser Co., slip. op. (9th Circ., May 31, 2005).

2. To find the hearing panel and other presentations, go to **http://www.ftc.gov/os/sectiontwohearings/archive.htm**.

3. The petition is available at **http://www.usdoj.gov/atr/cases/f216400/216422.pdf**.

4. The DOJ/FTC Horizontal Merger Guidelines are available at **http://www.usdoj.gov/atr/public/guidelines/hmg.htm**

5. U.S. v. Dentsply ("Dentsply"), 277 F. Supp. 2d 387 (D.C. Del. 2003), r'vsd and remanded, 399 F.3d 181 (3rd Circ. 2005). The DOJ alleged that Dentsply monopolized the market for false teeth for dentures by requiring distributors of its products to refuse to distribute products from its competitors.

6. Carlton, Dennis, "Loyalty Discounts: View 1," Loyalty Discounts Views and Discussion, International Industrial Organization Conference, Boston, MA (Apr. 9, 2006). Since the hearing, Prof. Carlton has been designated the Deputy Assistant Attorney General for Economics in the DOJ's Antitrust Division.

7. Space does not permit a full explanation, but it turns out that the discounter's marginal cost may be relevant, but only to the degree that courts would use marginal cost in calculating damages for breach.

8. Baumol, William, Janusz Ordover, Frederick Warren-Boulton, and Robert Willig, Brief of Amici Curiae Economics Professors In Support of Respondent, Verizon v. Trinko, 2002 U.S. Briefs 682.

9. Salop, Steven and David Scheffman, "Raising Rivals' Costs." American Economic Review Papers and Proceedings 73 (1983): 267-71.

10. U.S. v. Grinnell Corp., 384 U.S. 563, 570-71 (1966).

Who We Are

The University of Maryland, Baltimore County (UMBC) is a major research university in the Baltimore-Washington area. The Department of Public Policy offers a master's and a Ph.D. degree, and advanced graduate certificates. Our mission is to provide superior education for a diverse range of high quality students with aspirations and career goals related to public policy. Our interdisciplinary program prepares students for senior administration, policy analysis, research, consulting, and teaching. Our major areas of focus include evaluation and analytical techniques, health policy, public management, social policy, and urban policy.

For more information, visit our Web site, **www.umbc.edu./pubpol** or call **410-455-3201**.

UMBC Policy Briefs summarize important policy-related research by UMBC faculty and students.

Editor: Anne V. Roland, UMBC Department of Public Policy
© 2007 University of Maryland, Baltimore County