

Testimony of
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The Importance of Local Market Realities in Applying Section 2
to Resource-Based Input Markets

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I wish to thank the Federal Trade Commission and the U.S. Department of Justice Antitrust Division for the invitation to present testimony as part of this series of hearings on Section 2 of the Sherman Act. I offer this testimony not on behalf of any individual business or client, but from the perspective of the many small and medium-sized businesses (mostly family-owned) that I have been privileged to represent in the resource-based industries of the Pacific Northwest. I am now in my 30th year of law practice and have devoted most of this career to representing the interests of small and medium-sized participants in the forest products, fishing and agricultural industries. One of the common threads of this client base has been the production of commodities derived from the rich natural resources of the Pacific Northwest: logs, lumber and plywood in the forest products industry; salmon and crab in the fishing industry; and essential oils like peppermint in agriculture.

The application of Section 2 to these types of markets is important and must be analyzed within the context of the unique market realities that govern input markets where, in many cases, there is the potential for a dominant buyer to exercise monopsony power to the detriment of its smaller competitors, input sellers generally and ultimately consumers. These markets may be localized in that they are confined to a region of the United States and are often exemplified by what Professor Warren Grimes refers to as “small, atomistic sellers,” who are more vulnerable to market power abuses than consumers.¹

There are multiple such markets in the Pacific Northwest where a large and diverse number of small players are selling their commodity products to firms that process the logs, the

¹ W. Grimes, *Buyer Power and Retail Gatekeeper Power: Protecting Competition and the Atomistic Seller*, 72 Antitrust L.J. 563 (2005).

fish or the agricultural product into a host of other products. In some markets, the processor base may be small and dominated by one or a few large firms. As Professor Roger Noll has observed, local monopsony in conditions where market power is not present in a national or regional final product market “causes harm to consumers by misallocating production across localities.”²

The antitrust issues associated with input markets have received very little attention until quite recently. In fact, a good share of the scholarship on the subject is found in the 2005 quarterly issue of the *Antitrust Law Journal*, which contained a symposium collection of nine articles, including those of Professors Grimes and Noll to whom I have just referred. The application of Section 2 to input markets is an area of antitrust law deserving of more attention and it is about to receive it from the U.S. Supreme Court in its forthcoming decision in Weyerhaeuser v. Ross-Simmons Hardwood Lumber Company, Inc., which will likely be handed down in March or April of this year.

I argued the Weyerhaeuser case on behalf of respondent Ross-Simmons before the Supreme Court in late November. Although it is difficult (and some would say dangerous) to make predictions based upon the briefs and the oral argument, having been with this case since its inception as lead trial counsel and arguing counsel both before the Ninth Circuit and the Supreme Court, I believe the result is going to surprise people. When certiorari was granted, all of the pundits predicted that the case was taken to reverse. And that view is still being expressed post argument on various blogs following the Supreme Court docket.

² R. Noll, “*Buyer Power*” and *Economic Policy*; 2 *Antitrust L.J.* 589, 624 (2005).

The Weyerhaeuser case presents two issues: first, whether the Brooke Group price-cost test should be extended from the sell side to the buy side; and second, whether the jury instruction regarding predatory bidding was flawed on grounds other than Brooke Group.

On the first issue, based on the briefing and the oral argument, we are optimistic that the Supreme Court will affirm the Ninth Circuit's decision that the safe harbor for pricing behavior on the sell side established in Brooke Group does not apply "with the same force" to inelastic input markets like the alder sawlog market in the Pacific Northwest. Over the last quarter century, except for Brooke Group, the Supreme Court has eliminated or narrowed per se rules that did not have a sound economic foundation in market realities. The wisdom of Brooke Group is its protection of inherently procompetitive price-cutting in output markets. In the context of input markets, the challenged conduct involves price-raising, very few cases, and scholarship in its infancy -- conditions that are the exact opposite of those that prevailed when Brooke Group's per se rule was developed. In these circumstances, the correct approach is the one that has always been the gold standard of antitrust rules -- the rule of reason.

The rationale underlying Brooke Group was also grounded in concern about false positives, based in large part upon a sizeable body of literature to that effect. There is no similar body of economic literature offering a similar warning in the predatory bidding cases. In point of fact, the few cases of overbidding that do exist show that it is a rational strategy that works.

There are two reasons underlying my optimism that the Supreme Court will refuse to extend Brooke Group from the predatory selling context to immunize bidding conduct by a dominant buyer. First, the position of Weyerhaeuser and its many big business amici is based upon the notion of symmetry: that a rule that works for predatory selling in output markets

should apply equally to predatory bidding in input markets by the sheer force of logic alone. The law, however, is no slave to symmetry. As Justice Holmes has written, in what has been characterized by Judge Posner as “the most famous sentence”³ in American legal scholarship, “The life of the law has not been logic: it has been experience.”⁴

In the past, notions of symmetry have influenced the antitrust jurisprudence of the Supreme Court. However, in the last 25 years, market realities have consistently trumped symmetry and the per se rules which it produced. The Supreme Court embraced symmetry in equating maximum and minimum vertical resale price constraints as per se illegal in Albrecht v. Herald Co.⁵ in 1968, but relied on market realities in overruling Albrecht’s prohibition against maximum resale price agreements nearly 30 years later in State Oil Co. v. Kahn⁶ in 1997. The other half of that rule now appears in jeopardy with the Supreme Court’s recent decision to reexamine whether vertical minimum resale price maintenance agreements should be deemed per se illegal under Section 1 of the Sherman Act, or whether they should instead be evaluated under the rule of reason. I refer to Leegin Creative Leather Products v. PSKS, Inc., No. 06-480, a decision out of the Fifth Circuit on which certiorari was granted last month.

In my view, the Supreme Court is clearly focused on eliminating per se rules or presumptions in antitrust which are not justified by market realities or which distort the factfinding process at trial in a manner that unfairly disadvantages one party or the other. The

³ Richard A. Posner, *The Federal Courts*, 304-05 (1996).

⁴ Oliver Wendall Holmes, Jr., *The Common Law*, 1 (1881).

⁵ *Albrecht v. Herald Co.*, 390 U.S. 145 (1968).

⁶ *State Oil Co. v. Kahn*, 522 U.S. 3 (1997).

Independent Ink⁷ case of last term in which the Court abandoned the per se rule that a patent equals market power in a tying case is the most recent example of this trend.

My second reason for optimism on the Brooke Group issue comes from the oral argument. We were struck by the apparent lack of enthusiasm among the Supreme Court justices for extending Brooke Group from the sell side to the buy side. Several justices including Justice Kennedy, who wrote the majority opinion in the 6-3 Brooke Group decision, expressed concern about the workability of converting the Brooke Group price-cost test into a price-revenue test on the buy side. There was record evidence that Weyerhaeuser used below-market transfers of alder sawlogs from its fee lands to subsidize its bidding up of sawlog prices in the so-called open market in which it competed with Ross-Simmons. Weyerhaeuser argued that such bidding was immune from antitrust scrutiny so long as its alder division was not losing money overall. Adoption of such a rule, however, would put any large company that has amassed low cost raw materials in a position to eliminate its competition by bidding up scarce supplies of open market sources and subsidizing that predation with below-market transfer prices from its own captive supplies. The result would be underdeterrence of predatory bidding behavior while impeding the most efficient allocation of scarce resources.

Another administrability problem (not found in the application of Brooke Group on the sell side) is associated with the fact that the relevant inputs (alder sawlogs) are used to produce many products. The three main product categories are chips, pallet lumber and kiln-dried, finished lumber, but Weyerhaeuser's finished lumber product mix included 25 to 50 different lumber grades annually. Each sawlog produces some of all three major product categories, but

⁷ *Illinois Tool Works v. Independent Ink, Inc.*, 126 S. Ct. 1281 (2006).

larger diameter logs yield a higher percentage of the highest value item, finished lumber.

Accurate cost allocation and revenue projections in this complicated input/output environment are extremely difficult. There is no comparable corollary on the buy side to the commonly utilized average variable cost or marginal cost formulations used in sell-side predatory pricing cases.

In sum, regarding the primary question of whether to extend Brooke Group to the buy side, we are guardedly optimistic that the Supreme Court will decline to do so because of the Court's consistency over the last quarter century in refusing to create new per se rules or to extend old ones unless justified by the market realities of the particular industry or the particular type of antitrust claim. And also because of the tenor of the oral argument. Brooke Group really was an exceptional case. Today, 14 years after Brooke Group, the rule of reason shines even more brightly as the gold standard of antitrust analysis.

Assuming the Supreme Court does not extend Brooke Group to the buy side in the Weyerhaeuser case, it must then examine a second issue: whether the district court's instructions defining when predatory bidding will constitute anticompetitive conduct were flawed on some other basis. This was the instruction in which the district judge, after having given the standard ABA model instructions regarding monopolization and anticompetitive conduct, instructed the jury that it could find that Weyerhaeuser engaged in anticompetitive conduct if it bought more logs than it needed or "paid a higher price than necessary in order to prevent plaintiffs from obtaining logs they needed at a fair price." This formulation was pounced upon by Weyerhaeuser and its amici as standardless gibberish that constituted an independent ground beyond Brooke Group for reversal of the Ninth Circuit opinion. However, as set out in our merits brief,

Weyerhaeuser never preserved any such alternative objection to this instruction. Attacking a pair of sentences in the jury instructions as unduly subjective and “an invitation for unguided speculation” proved an effective springboard for a grant of certiorari, but deciding the case on the merits requires an assessment of the instructions as a whole in light of the evidence, the closing arguments and the other instructions. In the trial court, Weyerhaeuser’s counsel actually invited the linguistic formulation of the two sentences that have been so criticized in the commentary about this case. In opening statement and again in closing argument, Weyerhaeuser’s counsel told the jury that multiple witnesses would (and did) testify that the company never bought more logs than it needed or paid a higher price than necessary in order to hurt its competition. At trial, a two-question litany was put to 13 different witnesses asking each whether he or she ever participated in or had knowledge of any effort by the company to buy more logs than it needed or to pay higher than market prices in order to hurt competition.

It is worth noting that the Supreme Court has already decided a case this term involving a challenge to ambiguous language in a jury instruction. In Ayers v. Belmontes, No. 05-493, the Court examined California’s catchall mitigation factor in the instructions used in the penalty phase of a capital murder case. Based upon the way the case was tried and the evidence presented, a 5-4 majority found no reasonable likelihood that the jury applied the admittedly ambiguous instruction in a way that prevented consideration of constitutionally relevant evidence. If that type of “commonsense” approach (the Court’s term) to the instructions should prevail in a capital murder case, there is no reason for a stricter approach in antitrust, especially where the defendant tried the case in a manner that invited the very formulation used by the district judge.

In fairness, it should be noted that I was pressed particularly by Justice Souter at oral argument regarding the vagueness of the instruction on predatory bidding and the need for the Supreme Court to say something about that instruction. I conceded that the instruction was not perfect, but emphasized that neither the district judge nor plaintiff's counsel was given any chance through a defense objection to consider whether the instruction could have been made more precise with other language. At trial, we never attempted to exploit the instruction by asking the jury to award whatever damages that they considered "fair." Instead, we presented detailed market evidence through forest economists to show how much the market for alder sawlogs had been artificially elevated above where it otherwise would have been through Weyerhaeuser's manipulative bidding and other anticompetitive practices. Ultimately, the jury selected to the dollar one of the three damages alternatives presented by these economists.

Had Weyerhaeuser challenged the "paid a higher price than necessary" language, we would have had no problem with language adding precision to that instruction by linking the higher log prices to market factors tied to Weyerhaeuser's manipulative behavior as opposed to the normal operation of the market. In fact, we could have accepted the suggestion made by the eight Amicus Curiae States supporting Ross-Simmons including Oregon and California that the instruction define predatory bidding as having anticompetitive effect "if the conduct (a) raised the price that the buyer's rivals had to pay for the input beyond a level that could be justified or explained by other market or exogenous factors, and (b) substantially affected the ability of the buyer's rivals to compete for the input." States' Amicus Brief at 29. Because our evidence was designed to show how the historic relative equilibrium between finished lumber prices and log prices had been distorted by Weyerhaeuser's predatory behavior in order to kill off rivals, I am

confident there would have been no change in the result at trial with a more precise formulation defining when bidding conduct in an input market can be anticompetitive.

What happens, however, if my admittedly optimistic view is wrong and the Supreme Court reaches the vague instruction issue and reverses on that basis. In all likelihood, a retrial will then be necessary, but we are very confident of a similar plaintiff's verdict for two reasons. First, the Ross-Simmons' verdict generated several follow-on cases in which Weyerhaeuser produced thousands of additional pages of incriminating documents demonstrating the deliberate character of its multi-tactic plan to monopsonize the alder sawlog market. In other words, we are even stronger on liability in a retrial than we were the first time around. Perhaps that is why Weyerhaeuser settled three of these cases involving 10 plaintiffs for a total of \$62 million. Provided we are not saddled with a Brooke Group test, our damages theory can easily be matched up with a more objective formulation of market-distorting bidding conduct than the two sentence formulation now at issue in the case.

However it turns out, the Weyerhaeuser case will be important for all resource-based input markets, particularly those at the inelastic end of the spectrum. Section 2 has a real role to play in these markets. If you are a tree farmer, you want to have a healthy number of sawmills competing for your log production within a reasonable haul distance of your tree farm. And even if you happen to sell your logs of a particular species to an emerging monopsonist paying premium prices during a period of predation, your concern about the long-term health of the input market for that particular species will likely cause you not to replant that species if you fear there will only be a single buyer 30 to 50 years down the road when the seedlings you planted have reached maturity and are ready for harvest. It was precisely this sort of real market

consideration that caused most of the log seller community in the United States represented by the National Woodland Owners Association and the American Loggers Council to support Ross-Simmons in an amicus brief in the Supreme Court.

Avoiding expansion of Brooke Group to the buy side is important in other input markets as well. Most U.S. fish markets are classically inelastic because the total catch is fixed by state and federal regulators. The crab fishermen plying U.S. waters off the coasts of Oregon, Washington and Alaska need a healthy mix of seafood processors to ensure market prices that sustain the crab industry and its U.S. fleet. A flexible rule of reason approach to exclusionary conduct in this type of market is vital both to deterring illegal conduct and to ensuring fair results at trial. Many agricultural markets, especially those like peppermint and spearmint where production is regulated by federal marketing orders, are susceptible to abuse in the form of artificially low prices dictated by a dominant buyer or oligopolistic behavior in a highly concentrated processor market.

I would like to take this opportunity to thank the Federal Trade Commission and the DOJ Antitrust Division for holding this hearing out on the West Coast rather than in Washington, D.C. I believe it is critically important for federal antitrust enforcers to be out in the field regularly in order to have a full appreciation of the importance of local and regional markets. Indeed, the lack of consideration of local and regional markets reflected in the Solicitor General's brief supporting Weyerhaeuser was one of the primary reasons I am told that eight states on short notice submitted an amicus brief in the Weyerhaeuser case. In its antitrust jurisprudence, the Supreme Court has repeatedly emphasized that antitrust analysis "must always be attuned to the

particular structure and circumstances of the industry at issue.”⁸ In my view, this can only be accomplished if one is immersed in the facts and circumstances of a given industry: the who, what, when, where and how that requires extensive use of investigative interviewing in addition to and not as a substitute for analysis of raw data.

From my experience in the northwest corner of the U.S., I have three suggestions for FTC and DOJ in its evaluation of antitrust issues in resource-based input markets:

1. Please do not discount or dismiss the significance of a local or regional market simply because the dominant buyer/processor may not have market power in the downstream output market. As Professor Noll so convincingly demonstrates in his article, this is an area where input sellers are vulnerable and can be abused by a monopsonist to the detriment of both the regional and national economies.

2. Please be aware of the influential impact of the extraordinary legal and organizational talent brought to bear by large corporations and their affiliated support organizations on the antitrust issues that come before you. The small, atomistic sellers who make up so many of the local or regional resource-based input markets in the U.S. are nowhere nearly as well organized and have precious little in the way of financial resources to devote to long-term efforts to shape the direction of Sherman Act jurisprudence. It is therefore particularly important for federal and state antitrust enforcers to look behind the incredibly capable advocacy available to large corporate interests and to independently investigate the relevant facts of each market and each industry in the field.

⁸ *Verizon Communications, Inc. v. Law Office of Curtis V. Trinko*, 540 U.S. 398, 411 (2004).

3. From my experience in three resource-based sectors of the U.S. economy in the Pacific Northwest, I have been struck by the close match between my own experience and two bedrock principles of antitrust law: (1) that the forms of anticompetitive conduct are “myriad” and (2) that sound antitrust analysis is joined at the hip with the fact-laden structure of the particular market and industry at issue. In my view, this amazing factual variability makes the quest for a unitary standard of exclusionary conduct illusory. It is a much sounder policy to embrace the flexibility of the rule of reason standard and to apply it appropriately to the market realities of the industry in the particular case.

On this last point, it is interesting to note that our new chief justice appears to be no fan of ideological purity in the way the Supreme Court should decide cases. In a very insightful article by Jeffrey Rosen in the January/February issue of The Atlantic Monthly, Chief Justice Roberts said the following when asked to define the qualities of judicial temperament that he thought successful chief justices like Marshall (Chief Justice Roberts’ own personal model) embodied: “I think judicial temperament is a willingness to step back from your own committed views of the correct jurisprudential approach and evaluate those views in terms of your role as a judge. It’s the difference between being a judge and being a law professor.”

I think the quest by some in the Antitrust Division to develop an overarching standard defining all anticompetitive conduct under Section 2 of the Sherman Act is inconsistent with the highly fact-laden and industry-specific character of antitrust. Such a quest is too much of the law professor and too little of the practical, fact-based enforcer. It should be abandoned and the energy of our antitrust agencies refocused on investigation and enforcement.

Thank you for the opportunity to present this testimony.