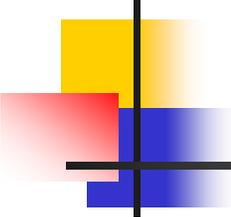


Refusals to Deal

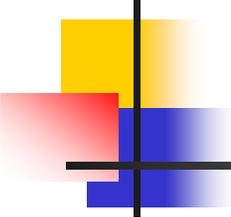
Steven C. Salop
Georgetown University Law Center
CRA International

*FTC/DOJ Hearings on Exclusionary Conduct
July 18, 2006*



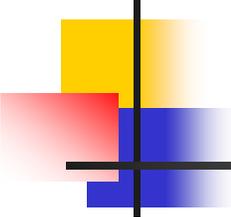
General Exclusion Standards

- Alternative Standards
 - Consumer Welfare Effect
 - Profit Sacrifice/No Economic Sense
- Benefits of CWE
 - Focused on goal of antitrust
 - Flexible – “an enquiry meet for the case”
 - Implies tailored structured inquiry for each type of exclusionary conduct
 - Unifies Section 1 and Section 2 analysis under the rule of reason
- Misperceptions about CWE standard
 - Does not require open-ended balancing – permits different specific legal tests in different exclusion settings
 - Does not lead to false positives
- Sacrifice/NES standard causes false negatives and false positives



Innovation Incentives

- Innovation incentives are a claimed rationale for restricting Section 2
- *But*, basis and significance of concern are unclear
 - Firms have strong incentives to innovate in competitive markets
 - Market innovation incentives improved by competition
 - Monopolists have weaker incentives than competitors
 - Exclusionary conduct reduces innovation incentives of entrants and rivals, by reducing or eliminating their market prospects
 - No evidence of weakened innovation from fear of antitrust
- Thus, justification for restricting Section 2 is weak



Comparing Standards for Refusals to Deal: Summary

- Alternative Standards
 - Consumer Welfare Effect
 - Profit-Sacrifice/No Economic Sense
 - Per Se Legality
- CWE and Sacrifice/NES have similarities
 - Both require a price benchmark
 - But, Sacrifice/NES standard may not require proof of anticompetitive effects (causes false positives)
- Per se legality leads to reduced competition and significant false negatives
 - Limits of per se rule also are unclear

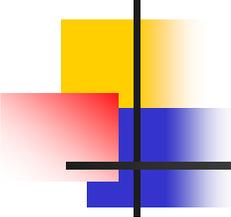
Proposed Rule under CWE

Standard: What Plaintiff Must Prove

- Monopoly power
 - Monopoly power in input market
 - Actual or likely monopoly power in output market

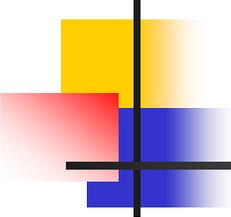
- Plaintiff has made a genuine offer to buy at or above the appropriate “non-exclusion benchmark” price, as defined below; whereas defendant has failed to accept such an offer or made a genuine offer to sell at or below that benchmark price. (“compensation” test)

- Refusal to deal would cause prices to be raised or maintained at supra-competitive level. (“effects test”)
 - Output market
 - Input market
 - Another market where the entrant is an actual or potential competitor of defendant



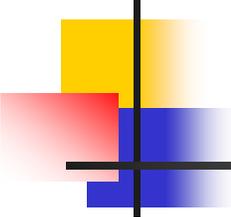
Non-Exclusion Benchmark Price

- Non-exclusion benchmark price: potential alternatives
 - Prior price charged to plaintiff
 - Price charged to other buyers
 - Price that compensates defendant for monopoly profits on output sales lost to plaintiff (“protected-profits” benchmark)
- Potential adjustments to benchmark
 - If dealing raises defendant’s production costs
 - If plaintiff creates reputational free riding
 - If monopoly power attained or maintained illegitimately
- Burden may shift to defendant to show plaintiff’s price offer is below benchmark
 - If non-negotiable (“flat”) refusal to deal



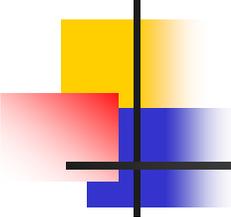
“Protected-Profits” Benchmark

- Properties of benchmark
 - Compensates for lost output market monopoly profits from defendant’s customers who switch to entrant
 - But, no compensation for price competition caused by entry by firm with lower costs or superior product for some consumers
- Derived from ECPR literature
 - Baumol/Ordover/Willig
 - Commentators (e.g., Armstrong/Doyle/Vickers/White)
- Benchmark input price: $W = Cu + D \times Md$
 - Cu = monopolist’s marginal cost of input (in dollars)
 - Md = monopolist’s output “gross margin” over costs (in dollars)
 - D = fraction of entrant’s output sales diverted from monopolist



Example: Verizon and AT&T

- Protected-profits benchmark is practical for courts and firms to calculate
- Assumptions: relevant data
 - Verizon's incremental cost of DSL inputs is $\$10$
 - Verizon earns monopoly margin over costs of $\$50$ on retail DSL
 - If Verizon deals with AT&T, 50% of AT&T DSL customers would come from Verizon retail DSL, with rest from cable and dial-up.
 - $D = 50\%$
- Benchmark input price: $W = \$35$
 - If $D=1$ (100% diversion), then $W=\$60$



Trinko's Cautions

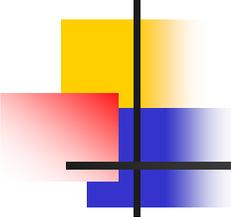
- No general Sherman Act duty to deal
 - Cf *Colgate* (no duty “in the absence of any purpose to create or maintain a monopoly”)
- Forced dealing raises red flags
 - Compelling firms to share may lessen investment incentives.
 - Enforced sharing requires courts to act as central planners
 - Compelling negotiation can facilitate collusion.

Investment Incentives Concern: Some Answers

- Benchmark price compensates defendant for monopoly profits on lost customers.
- Entrant unlikely to enter input market
 - Defendant's input market monopoly power implies durable entry barriers
 - This also makes leapfrog competition by entrant less likely
- Competitive market will increase defendant's innovation incentives
 - Monopolists have weaker innovation incentives
- Ability to enter output market will increase entrant's innovation incentives
- Entrant cannot be called a free-rider on the grounds that it competes with defendant in only one market, rather than entering both markets
 - *Kodak ("this understanding of free-riding has no support in our case law")*

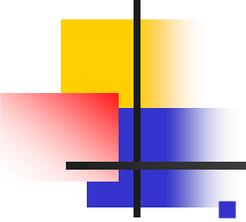
Courts as Central Planners

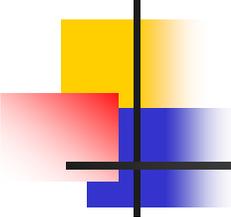
Concern: Some Answers



- Courts and agencies routinely compare prices and costs, and use other quantitative economic evidence
 - Eg, *Brooke Group*, *Ortho*, *Kraft*, agency merger analysis
- Task is not beyond the capabilities of District Court judges
 - Market prices often provide a good benchmark
 - Protected-profits benchmark is not too difficult to evaluate
- If antitrust withdraws, then alternative may be new public utility regulation
 - Is FOSC the next step?
 - **Federal Operating System Commission**
 - Rare use of essential facilities doctrine could serve as an intermediate stopping point

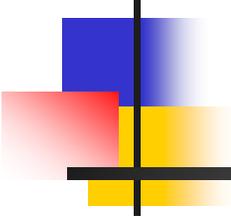
Facilitating Collusion Concern: Some Answers

- 
- Court's caution is very broad. Firms have independent incentives to negotiate, *and independent incentives to collude*.
 - Would Court's reasoning lead it to prohibit *voluntary* dealing between competitors because it can lead to collusion?
 - Or, prohibit joint ventures, which can (and sometimes do) serve as forums for collusion?
 - Or prohibit patent settlements, which can (and sometime are) used to strike non-compete agreements or collude on price?
 - Refusals to deal against competitors may hide (or amount to) non-compete agreements:
 - ***"I will sell to you if you promise not to compete with me."***
 - Collusion is less likely when negotiation is forced (and potentially monitored) by a court
 - Incremental effect of forced negotiation on collusion likely insignificant or negative



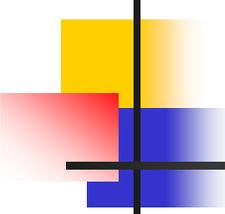
How Would a Rule of Per Se Legality be Limited?

- If it is per se legal to refuse to deal with firms that compete with you ...
- Then why not also per se legal to refuse to deal with firms that ...
 - Sell output to your competitors? (“exclusive dealing”)
 - Purchase inputs from your competitors? (“exclusive dealing”)
 - Buy other products from your competitors? (“tying”)
 - Announce their intention to compete with you in some product market? (“non-competition agreement”)
 - Charge low prices for their competing products? (“price fixing”)



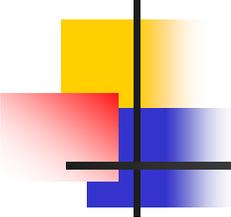
Appendix

The Overarching Antitrust Standard:
“Consumer Welfare” vs “Total Welfare”



Economic Welfare Standards

- True consumer welfare standard
 - *Consumer surplus*
- Total welfare standard
 - *Total surplus*
 - Bork named this “consumer welfare” -- deception or just confusion?
- Why use the **true** consumer welfare standard?
 - Does not permit *competitor injury* to trump *consumer benefits*
 - ***But, total welfare standard does allow this trump -- Did Bork know?***
 - Consistent with precedent
 - Simpler to evaluate (*price and output*)
 - Induces efficient conduct
 - Firm can marginally restructure transactions in efficient ways to eliminate consumer harm and raises total welfare in the process
 - Offsets unwillingness of courts/agencies to rigorously apply less restrictive alternative standard or gain full information about potential alternatives, thereby preventing inefficiencies
 - Better supports innovation incentives



Innovation Incentives and Welfare Standards

- Consumer welfare standard supports greater overall innovation incentives
 - Total welfare standard allows the dominant firm to destroy higher cost rivals that otherwise would innovate, thereby reducing innovation
 - Total welfare standard allows mergers and exclusion that eliminate competition, leading to a dominant firm with less incentive to innovate
 - These harms likely are larger than any marginal efficiency benefits from allowing mergers or exclusionary conduct that modestly reduce costs, while leading to higher prices to consumers
- Thus, adopting the true consumer welfare standard leads to higher long-run *total welfare*, as well as higher long-run *consumer welfare*.