SHERMAN ACT SECTION 2 JOINT HEARING
UNDERSTANDING SINGLE-FIRM BEHAVIOR:
EXCLUSIVE DEALING SESSION
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PANELISTS:

Morning Session:
Jonathan M. Jacobson
Howard P. Marvel
Richard M. Steuer
Mary W. Sullivan
Joshua D. Wright

Afternoon Session:
Stephen Calkins
Joseph Farrell
Benjamin Klein
Abbott (Tad) Lipsky
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MR. VITA: Good morning, everybody. My name is Mike Vita. I am an economist here at the Federal Trade Commission. My title is Assistant Director for Antitrust in the FTC's Bureau of Economics. My co-moderator is Dan O'Brien, Chief of the Economic Regulatory Section at the Department of Justice, Antitrust Division.

I am going to be leading the morning session, and Dan will be leading the afternoon session, and before we get started with the substance of today's hearings, I am going to cover a few housekeeping matters.

First, turn off the cell phones. You'll get detention if you -- the BlackBerries and any other devices that make noises, that's very important.

Second, for those of you who aren't familiar with the setup here at 601 New Jersey, the rest rooms are down the hall, past the guard's desk and to the left. I think there are signs out there in the lobby to guide you.

Third, a safety tip particularly for visitors. In the unlikely event that the building alarms go off, which they actually did yesterday, please proceed calmly
and quickly as instructed. Dan and I will keep everything calm and orderly. If we must leave the building, exit the New Jersey Avenue exit by the guards, that's where you probably came in, and follow the stream of people running to a gathering point where you can await further instructions.

Finally, we request that you not make any comments or ask questions during the session. Thank you.

Okay, today's session concerns exclusive dealing, one of the most interesting areas I think of all the various topics involving vertical restraints and vertical contracts. It has been an active area of economic research and an active area of antitrust as well. We are honored to have assembled a distinguished panel of practitioners and professors who are very knowledgeable in the issues we are going to tackle today, and there are going to be two sessions, one in the morning and then one later in the afternoon.

I will just briefly introduce the panelists for this morning before we get started, and I will give a little more detailed introduction as each speaker takes his or her turn. I do not know if everybody is in some sort of order, but it looks like they are.

Okay, so immediately to Dan's left is Richard M.
Steuer, who is a partner at Mayer Brown Rowe & Maw, LLP. Next to Richard is Mary Sullivan, who is an Assistant Professor of Accountancy at George Washington University. Next to Mary is Josh Wright, who is Assistant Professor of Law at George Mason University School of Law. Next to Josh is Howard Marvel, who is a Professor of Economics in the Department of Economics at Ohio State and also Professor of Law in the Michael Moritz College of Law at Ohio State University. And at the very end is Jonathan Jacobson, who is a partner at Wilson Sonsini Goodrich & Rosati and a Commissioner of the Antitrust Modernization Commission.

So, I think we will just get right into it, and let me introduce in detail our first speaker, and in those handouts that you got, there is a more detailed biographical description of each of the speakers as well, and you can also find them on the FTC and Department of Justice web sites.

Our first speaker is Richard Steuer, who is a partner at Mayer Brown Rowe & Maw, where he specializes in the practice of antitrust law, including litigation, mergers and acquisitions, intellectual property licensing, franchising and e-commerce. Richard has written a book and several articles on antitrust law which have appeared in various journals throughout the
country. For three years Richard served as chair of the Antitrust Committee of the Association of the Bar of the City of New York.

Richard?

MR. STEUER: Thanks, Joe.

In baseball they say you can learn a lot by watching, and I have been fortunate over the years to have been able to observe a great deal about exclusive dealing and in various contexts, both in litigation and counseling, and I put what I knew into three articles that I have written, and I thought that the best way to try to present what I have learned about exclusive dealing would be to go through those articles and briefly outline what it is that I have learned from watching.

The first one was an article on "Exclusive Dealing in Distribution," focusing on how exclusive dealing works when you are talking about selling to resellers, and this appeared in 1983. I will not take very much time on the history, but it is interesting that once upon a time, the FTC considered most exclusive dealing to be virtually per se unlawful. The Standard Stations case in 1949 introduced the rule of quantitative substantiality. Then the major case of Tampa Electric in 1961 brought in qualitative
substantiality, and then we found a more nuanced rule of reason approach with the Beltone case from the FTC in 1982, Jefferson Parish in the Supreme Court in ’84, and added to that are the nuances of rule of reason analyses we get from California Dental.

Now, what I have found is the level of distribution really matters in assessing the impact of exclusive dealing. What we are measuring with exclusive dealing -- why exclusive dealing is different from other restraints -- is that we are looking more at foreclosure of competitors than anything else. Exclusive dealing is interesting among the vertical restraints. This is the one that, although it has almost always been a rule of reason offense, plaintiffs win quite often, and what we are looking at is something quite different than in vertical resale restraints where the restraint is on reselling rather than purchasing. Exclusive dealing is a restraint on purchasing, not on selling.

So, the level of distribution could be wholesalers. One wholesaler can reach every retailer in America, potentially. With retailers, it is different. Retailers are chained to a location typically, although with the Internet, that is not quite as true anymore, and this is a fluid field. Retailers could be in chains, but basically they have a universe of consumers
that they reach. Wholesalers are a little bit different, because foreclosing wholesalers does not mean that you are foreclosed from reaching retailers. Foreclosing retailers may or may not mean that you are foreclosed from reaching end users. Reaching end users is the simplest. To the extent that there is an exclusive dealing arrangement tying up 10 percent of end users, you have got 10 percent of the market.

Type of product is important. Shopping products are products for which consumers will go from place to place to compare prices, to compare features. The fact that each dealer only has one brand does not necessarily have as much of a foreclosure effect, because consumers will not stop at that dealer. They are more likely to go and continue shopping, looking at other brands at other dealers.

Convenience products, on the other hand, include impulse products, products that a consumer is more likely to buy because he or she is at the retailer, and that goes to the concept of "can the retailer deliver customers?" Is the retailer such that, when you think about the nature of the retail operation, a customer going to that retailer is going to buy whatever brand there is, so that exclusive dealing is going to have a more considerable impact.
Another variable that is important to keep in mind is alternate channels of distribution -- what is sometimes called intertype competition -- and there was a rather classic book that Palamountain published in 1955 on that. Today, the variation in intertype competition is richer than ever with the rise of the Internet and other alternate channels. So, one needs to look, when you are dealing with resellers, at what other types of means are there, direct sales and so forth, for getting the product distributed.

Another possibility is simply establishing new distributors. Is it more efficient, is it more competitive, to have competitors with other brands establish their own distribution networks than just piggyback on the existing distribution network and possibly compromising the amount of vigor with which the intermediate, the reseller, is pushing each brand? Are you better off having one brand at each reseller and having them competing against one another?

Foreclosure is measured in many, many antitrust defenses. There is a measure of foreclosure for monopolization, for attempted monopolization, under Section 3 of the Clayton Act, under Section 1, and I recently had an opportunity to study what the different tests are, and I will not belabor the point here -- we
do not have time -- but they are all over the lot.

The interesting thing is "foreclosure" is a term that is used throughout the antitrust lexicon, but it has a different meaning with each substantive offense, and that is important to keep in mind.

The procompetitive effects when you are going through distribution: Combating manufacturer-level free riding. This is not the kind of free riding that we were talking about in a case like Sylvania where one retailer free rides on the efforts of another. This is one manufacturer free riding on the efforts of another manufacturer, and exclusive dealing, by keeping other manufacturers out of a particular wholesaler or retailer, prevents that.

Of course, stimulate distributors. If the distributor only has one brand of a product, it is going to devote all of its efforts to that brand, but again, in measuring how valuable that is, there is a distinction between commodities and differentiated products. With a differentiated product, there is something more for the dealer to explain, typically, about the features of the product. With commodities, that is probably less so.

Stimulating suppliers. Exclusive dealing also stimulates suppliers to put more time and effort and
money behind their channels of distribution, because they know that other brands are not using the same retailer or same wholesaler, and they do not have to worry about divided loyalties where they are wasting their effort.

Protecting trade secrets is similar. To the extent that a manufacturer is providing trade secrets to a retailer or a wholesaler on how to sell, if that retailer or wholesaler is carrying other brands, it can use that kind of information for the benefit of the other brands.

Quality control as well is something that can be controlled more directly with exclusive dealing where there are not other brands in the house, and that is particularly true where retailers or wholesalers are doing things with the product, to the product, where, if there is some kind of adulteration, it is hard to control quality with other brands in there.

Resale restraints. There is a lot of talk and we were talking earlier about whether there is going to be a change in the rule on resale price maintenance. Some of these same considerations also go into the kind of resale restraints we looked at in a case like Sylvania, customer restraints, territorial restraints, resale price maintenance, but those are all restraints
on selling, not on buying. So, some of these apply, but they do not apply in the same way.

The next thing I looked at ten years later was "Discounts That Induce Exclusive Dealing," and this is a little bit different again, but yet another nuance. I started with single products. In the simplest case, there is one product involved, the grand daddy of the cases is United Shoe Machinery, 1922, but these cases still continue. The latest one, and I am not going to dwell on cases, but there is a case this year from the Sixth Circuit that the plaintiff won on essentially a single product. Big cases out of the U.S. were Nutrasweet, which involved one product, and Tetra Pak, packaging.

The important thing to know in these cases is whether or not there is an offer you cannot refuse. These are discounts to induce exclusive dealing. It is not an outright exclusive, but it is basically a deal saying if you buy 50 percent of your requirements from me, you get one price; if you buy 75 percent, you get another price; if you buy 100 percent, you get still another price. It does not sound like it is quite as much foreclosure as exclusive dealing, and in many cases, it is not as much foreclosure, it is perfectly fine.
However, sometimes it is essential for the buyer to buy some of the product from one brand, and a classic case, we talked about learning from observing, there was one case that I was involved in where it was almost a commodity product. It was a fairly undifferentiated product, but it was differentiated in certain quality aspects, and because the buyers had to buy a particular brand to satisfy their customers, because it was spec'd in, there was one company that had 100 percent of the manufacturing. When a second company came along and was about to turn the key to open their factory, the first company came up with a discount schedule, that as long as you bought 80 percent from me, you got a much lower price. If you only bought 79 percent from me, you got a much higher price.

Well, it turned out that about half of what all the customers needed they could not buy from anyone else, not because one product was better than the other or even very different, but it was spec'd in, they had to have it, and so it was an offer they could not refuse, because if they bought less than 80 percent, they would be paying a lot more for everything that they bought. The company that would be trying to break into the market would have to replace all of those lost discounts on the quantity that they could not have. So,
even though it was not really a different product,
analytically, it almost was a different product, because
there was some quantity that they had to have from the
other brand.

A little like bundling. Bundling is almost
easier to see, because there are different products in
the bundle. Some of them are products you have got to
have because they are patented in some cases. Sometimes
you do not have to have them, and there are ways of
ameliorating it. I am not going to spend time on
bundling, because I know you have another program
devoted to that entirely, and I could spend a whole day
on bundling.

The last thing I looked at was, who is
instigating exclusive dealing, and should it make a
difference? And particularly, "Customer-Instigated
Exclusive Dealing." There are mixed motivations on how
many suppliers you would like to have in the market.
End users have two different motives. On the one hand,
they would like to assure that there are plenty of
suppliers, because they would like to have alternatives,
and they want to play one supplier off against another
to get the best price. At the same time, there may be
cases where if there is a requirements contract -- and a
requirements contract not only means I will buy
everything from you, but the seller promising I will supply everything that you need -- if one buyer can get a requirements contract and there are not enough other sellers to go around, it could have an impact harming competitors of the buyer. So, it is possible that there are situations where an end user would have a motive, at least in the short term, not to have as many suppliers survive.

Resellers, it is somewhat similar. In the short term, if you are an exclusive reseller of a particular brand, you would like to see all the other brands disappear. They only provide competition to you. In the long term, though, if that arrangement is not necessarily perpetual, the day may come when you would like to have some options with other brands that could supply you.

Now, why would a customer want exclusive dealing? The most obvious reason is to induce lower prices, to say to a supplier, I am giving all of my business to one supplier, and it may be you, but it may not be, so sharpen your pencil and give me your best price.

Another reason is to assure a dependable supply, and that is the requirements contract. Another is to assure quality, in that it is expensive to qualify
suppliers in certain very technical industries, and you do not want an unlimited number of them. In some cases, assuring uniformity is important. There is a case involving auto racing where it was felt to be important that everybody have the same tires so that there is a level playing field among competitors. And achieving logistical efficiencies. In some settings, just having fewer suppliers is going to wind up lowering expenses.

Now, how do you find an appropriate legal analysis where it seems that the buyer has instigated the exclusive dealing? The supplier's objectives often are twofold. One is to foreclose others, and that is the one we always look at when we are trying to see an impact on competition -- will exclusive dealing foreclose other suppliers from having customers or having distribution? Another is to achieve distributional efficiencies.

The reseller's objectives are the ones we just talked about, pricing, supply, quality, uniformity -- and there are mixed motives about how strong a reseller wants other brands to be.

The end user's objectives are a little bit different. Again, the end user of course wants better pricing, may have concerns about delivery, quality, uniformity, efficiencies. It is less likely that an end
user who is insisting on giving all of its business to one supplier is really in favor of weakening other suppliers. There may be those rare cases, but it is less likely that that is what you are going to find.

So, what is the right analysis? When should courts second-guess buyers for instigating exclusive dealing and replace the buyer's judgment that it wants an exclusive with the court's judgment? I think that certainly when the buyer has a demonstrable motive to eliminate competition at the supplier level so that it is helping itself in terms of competition, that is one to take a hard look at, but generally, I think it is important to trust the buyer's judgment if it is instigating exclusive dealing.

Let me just conclude by saying I hope this quick snapshot has highlighted some of the very many differences that exist among exclusive dealing arrangements. All of us as lawyers and economists are always searching for those unifying principles that make it easy to do the analysis, but I think what is important here is that we not get lazy and overlook that some of these variables that we have just been talking about really do make a difference to the analysis.

I will leave it there, and thank you very much.

(Applause.)
Our next speaker is Mary Sullivan, who is an Assistant Professor of Accountancy at George Washington University. Mary received her Ph.D. from the University of Chicago, Department of Economics, and taught marketing at Chicago Graduate School of Business from 1987 through 1997. While at Chicago, she conducted research on industrial organization and marketing issues, such as slotting allowances, brand names and trademarks.

In 1997, Professor Sullivan left academia for the U.S. Department of Justice Antitrust Division where she worked on a variety of antitrust matters and served as Assistant Chief of the Competition Policy Section.

In 2004, she joined the Accountancy Department at George Washington University, and as many of you know, Mary's research has been published in numerous leading economics journals.

Mary?

DR. SULLIVAN: Thank you. I would like to start by thanking the DOJ and FTC for inviting me to participate in these hearings, and I need to keep track of the time very closely, because I have been threatened by Dan and Mike that if I go over my time limit, that
they might charge me a slotting allowance, although in practice, I have learned that it is very difficult to charge one unless you charge it in advance. Nonetheless, I will try to stay on track.

Slotting allowances and payola are two allegedly exclusionary practices that receive different regulatory treatment. What I am going to do in my talk is address whether the different regulatory treatment is warranted.

Slotting allowances and payola are similar in many respects. They are basically the same practice used in different settings. Slotting allowances are payments made by manufacturers to retailers for stocking new products. Payola consists of payments made by recording companies to radio stations or DJs for playing a particular piece of music. Both practices have promotional effect. They serve to increase demand by providing exposure to the product or music to consumers.

In each case, there is a scarce resource that needs to be allocated, shelf space in the case of slotting allowances and airspace in the case of payola. For both types of fees, there are concerns about exclusionary effects. If you read news articles or, you know, just search the web for these practices, or if you have talked to industry participants, you will learn that these practices are widely believed to be
exclusionary, and the potential exclusionary effect is a major motivating factor in the regulatory scrutiny that each of these practices has received.

Now, oddly, despite their similarities, the practices receive different regulatory treatment. Slotting allowances are not regulated by the FTC. In the FTC's 2001 report on slotting allowances, they said that the fees need to be judged on a case-by-case basis with attention both to likely competitive harms and to likely procompetitive effects. So, they take a basic rule of reason approach.

Alternatively, the FCC does regulate payola. According to the FCC regulations, payments are prohibited unless an announcement of the endorsement is made every time a song is played, and this increases the cost of using payola. Now, in addition to the FCC regulations, the major recording companies have recently settled investigations brought by Elliott Spitzer, as many of you are probably aware. I think what is less well known about these settlements is that the terms of the settlements are more restrictive than the FCC regulations, with payola completely banned in most cases even if an announcement is made of the endorsement.

Now, given over the past few years we have learned a lot about slotting allowances, both in terms
of the economic theories and in legal challenges, I thought it would be an interesting exercise just to go through some of the things we have learned to try to get some insight as to why payola has received different regulatory treatment and whether this makes sense.

Okay, so we will start with a little bit about the theories of exclusion. Can theories of exclusion explain slotting allowances and payola? Now, there are two general classes of theories that I will talk about. There are the popular theories or notions of exclusion, and then there are the economic, sort of rigorous economic theories of exclusion.

The popular theory of exclusion, according to these theories, the payment of the fees increases the cost of introducing a new product or a new song. The increased entry cost may exclude manufacturers, particularly small ones, and many of the complaints are of this nature.

However, this so-called theory cannot really explain exclusion. It is fairly well accepted that auctioning scarce resource results in efficient allocation, and unless something in the auctioning process reduces the number of slots that are available, it is very easy to see how this could result in exclusion. If a product or song is very promising,
someone will give the product financing in order to introduce the product. Therefore, I really don't consider this a valid theory of exclusion.

The other class of theories are the economic theories, and the two that I have really looked at for the purpose of this talk are Farrell 2001 and Shaffer 2005. Now, without going into much detail at all about these theories, all these theories share the feature that you need to have a contractual provision for the retailer to actually exclude a competitor in return for the fees. You must have a situation in which the retailer is reducing the number of slots available for exclusion to occur and for harm to result from it. So, one important conclusion that I take away from these theories is that simply paying a slotting allowance is not enough to cause exclusion.

So, the next thing I want to do is take a look at the evidence, what do we know about slotting allowances and payola, and ask the question whether the evidence is consistent with the Farrell/Shaffer type theories of exclusion.

In the case of slotting allowances, the answer is sometimes. Occasionally slotting allowances are accompanied by a contract to reduce the shelf space available to competing manufacturers which could weaken
them and potentially exclude them. According to the
FTC's 2003 study of slotting allowances, such contracts
are fairly unusual, but they do occur.

For payola, the answer is no. There is no
evidence that exclusionary contracts are being used with
payola. The evidence that I have seen suggested that
recording studios are simply trying to use payola in
return for getting the radio stations to play their
songs, not that they would not benefit if they could
exclude a popular song of a competing recording studio.
I think, you know, if they could exclude a competing
song, it would allow them to sell more records; however,
there is simply no evidence at all that that is what is
happening, and believe me, if you take a look at some of
the Spitzer settlements, you will see that the evidence
he collected was quite thorough. What I conclude from
this is that according to the economic theories of
exclusion, payola is very unlikely to be exclusionary.

Now, I also wanted to take a look at some of the
evidence from the courts to see what the courts say
about slotting allowances and exclusionary effects.
This is not really intended to be a comprehensive review
of the legal cases on slotting allowances. What I did
do is I looked at two legal challenges to slotting
allowances that are both important, have been very
influential, and I see cited quite often in other cases. In both of these cases, the courts found that the fees are a valid means of competing, and here are the two cases.

One of the quotes from the Gruma case is particularly revealing. In this case, the Court said, "Some of the plaintiffs' losses are due to a 'self-inflicted' wound -- they chose not to compete for shelf space."

Now, in this case, the plaintiffs were small companies, small tortilla manufacturers who were complaining that Gruma, the large manufacturer, was buying up all the shelf space and giving it unfavorable locations. The Court ruled, well, your tough luck. If you want to be in this game, you need to compete for shelf space.

Now, in the Reynolds Tobacco/Philip Morris case -- which is often referred to as the retailer leaders case, which was the name of the Philip Morris program that was being challenged in court -- it was a somewhat different situation, because Reynolds, the plaintiff in this case, was actually a large company, but the conclusion of the Court was the same. In this case, the Court concluded that the Philip Morris program that involved the payment of slotting allowances
increased industry competition.

Okay, so if the theory predicts that payola is unlikely to be exclusionary and the courts have ruled that slotting allowances are an efficient means of allocating scarce shelf space, then why -- this leads us back to the original question -- why does payola receive different regulatory treatment than slotting allowances? The answer seems to be that since the air waves are owned by the public, there is a belief that radio stations should select music on the basis of public interest rather than the radio station's commercial interest. This view highlights the difference between slotting allowances and payola.

The FTC and the courts see slotting allowances as a valid and efficient means of allocating shelf space, but the FCC believes payola results in an allocation of airspace that is not in the public interest apparently because it allows the radio station to play music that increases their profits. Now, does this make sense?

Another way of asking that is, will regulating payola cause radio stations to select music that is in the public interest, whatever that is? The answer is no. To see why, it is helpful to understand a little bit about how radio stations are going to decide what to
play both with and without payola.

Now, if payola is banned, radio stations are going to earn all of their money from creative -- selling -- or playing music that appeals to an audience that will buy advertisers' products. In other words, they are going to earn all of their profits from advertising dollars. So, what they are going to do is they are going to select music that appeals to people who buy the advertisers' products.

Now, if payola is permitted, radio stations earn revenue from both advertising and payola, and this may cause the radio stations to change their selection of music. They may play more songs that appeal to people who buy records and play less songs that appeal to people who buy advertised products. It is not obvious to me that the selection of music will be more in the public interest if payola is banned. In either case, the radio stations choose what music to play on the basis of what maximizes its profits.

So, I have several conclusions from this. The first conclusion from the analysis, from this exercise, is that it seems highly unlikely that payola will exclude promising music. This argument of exclusion should not be used to support the regulation of payola.

Second, regulating payola will not help achieve
the goal of serving the "public interest." With or without regulations, radio stations will design playlists to serve their own commercial interests. This is unavoidable.

Third, prohibiting explicit payment for radio airspace will not make competition for airspace disappear. There is a scarce resource, and there is going to be competition for it. The competition will take a different form. To the extent that recording studios can find loopholes in the regulation, then there will be little effect on the regulation on what is played.

So, my own personal conclusion from this is that the regulation of payola it seems to me does not serve the public interest, appears to be wasteful, and leads to needless enforcement costs.

Thank you.

(Applause.)

MR. VITA: Thank you, Mary.

DR. SULLIVAN: No slotting allowance?

MR. VITA: You are off the hook, for now.

DR. SULLIVAN: Okay.

MR. VITA: Okay, our next speaker is Joshua Wright, who is an Assistant Professor of Law at George Mason University School of Law, where he teaches in the
areas of antitrust, contracts, and law and economics. Professor Wright's research focuses on the law and economics of the competitive process for product distribution, including slotting allowances, category management, exclusive dealing and other contractual arrangements. He has published in numerous journals.

Professor Wright received his Ph.D. in economics from UCLA, Department of Economics, and he also received his JD from the UCLA School of Law, where he was a managing editor of the UCLA Law Review.

Joshua?

MR. WRIGHT: Thank you.

Okay, so I am going to sort of hop on the back of some of Mary's comments on slotting and do a little less background talking about what they are, since that has already been covered. My comments here, just as a preface to get out of the way, are based on two papers that are up on the FTC web site, which has all of the slides and papers from the other panelists, both co-authored with Ben Klein, who I think will be here in the afternoon.

So, a tiny bit more detail on -- I am going to use a slightly different definition of slotting arrangements than Mary used and define the contracts as per unit time payments made by manufacturers to
retailers for shelf space. There is a couple of
differences here. One is that sometimes, and indeed, in
the FTC report that has been referenced, you will find a
distinction between per unit tying payments and
discounts for slotting contracts, and it is an important
difference and one that I am going to end up not talking
much about here, but there is a discussion in the paper
I just referenced on the economics of slotting
contracts, on when we might expect the efficient form of
a distribution contract to be a per unit tying payment
or a discount. That said, I am going to ignore the
issue for the next 19 minutes.

What else we know about slotting is that they
cover both new products and established products. So,
they cover -- you know, Coca-Cola pays slotting
allowances, products where we do not have any sort of
risk imposed on the retailer by giving shelf space to
some unproven product. We see slotting allowances on
those products as well.

What else we know is that they increased, there
was a spike in the prevalence and the magnitude of
payments somewhere between 1981 and 1984, and over the
last 20 years, that trend of increasing and over the
products covered and the magnitude of payments has
continued.
So, the anticompetitive theories of slotting, first, before I try to explain a procompetitive rationale for shelf space contracts. We see slotting contracts used by manufacturers with small market shares. We see -- in general, the FTC report finds that the normative time for these agreements are between six months and a year. We see them on products where there are not significant economies of scale in manufacture, one of the conditions that drives the anticompetitive theories in the literature. And also, the anticompetitive theories have a difficult time explaining the jump in the use of the contracts in the middle of the 1980s.

In terms of the procompetitive story for slotting allowances, there are really two important economic questions with respect to slotting fees, and the first is why you see a separate contract at all, right? The first economic intuition one might have is why don't we see, like the setting of retail prices in a competitive retail market, supermarkets, et cetera, why don't we see manufacturers just set the wholesale price and allow the retailer to set the level of shelf space that is supplied for different products like we let them set the price? So, why do we see this separate contract for the shelf space?
And the second is, and more related to the panel discussion today, is we see sometimes that these contracts include exclusivity provisions, unlike the payola contracts. We see provisions that say, give me 70 percent of the shelf space, give me a space to sales, give me the full exclusive, do not put anyone else on the shelf space. So, we see this additional variation in the contracts that we are going to need to explain. So, I will turn to that second. There are other interesting questions, again, the form of the payment and these things, which for the moment I am going to skip so I can focus on exclusivity.

So, the answer provided by Ben Klein and myself in the paper I alluded to earlier, the intuitive answer is what you see on the screen, and it is that slotting contracts solve this pervasive incentive incompatibility problem where the retailer does not want to supply the joint profit maximizing level of promotional shelf space under the conditions where the supply and the shelf space does not induce consumer switching. So, we have cases like McCormick and we have 90 percent of the shelf space allocated for spices. Well, supplying additional promotional shelf space to spices does not induce a greater number of consumers to say I will not shop at this retail outlet because they have given 90 percent of
the shelf space to spices, and they have two brands, and so I am going to leave. So, we expect to see this incentive incompatibility problem solved with a separate contract under these conditions.

Now, I am going to go through a little bit of the analysis with a simple model with a little bit of math, but here is the intuitive answer. So, the fundamental point here is that for many products, and differentiated products, we have manufacturers with a large profit margin. So, the manufacturers, the wholesale price over the marginal cost, this \( P_{W} \) minus the marginal cost of manufacture, is large relative to the retailer's incremental profit, whether it sells Coke, Pepsi or any brand of soda, okay?

For a number of products, this is generally the case. So, the retailer, when it is making its decision on the optimal level of shelf space, promotional shelf space to supply to the manufacturer's products, say Coca-Cola, does not take into account that these promotional sales induced by giving, say, the eye-level shelf space, or if you are in the children's cereal aisle, the children's eye level shelf space, these incremental profits are large for the manufacturer and not taken into account by the retailer.

Now, we can make the same argument with respect
to price competition, but there is a key difference as to why we see manufacturers in the retail setting, at least, allowing the manufacturers to set the retail price, and competition between retailers is sufficient to get an optimal jointly profit-maximizing price set but not the jointly profit-maximizing level of shelf space. So, why do we get prices right and shelf space wrong ends up being the question.

So, unlike the shelf space case, when we are talking about price competition, you see here we have got on the right-hand side is this large manufacturer's margin, that $P_{sub \ W}$ minus the marginal cost of the manufacturers. It is large. It is maybe 10-20 times larger than the retailer's margin for a good chunk of products. But we have this offsetting effect induced by customer switching. So, the intuition here is that while the manufacturer's margin is much larger, we have got this switching effect, so the quantity response faced by the retailer when it changes the price has these two different components.

One, when it reduces the price or increases the price of Coca-Cola, there are interbrand effects, so sales move from Coke to Pepsi, but there also are inter-retailer competitive effects, right? So, consumers may end up switching stores when we are
1 talking about price decisions or at least are more
2 likely to do so than when we talk about moving Coke from
3 the bottom level to the eye-level shelf space, right?
4            So, the key point and argument here is that
5 because promotional shelf space does not involve large
6 inter-retailer shelf space effects, we do not see
7 consumers switching on a number of grocery products. My
8 co-author on the paper and dissertation adviser likes to
9 use the example of dog collars in the store, right? So,
10 there is some exclusive space granted for dog collars,
11 and people pay and they compete for this space, but
12 nobody switches the stores because there is one dog
13 collar versus two, okay?
14            And because we have this idea that there are
15 these small inter-retailer effects, it is the case that
16 we have this incentive incompatibility problem, right,
17 and instead of this inequality, if we had the jointly
18 profit-maximizing level, we would see at least this
19 relationship be approximately equal. The big difference
20 is this elasticity from the retailer's perspective of
21 the shelf space effect, right?
22            And so this is all to illustrate the point that
23 where we see these small inter-retailer effects, again,
24 this incentive incompatibility problem is pervasive, and
25 this is especially so in the supermarket context. Now,
there are some limits on this idea. We do not see --
the distinction here is not just because of price and
nonprice competition, okay? There are elements of
nonprice competition where there are inter-retailer
effects because all consumers value the service.

So, the supermarket provides a free parking lot.
You can go and you park and you do not pay for it, you
know, when you go in to park. Everyone generally values
that there is a parking lot, maybe there is lighting
there so you don't get mugged when you go to the parking
lot, and everybody values this, and this means, because
consumers value some nonprice services, then they will
induce some switching, that for those services, the
incentive incompatibility problem is solved. The
retailer will supply those because consumers are all
willing to pay.

So, where we see this, the very idea of
promotional shelf space is to give some sort of
effective, targeted discount to the marginal consumers
who are sensitive to allocations in the shelf space,
right? They are sensitive to what is in the eye-level
shelf space, and there is a substantial marketing
literature which demonstrates sometimes some really
surprising results about how large the effects can be in
terms of changes in sales when we play around with the
shelf space allocation.

So, in these fairly general circumstances, the disparity in margins and the small inter-retailer switching effects from the supply of promotional shelf space, the manufacturer wants more shelf space than the retailer is willing to supply, and so we need to have some separate contract where the manufacturer pays the retailer for the supply of the shelf space in order to solve this incentive incompatibility problem.

So, now we have got a situation where Coke is paying for the eye-level shelf space to the retailer, and it pays them $10,000 per unit time for the month for some contracted-for level of shelf space. Now, this does not mean that the whole process is over, right? So, the manufacturer pays the retailer with this money, and the retailer has some incentive to not perform.

It can provide less than the contracted-for level of space. It can otherwise violate the implicit contractual understanding between the manufacturer and the retailer to sell the space twice, in other words, the simple way to think about it. So, it is taking the money and not performing under the terms of the deal. This is where we get to the function of full or limited exclusives in shelf space contracts.

Now, we see that in the slotting context, at
least a full or a partial exclusive seems to be -- at least appears to be thus far -- a necessary condition for liability. So, we have some form of exclusive -- we have -- well, there is no liability, but Gruma, Conwood, McCormick, so we have these cases where the contracts do not just buy the shelf space. They specify a percentage. They specify a full exclusive. They specify limits on the placement of rival products.

So, there are a number of procompetitive rationales for exclusivity terms in these contracts, and Mr. Steuer went over many of them, and so I am not going to belabor them here, but the key, following from this sort of shelf space contracting model, is that an exclusive can help facilitate performance of the contract, right? The retailer pockets this money and can have some short-term incentives to not perform.

So, a couple of things that exclusivity can do, it can efficiently define exactly what the manufacturer is purchasing. Purchasing all of the shelf space, detecting cheating becomes easy. The other thing it does is it allows the retailer to say, you are bidding for all or 70 percent or some large fraction of the promotional shelf space, and this intensifies the bidding process between the manufacturers for the shelf space, and this is a good thing in terms of the
antitrust analysis, a good thing for consumers, because
these shelf space payments are passed on to consumers,
and that is whether they are discounts or per unit time
payments.

Quickly, so I can end here, category management
contracts are just a form of limited exclusive, where
what we are doing instead of saying you get 50 percent
of the space is the retailer delegates the function to
the manufacturer to allocate the shelf space, and we see
this in circumstances where consumers' demand for a
particular brand is high. So, the implicit contract is,
you get to feature your product, Coca-Cola, and you can
allocate the shelf space, but if consumers come to me
and say I have a high demand for Pepsi and you're
putting it on the bottom or you have run out or you did
not put it on the shelf, then I know and I terminate the
agreement, okay?

Just to finish up, Conwood seems to get this all
wrong. So, Conwood, despite the sort of atmospheric
facts and the tortious behavior and lots of bad stuff
going on, there is some bothersome language in the
opinion about imposing a standard on category managers
that is tougher than the standard on monopolists using
full exclusives, and so the key idea is that exclusive
dealing can make economic sense in these circumstances
and that we need to make sure that the plaintiffs are demonstrating an anticompetitive effect before we engage in any sort of balancing under the rule of reason analysis.

I think I went over, sorry.

MR. VITA: Not too bad.

(Applause.)

MR. VITA: Thanks, Josh.

Okay, our next speaker is Howard Marvel who is a Professor of Economics in the Department of Economics at Ohio State, and he is also Professor of Law in the Moritz College of Law at Ohio State. Howard's work on vertical restraints is very well known. He has written on a variety of different topics, including resale price maintenance and exclusive dealing, and I know those papers have appeared in some leading economics journals.

Howard also has advised the Japanese International Trade Ministry, had a post in telecommunications, the Federal Trade Commission and the National Association of Attorneys General law on vertical restraints issues. In addition, he has served as an expert in vertical restraint matters for a number of firms.

Howard?

DR. MARVEL: Okay, I have seen a lot of you
before. I am happy that you have invited me to come
talk to you outside of the Third Circuit, and the topic
for today is exclusive dealing.

It is obvious that exclusive dealing is a very
common thing that we see every time, when you go to a
MacDonald's, you do not find a Burger King hamburger,
and Haagen Dazs has had the exclusive dealing in their
distribution contracts, car dealers typically have it,
there is exclusive dealing in beer distribution. It is
all over the place, and ordinarily we do not think
anything about it. You know, any business format
franchise is basically franchise or else, and it is most
commonly observed for our market leaders, the big guys.

Anheuser-Busch has it in the Chicago area, it is
under study, and you don't see that elsewhere. Haagen
Dazs had contracts with distributors with Steve's, which
at the time was a premium ice cream. I do not know if
it is still around. Anybody from Boston? Steve's did
not have that. The big guys have more reason to
foreclose, of course, but they have also more to free
ride upon.

So, for a long time we had a rule that Richard
talked about, how tough it was to engage in exclusive
dealing. The rule seemed to be that if you had market
dominance or a big share somehow, somehow, and you
practiced exclusion, if you had exclusion in your title
of whatever the practice was, you were toast. So, it
was essentially a per se violation.

Now, exclusion there does not mean foreclosure. It just means exclusion from a portion of the market, and that is very different than keeping the firm totally out of the market. Foreclosure is a different story.

Now, several of the -- I think John is going to talk about the Chicago view and why it is limited, so let's run through what the Chicago view of vertical restraints is. It is that vertical restraints create property rights. So, you have a problem that you want to get somebody to do something, but you are afraid that at the end of the day they will not do it because the fruits of their actions will end up being frittered away as other people take advantage of them, okay?

So, the idea behind vertical restraint is that it creates a property right for somebody or other, so exclusive territories, for example, create a property right for customers that a particular distributor or dealer generates, okay? So, I go out to get a customer, how do I guarantee if I am the seller who wants that customer generated, how do I guarantee the customer gets generated? I protect the rights to that customer for the guy who actually did the work?
Resale price maintenance is very similar. There is a property right for the services that the distributor provides, and Josh talked about how this sort of works in slotting as well, like exclusive dealing, that creates a property right for customers that the supplier's actions pull in, and I think that if you think about the -- almost all of the things that Richard included in his discussion from the 1983 paper, they all have that characteristic, that the supplier is doing something to pull in customers and those customers are being protected through exclusive dealing by -- from some sort of bait and switch approach.

Now, the problem with exclusive dealing and what makes it more serious and more of a worry than territories and RPM is that in territories and RPM, the supplier is creating a property right for somebody else. It says, you do this, and you get to keep the fruits, so I would police that. And I am an outsider, and I want to have the distribution system to be as effective as I possibly can make it be, but with exclusive dealing, the property right is for the creator and the monitor of the right.

I give myself the right, and then I protect that right, and we have a problem that can emerge there if the right is somehow something that you really don't
want the guy to have and be able to protect, and that is really what is at the heart of Aspen Ski, because in Aspen Skiing, Aspen Skiing and Aspen Highlands cooperated to develop the Aspen market as a destination for skiers, and then at the end of the day, Aspen Skiing said, well, gee, they passed a law here in Aspen where you have got to have a three-week rental instead of just a one-week minimum rental or a longer rental term, and so you essentially locked customers in. You didn't have to compete for customers so much, because they said, well, we will walk away with rents, and you can see that elsewhere.

If you have a patent holder who has accessories for his product, the patent is about to expire, the guy may decide to engage in exclusive dealing to try and freeze out the accessory guys that he's cooperated with to build that product, and believe it or not, I was an expert witness in a matter in which I thought exclusive dealing was used improperly in this way, so it's not clear that these are anticompetitive so much as fraud or contracting problems, but they are problems.

Okay, so the basic exclusive dealing story is simply that the manufacturer invests in a product or a reputation that brings in customers, if the manufacturer confers upon its customers -- its customers onto dealers
who are cloaked in its reputation. So, if I become a
dealer for a particular manufacturer, then customers
say, hey, that dealer is essentially certified as
knowing what he's talking about, so the customer walks
into the dealer, induced to do so by the manufacturer's
efforts, and then the dealer says, by the way, I have
got a better deal for you.

Now, a requirement for this to work is that the
customer cost, the cost of generating the customers has
to be included in the charge for the product. So, if
you can charge for leads separately, no sweat, okay?
You just charge for the leads, you do the promotion, the
customers walk in, and if the dealer who's paid for
those customers wants to switch them to some other
product, hey, that's fine, okay, but there are a lot of
circumstances in which you only charge for the customer
when they actually buy something, so it is rolled into
the product price, and this is, again, the way it works
with royalties in business format franchises, right,
because MacDonald's brings customers in, but they only
receive a charge, a payment, for those customers when
the royalty is generated, okay?

So, the dealer can avoid this particular charge
through a bait and switch scheme in which he says, okay,
you are a customer for firm X, firm X brought you in,
that is what you came looking for, but firm Y has got a
product that is cheaper, because it does not involve any
promotion, it is simply a free rider, so why don't you
switch to that one, and you can trust me, because I am
firm X's dealer, okay?

So, what is the evidence for this -- how this
works, okay? Is there any evidence to suggest that this
works? Well, you know, "can you hear me now" doesn't
necessarily need to be Verizon's slogan, it also should
be a slogan for the hearing aids manufacturers who were
engaged in exclusive dealing, and they were going out
and getting a lot of customers to come in, into their
dealers, and the customer comes in saying I saw an ad
for Beltone hearing aids or whatever, can you fit me
with a hearing aid? And the dealer at that point can
say, yeah, I am a Beltone expert, and by the way, I've
got a better deal on another hearing aid.

Now, the interesting evidence on this is that
the FTC decided to take four of the five hearing aid
manufacturers who used exclusive dealing, take them out
and shoot them, because the idea was if you agree not to
use exclusive dealing, we'll let you off the hook, and
at the end of about a year or so, the bodies of the
companies had agreed not to engage in exclusive dealing
washed up on the shore. They were out of the business.
So, that's a problem in these cases, the counterfactual, what would happen if the practice were forced to be given up, is very hard to prove until it is too late. When you see the corpses, then you know you screwed it up.

The manufacturers in the hearing aids case did not recognize the role of exclusive dealing themselves, and so they walked away from it. Beltone didn't, but the other manufacturers of hearing aids did, and they ended up dead in short order, okay?

Now, after the Chicago explanation came out, then we got a game theory counter-revolution, okay? A famous paper by Aghion and Bolton sort of launched the "why don't we get together, write a contract and screw the next guy to come along" approach to contracting, which is, I think, a fair way to say what their model is. It says, I am in the market now, I am the only guy in the market, you're my dealer, there might be somebody who comes along later and is better than me. Why don't we figure out a way to split the rents from that guy's advantage, okay? And the way we will do that is we will write a contract between ourselves that has a penalty clause, okay, and the penalty clause is such that -- five minutes, it says. Okay, I'll never get there, okay? I am a professor, you know, I am not one of these
lawyer guys. I just talk and talk. That's the way it works, but I'll be done.

Okay, so the Aghion-Bolton idea is that there is a contract that is written before the entrant shows up, and then we run off with the entrant's rents because of the existence of this contracting penalty clause, okay? The requirement for that to work is you have got to have a contract, right? That is what you have got to have before this works, because if the entrant does show up, then the dealers run to the entrant if he is better, okay?

There is a second set of theories that are contract-based, and you think of the names Segal and Whinston, Ramweyer, Rasmussen and Wiley, and these are train leaving the station contracts. The train is leaving the station, I am the only guy in the market, you better sign up with me or else, and then you have got to stay with me if I am no longer the only guy in the market, okay? So, these both require contracts. All of these theories require contracts. No contract, no problem, okay? And that is the characteristic of the game theory counter-revolution.

So, is Chicago out the window? Oh, they are, because Professor -- or Mr. Jacobson -- what is the appropriate -- Mr. -- Mr. Jacobson --
MR. JACOBSON: Hey you, hey you is fine.

DR. MARVEL: Hey you? Okay, he says, but Chicago writers -- post-Chicago writers long ago debunked the Chicago School, and it is now common ground that in many contexts exclusive dealing can be deployed in a way that is both profitable for the dealer and that allows the defendant to reap gains from the arrangement that far exceed the associated costs. Guess what? I agree, okay? True. Absolutely.

Now, we will wait for the first one of these to come along, but it is possible, in principle, for this to happen. I do not have the slightest disagreement with that.

Now, a couple of examples of this sort of thing, the first from your vintage Chicago School nut case, we appreciate the potential reply that it is impossible to say that a given practice "never" could injure customers. A creative economist -- there are creative economists -- could imagine unusual combinations that would cause injury in the rare situation, but antitrust law applies rules of per se legality to practices that almost never injure customers, and who might that be? Yes, Chicago.

Okay, but then we also have this statement the literature on anticompetitive exclusive dealing, so
actually what we are talking about today, has focused on producing "possibility results" in simple settings to counter Chicago School arguments. It is possible that something can go wrong, says Mike, okay? Now, he is not a Chicago guy, okay, and he is right. He has written some of the possibilities, but the possibilities take contracts, okay?

Problems are possible, and the problems involve foreclosure. If you get foreclosure, that does not mean foreclosing a particular set of dealers. It means foreclosing the market. If you get that, that is a problem. The benefits are going to be really hard to prove from exclusive dealing up front. Again, like I said, until you see the bodies wash up on the beach.

The default rule in these cases is going to determine the outcome, okay? If the default is that exclusion could be bad, what will happen is that exclusion will be found to be bad despite the absence of factors suggesting the presence that we might have one of the bad theories of exclusion, the proof of concept or possibility theories, present. So, if we get the default rule wrong, what will happen is that we always find that possibility means exclusion, becomes the default rule, and we are back to where we started. Exclusion plus dominance will equal violation. That is
where we were before. One minute.

Beltone, forget them, okay?

So, what should we do about all this in the last minute? The first possibility is that all of the possibility results that I know of, and even this guy Joe Farrell back there who just walked in seems to know of, are contract-related, okay? So, why don't we start by requiring a contract? No contract, no problem, okay?

Then, we ought to require some notion that there might be something wrong in this market in the sense that there be a showing of foreclosure, and success should not be defined as foreclosure. If I do better than you do, I get a big share of the market, so what? And if my dealers then get that share, so what? Success should never be considered the equivalent of foreclosure.

But if you get to that point where you have found that there is a contract and there is a showing that foreclosure is a real problem in this industry in the sense that there is not another way to get to market, then, and only then, after you have gone past those two standards, should you go ahead and run your trade-off analysis, and I am reasonably convinced that that trade-off will often, if not always, that you will find it very difficult to prove that the efficiency
benefits that you are claiming are really present.

   With that, we will be done, okay?

   (Applause.)

MR. VITA: Our final speaker before we take a short break is Jonathan Jacobson, who is a partner at Wilson Sonsini Goodrich & Rosati, where he practices antitrust law and has taken a lead role in many significant antitrust matters over his 30-year career. Among other cases, Jonathan was lead counsel for Coca-Cola in Pepsico v. Coca-Cola, a leading Section 2 monopolization case.

   Jonathan was appointed by Congress in 2002 to serve on the Antitrust Modernization Commission, which is dedicated to studying the nation's antitrust laws and considering several changes. He also is the editorial chair of the ABA's Antitrust Law Developments and has chaired a number of ABA antitrust section committees. He has written and edited numerous articles and books on antitrust, and his most recent paper co-authored with Scott Scherr is entitled, "'No Economic Sense' Makes No Sense For Exclusive Dealing."

   John?

MR. JACOBSON: Thank you.

   I also want to express particular thanks for seating me on the far left wing on this panel. I think
that is entirely appropriate, although I would comment
that in exclusive dealing cases, I have never
represented a plaintiff. I would like to, but it has
always been defense representation so far.

So, let's talk about exclusionary conduct and
exclusive dealing in particular. There are lots of
different exclusionary conduct devices, and these
hearings will cover most of them. I actually think
ripping your competitor's racks off the shelves is
pretty exclusionary, so maybe we can talk about that in
the dialogue, but that is one example of exclusionary
conduct. The other is price cutting, which is, you
know, rarely, rarely, rarely harmful and yields, you
know, major significant consumer benefits.

Exclusive dealing is in the middle, and it
presents a real challenge, because what makes exclusive
dealing potentially harmful is the very same mechanism
that makes the arrangement efficient and may lead to
lower prices for consumers.

So, what are the consumer benefits? I think
Richard went through them and I will just go through
briefly, but basically the distributor, if we are
focusing on distribution, which is the typical case, the
distributor focuses his or her attention on the
supplier's product and becomes a more effective
distributor, and from the supplier's perspective, the
supplier has an incentive to provide the distributor
with information and displays and all sorts of that
stuff without concern of free riding by competing
suppliers.

So, these benefits are very important, but they
are possible only because the arrangement is exclusive,
denying rivals access to the distributor's capabilities.
This same exclusivity can have the effect -- and it is
not an ephemeral possibility, it can happen, although it
is not necessarily the default rule, but it is a real
world phenomenon -- that the exclusive can deny the
rivals access to customers or supplies and have the
effect of driving their costs up and rendering them less
effective competitors, less effective constraints on the
defendant's market power. And the result of that can
be -- and this is the case we need to be alert to -- to
allow the supplier to increase prices to consumers as a
result of the weakening of that competitive constraint.

So, the question is, how do we evaluate
exclusive dealing and quasi-exclusive dealing
arrangements in light of these simultaneous benefits and
harms?

Now, today I think, you know, I have not been
here for these hearings, I have read a lot of the
summaries and some of the testimony, but I suspect that there is agreement on really four issues in terms of an overall approach to exclusionary conduct. One, we do want to prohibit behavior that leads to the creation or expansion of significant market power. We want to be careful, and I think that is a principal focus of these hearings, to avoid deterring procompetitive conduct. We want to have rules that businesses can understand and apply so that they know what they are doing is legal or illegal. And we want to provide the courts with sufficiently clear rules so that they can tell in the context of a lawsuit what is illegal and what is not.

So, for exclusive dealing, we have applied these goals. I think you can go back to Tampa Electric and say we have had a rule of reason since then, but I will respect Richard's qualification of that and take the rule of reason back to Beltone, which is clearly the first sort of modern formulation of the rule of reason in exclusive dealing cases. And where we are coming to now, I have another paper where I comment that the focus on foreclosure is unfortunate, and my basic point of view on this, and I think where the law is going to come to if it has not come to already, is that in an exclusive dealing case, what the plaintiff must show to prevail is that the net effect of the conduct, including
the efficiencies, is to raise prices or otherwise harm consumers. And I think, you know, if you look at the major exclusive dealing cases over the last ten years, the results largely -- not entirely -- but are largely consistent with that kind of paradigm.

So, the recent debate was spurred in part, I think, by the thinking of folks like Judge Easterbrook, who gave a talk a few years ago saying that we should abandon Section 2 enforcement entirely, but that has led a lot of conservative thinkers and some more mainstream and liberal thinkers, like Steve Salop, to try to determine whether there is a universal test for examining exclusive conduct, and at some level we have been searching for the universal rule ever since Learned Hand's decision in the Alcoa case.

I would commend to all of your attention an excellent article in the Antitrust Law Journal a few months ago by Marc Popofsky, that having a one-size-fits-all approach that can be applied equally to practices as diverse as predatory pricing, refusals to deal, ripping your competitors' products off the shelves, has proven to be elusive. And I do not think we have gotten there yet, and I question whether we ever will.

The main area of disagreement is the extent that
we need extraordinary screens to ensure that procompetitive conduct is not deterred. The sort of screens that I would add that we do not see in most areas of the law other than antitrust. Antitrust, at least in the last few years, has been very sensitive to avoid deterring procompetitive conduct at the cost, many recognize, of allowing the occasional illegal behavior to go through.

All right, so -- by the way, thank you for not allowing questions from the audience, because Greg Werden is here -- and it is with quite a bit of trepidation, although he and I have had a few discussions on this subject, that I challenge the no economic sense test or Doug Melamed's version, the profit sacrifice test. This issue has gained -- and appropriately so -- a lot of attention, and under at least one articulation of the no economic sense test, a practice is not exclusionary for purposes of Section 2 unless it would make no economic sense for the defendant but for the tendency to eliminate or lessen competition. And in varying degrees, some of the advocates of this test urge that it be applied to all single-firm and vertical conduct.

If you look at the certiorari brief filed by the Justice Department in the Trinko case and the briefs
filed in the Court of Appeals in the Dentsply and
American Airlines cases, the Justice Department has
argued variations on this test as a rule of law. It has
not been adopted by any of those courts, but it has been
argued with some vigor by the Department of Justice.

One of the issues I have with the no economic
sense test is that it is fundamentally the Areeda Turner
predatory pricing pricing test in new garb. Areeda
Turner made a major advance in the law in 1975 when they
urged that predatory pricing not be condemned unless it
is below cost with a likelihood of recouping the lost
profits through the market conditions that will result
from the predatory pricing scheme. And their test was
acknowledged and stated by them to be an extraordinary
test reserved exclusively at that time for price
cutting, because price cutting is so rarely harmful and
so extraordinarily important to our economy that we want
to have a test that really makes sure that errors are
purely on the side of allowing the defendant to win
rather than the plaintiff to prevail.

Now, there have been efforts starting with the
article that Janusz Ordover and Bobby Willig put out a
few years after that to apply this sort of analysis more
regularly to other forms of exclusionary conduct, but in
general, we have been asking ourselves the question
since the no economic sense literature came out, is this purposefully extraordinary test -- and it was designed as an extraordinary test -- is it appropriate to apply it to other types of exclusionary conduct?

In my view, as applied to exclusive dealing, the no economic sense test really does make no economic sense, and I say that because exclusive dealing arrangements make economic sense precisely because they lessen competition by rivals for the affected business. So asking that question tells us nothing about whether the arrangement is procompetitive or anticompetitive.

Exclusives are usually associated, even in extreme cases like Dentsply, I think you can say that exclusives are usually associated with real efficiencies and sometimes cost very little to implement. So, unless you apply the economic sense test with the rigor that a Greg Werden would, and if you apply it in the real world, it is very easy to come out with the determination that the exclusive makes economic sense for the defendant.

But the way in which those efficiencies are achieved, as I said before, is through this mechanism of exclusion. So, the judicial audience, the business audience out there, is wondering, how can I do this? This arrangement makes no economic sense to me unless I
can exclude my rivals, but that seems to be the test for illegality, so what do I do? And I think the answer to that is you apply a different test.

So, exclusive dealing is also interesting and different, as Steve Salop points out, because at least under some scenarios there need be no period in which profits are sacrificed during the course of the exclusive dealing arrangement. You can have simultaneous exclusion and recoupment.

All right, recent case, not a federal case, although I will tell you we did our best to get the Justice Department and Federal Trade Commission to file a brief and they politely declined, but the Court came out correctly I think anyway, although it was a 5-4 decision, and if you really want to read something interesting, read the dissent in the case. It is a decision that came out less than a month ago out of the Texas Supreme Court, and it involved exclusive promotional agreements with retailers, not exclusive dealing arrangements, but exclusive promotional agreements.

In some of the agreements, Coke -- in all of the agreements, Coke had to get a reduced price. In some of the agreements, it provided that the low price had to be the lowest in the store on that particular package. The
exclusives required the most prominent displays in the stores and also exclusive ads.

In return for this, Coke provided very significant lump sum promotional payments and deeply discounted wholesale prices. So, the result was to reduce the retailer's costs, both marginal costs and total costs. Coke had 70 to 80 percent of the market if you accepted the market definition in the case. The result of this was lower prices for Coca-Cola products, and it was not seriously disputed that the level of promotional activity resulted in overall lower prices in the marketplace for carbonated soft drinks as a whole.

Now, the exclusivity in that case, the agreements, made economic sense only because the exclusives made more -- made things more difficult for rivals, and the easy example is to ask why would Coke pay thousands of dollars to a supermarket for a promotion? Let's say the promotion is two-liter and you expect that the reduced price would be something like 99 cents. If the consumer is going to walk in the store and the first thing she is going to see is a Pepsi display of two liters at 89 cents, that promotion really is not worth very much for Coke. Why would Coke spend the money for that promotion? Why wouldn't it just figure out some other way to sell soft drinks?
The problem, as the dissent points out, is that this kind of exclusivity could fail an incautious application of the no economic sense test, but appropriately, the majority upheld the agreements under the rule of reason because there was no showing that they led to increased prices in the market as a whole.

Now, I will very briefly talk about Microsoft, and I am not going to go through the whole slide, but the basic concept here is a lot of what Microsoft was doing was virtually costless. Leaving Internet Explorer out of add/remove programs was virtually costless, and if you apply the no economic sense test to Microsoft, you can easily get a situation where the Court would say that this conduct makes economic sense and is, therefore, upheld. I think the Court went through an elaborate recitation of the rule of reason, and I think we have a good precedent there.

I had promised not to go over time, and I see that I already have. What I do want to point out is that the focus that we care about in antitrust generally and in exclusive dealing cases as one piece of that overall puzzle is does this behavior injure consumers? Does it raise prices? Does it otherwise injure consumers and the benefit of the bargain that they are going to receive?
The no economic sense test asks that we bypass that question. My point is simply, let's look at that question directly. Let's try to get to that analysis directly. The shortcut, which if applied incorrectly can lead to very questionable results, is not a necessary route. It does not protect competitive conduct any more than a careful application of the rule of reason would. So, let's just ask the question that we really want the answer to and guide our analysis on that basis.

Thank you.

(Applause.)

MR. VITA: Thank you, John.

I think we will take a short break right now. Why don't we come back at -- ten past? -- yeah, ten minutes past, and we will reconvene.

(A brief recess was taken.)

MR. VITA: All right, let's get started.

I think the first thing we will do here is take a few minutes and just open it up to the panel to allow them to react to some of the things that they might have heard and pose questions to the other panelists. So, Jonathan, you came by before and said you had an issue you wanted to raise. I'll let you have the honor of going first.
MR. JACOBSON: Well, thank you. I previewed this with Howard, because I think the no contract --

MR. VITA: Jonathan, speak into the mike.

MR. JACOBSON: I think the "no contract, no problem" scheme is a problem, so to speak, and what I would ask Howard is, isn't it a fair observation that you worry more about exclusive dealing the larger the market share of the defendant, and don't you run into cases where the defendant's share is so high -- it is not really the share, but the market power of the defendant -- where the defendant's market power is such that they can enforce exclusives on the offer you can't refuse or the all-or-nothing offer that Richard was referring to with a lot of the detriments that can be associated with exclusive dealing with little or none of the benefits?

And again, you know, Microsoft is not a bad example. Those were not contracts at least of any duration in that case. Microsoft basically told Dell and Compaq and Hewlett Packard, you know, here it is, deal with it, and, you know, it was not a really good option for them to go to UNIX, and Apple was not available. So, let me put that one back to you.

DR. MARVEL: Well, I guess what I would say is that looking at the economic analysis of exclusive
dealing and at the places where the game theoretic models have found problems, they are all cases in which there is not an option today and I sign up everybody today and I lock them in, okay? And since that is virtually always the case in all these models, if you find another example of a circumstance in which you say there is a real economic loss that results from this, I would like to see an economic analysis of why there was an economic loss there. So, I wait for some economist, the clever economists that Easterbrook was talking about, to come up with the explanation.

I think I probably could for Microsoft as to why Microsoft's behavior might be a problem, but that is not similar to the ones that we have already talked about, okay? So, in -- I hate to do this with Gail here -- but in Dentsply, one of the things that was interesting about that case was that the Justice Department seemed to recognize early on that they needed to provide a de facto contract analysis as to why there was lock-in, okay? So, they said, okay, it is because of inventory investments. I bought so many inventories from these guys, from Dentsply, that if I walk away from them, I am stuck with the inventories, and the alternative explanation in that case said, hey, you really want those inventories to tide you over while you are trying
to convert customers, right?

And so, in fact, in that case, the lock-in turned out not to be lock-in, because Dentsply was happy to buy back those inventories, and the guy that walked away from Dentsply to sign up with rivals found that he sure wanted a hell of a lot more Dentsply teeth than he was going to get. So, there was no lock-in there in that case at all.

And again, it is possible to imagine circumstances in which a manufacturer exerts or creates a property right for itself to take advantage of somebody who has sort of cooperated with it to develop a new product, and then the manufacturer says, hey, why don't I seize that new product on my own and define this property right and take that right away from the other guy?

That is a problem, but that is almost as much of a fraud or a contract problem as it is an antitrust problem. It becomes an antitrust problem only if you get to the point where it says people are standing on the sidelines unwilling to invest because they are subject to this misappropriation of their up-front investments.

So, I can imagine circumstances under which that might work, but I am not sure that you need to attack
them in this sort of standard exclusive dealing context.

MR. JACOBSON: I don't want to hog the mike, and I know Dentsply, we would get a very different view of the facts from people like Gail and Mark Bodde (ph), but what about Lorraine Journal? No contracts, you know --

DR. MARVEL: Well, you brought that one up to me, and unfortunately, not being a lawyer -- and I am not a lawyer, even though I am a professor of law -- I am going to have to duck on that one, because I do not know the facts.

MR. STEUER: Well, maybe if I can jump in --

MR. VITA: Let me remind people, just pull the mikes up close to your face so they actually function.

MR. STEUER: It may be that lawyers and economists do not always define "contract" exactly the same way, and lawyers get hung up with the whole Colgate doctrine. In the case that I alluded to before, for example, a monopolist had 100 percent share of the market and came up with a discount schedule that basically made it advantageous for customers who needed to have some of its product to buy all of that kind of product from it so that when a new competitor opened its factory, it was facing the daunting challenge of having to replace all of the discounts that would be lost by potential customers giving up any of it. There was no
contract.

It was similar to a Colgate relationship that way. It was simply a unilateral policy, "Here is my price schedule if you do what I want you to do," and yet it seemed to have all of the foreclosure effect that a bilateral contract would. So, to some extent, maybe we are talking past each other a little bit in terms of the terminology and what is a contract and what is not.

DR. MARVEL: Well, maybe so, but one of the things that you brought up, Richard, in your discussion was this NicSand case, right? And one of the things that has really impressed me about the cleverness of the post-Chicago world is how really imaginative they are at coming up with sort of contract-based explanations for why you could have problems, but, of course, the Chicago side does that, too, and you look at Lepage's and NicSand, and those are matters in which the Justice Department says we don't know yet what we should be doing, so let's wait a while before we have the Supreme Court step into that, or at least that is what happened in Lepage's.

But, in fact, we are starting to figure out that those things involve -- I mean, maybe Lepage's was collateral damage, because there was a real problem with getting your entire line carried if you are going to a
discounter, like a WalMart or a K-Mart. So, it is very possible that in a case like that, what you are really trying to do is induce the discounter that you are dealing with -- and this is particularly true for discounters -- to carry a much broader portion of the line than they would otherwise carry, and that is going to increase consumer welfare even though it is going to increase prices or it is going to increase economic welfare.

So, I mean, you can get into these circumstances where you say, I don't understand yet why the manufacturer is doing this, so it must be foreclosure, but if you stand back for a while, maybe somebody will come along and say, hey, some of these bundling schemes have the efficiency effects that are pretty significant, and I think that cases like those may just be circumstances in which you are dealing with a guy who is going to carry a very narrow portion of your line, and you do not like that, so you pay him to carry a broader portion, and if somebody -- and you say, well, I am offering you this really good deal to carry the broader portion of the line, and maybe if that excludes somebody else, well, yeah, that could very well do that, but that is not the only effect of it, and so it is a really -- these are really tough questions.
MR. STEUER: Well, Lepage's had a "have to have it" kind of product in the bundle. NicSand is almost more interesting, because it was real competition for the contract, and I am not sure we have seen the last of that case.

MR. JACOBSON: Well, it was a 12(b), so...

MR. VITA: Anybody else? Josh, Mary, anything you would like to pose to the other speakers before we --

MR. WRIGHT: I have one.

MR. VITA: Yeah, go ahead.

MR. WRIGHT: I maybe was being too sensitive to one of the comments, so I heard it directed at me, but Jonathan had mentioned that he --

MR. JACOBSON: Ripping competitors' racks off shelves? Yeah.

MR. WRIGHT: So, I think you either mischaracterized what I said, but since I didn't say anything about the shelves, then maybe that's not it, but to be clear, what the paper is about and what we are arguing about in the paper is the economic analysis of category management contracts, giving a procompetitive explanation for why, under some conditions, the retailer may want to delegate to the manufacturer the responsibility of the shelf space allocation decisions.
That has nothing to do with the decision in Conwood.

What the point is about the decision in Conwood is -- and I agree, and I am happy to say, court reporter and everything, that I agree that ripping shelf space -- ripping displays down is bad, it is exclusionary. It would be bad --

MR. JACOBSON: Makes no economic sense?

MR. WRIGHT: -- it would be bad if -- also if the United States Tobacco employees sat out in the parking lot with bats and said don't come in and bring in product. All these things would be bad, but the point is about whether or not there is anticompetitive effect and whether or not there are any foreclosure effects and whether or not the conduct was sufficient or likely to generate anticompetitive effects.

I know I am to the right of you on the panel, so I will use someone else. Professor Hovenkamp, in Antitrust Enterprise, using the testimony in the record, estimates the distribution cost increase as something like 33 cents per store per month, and there is some other evidence we talk about in the paper, but the idea is that there is this other question about whether or not there is a likelihood of anticompetitive effect and that even in the case of really nasty, nasty, bad, wrong conduct, we should be asking the question.
MR. VITA: Mary, do you have anything?

DR. SULLIVAN: Ah, no.

MR. VITA: Okay, Brandon, why don't we move along then, and what we would like to do is put some propositions up and get some reactions from the panel, and I am going to go ahead -- I am going to read these, they have to be read into the record, so let me just go ahead and read the first one here, and this is a quotation from Justice O'Connor's concurring opinion in Jefferson Parish Hospital District Number 2 versus Hyde, 1984, and the statement is, "Exclusive-dealing arrangements are analyzed under the rule of reason."

Let me just pose probably a simple question to the panel, and this is more to the lawyers, I think. Does this statement from Justice O'Connor's concurrence in that case accurately summarize the law regarding exclusive dealing? Richard and Joshua, Jonathan?

MR. STEUER: I think it does. I think that the rule of reason is still a work in progress since Cal Dental, and we will see what the content is in judging these, but there really are three elements I think that go into it with exclusive dealing. One is the nature of the product and relationship, all the things that I talked about. The second is, of course, the percentage of the market once you have defined it that's
"foreclosed," and the third element is the duration, the
time period. So, I think those are the big moving parts
in a rule of reason analysis, and the nuances await the
development of the case law.

MR. JACOBSON: Yeah, I agree with that. I was
actually surprised, because this is also on the first of
the questions that you sent out to us yesterday, that
this would be perceived as controversial. I mean, the
law is fairly clear about this, certainly under Section
1, and I think Microsoft and Dentsply, properly read,
import this analysis into Section 2. The greater the
market power of the defendant, the lower the degree of
impairment of rivals you are generally going to require
before you see a price effect, but I do not think this
is a controversial proposition. So, I wonder what is
motivating the inquiry.

MR. O'BRIEN: We didn't necessarily think it was
controversial, but in this area where we are trying to
build some kind of consensus in terms of what we all
agree on, we thought we would start simple.

MR. JACOBSON: Well, I "concense" this.

MR. VITA: Josh, are you on board, too?

MR. WRIGHT: I third the motion.

MR. VITA: Let me follow up on that, then, and
ask again, and anybody can step in here, does anybody
think there are exclusivity arrangements that should be per se illegal? And similarly, does anyone think there are exclusivity arrangements that are always or nearly always procompetitive and are thus appropriate candidates for a safe harbor? Just if anybody has any thoughts on that, you can step in.

MR. JACOBSON: Yeah, but dissent in the Harmar case, four Justices saying that exclusive dealing arrangements with multiple retailers are illegal because Klors as originally understood is correct, but I do not think anyone else believes that, and I think it would be really wrong-headed to circumvent, you know, 30 years now of rule of reason foray after Sylvania, to go back to a per se rule on exclusivity here.

I think there are going to be safe harbors, but they are basically going to be low market share safe harbors and in a properly defined market, and the open question in those cases is going to be, well, what if the whole market is tied up with exclusives as in Standard Stations? Do we really look just at the defendant's share of the market as a screen? I think the answer is yes, but I think it is a difficult question.

MR. VITA: Anybody else?

MR. WRIGHT: Sure.
MR. VITA: Josh?

MR. WRIGHT: The first question I think was are there any that should be per se illegal, no. And the second question is with respect to safe harbors, and I think in addition to the point about safe harbors for exclusives that do not foreclose some significant share of distribution, sort of foreclose trivial shares of distribution, then that is an appropriate place for a safe harbor.

And I know there is at least -- I mean, there is not a consensus on this point about the duration of the contracts, but I believe it is certainly the case that short-term arrangements, like the ones we see in slotting, six months in duration, may also be, though I recognize this is subject to probably more debate, may also be appropriate for safe harbors.

MR. STEUER: Some courts have misapplied the term "exclusive dealing" to both exclusive selling and exclusive buying. There is almost a safe harbor for exclusive selling other than those rare arrangements where one dealer has the exclusive for every brand there is, and there have been a couple of cases like that. In terms of real exclusive dealing, exclusive buying, there is almost a safe harbor of a third coming out of Jefferson Parish, talking about 30 percent.
There are some other contexts where 20 percent is surely a safe harbor. I think that Jon is absolutely right, that the tough issue is, well, if somebody has an exclusive for 33 percent, but then there are two others who have 33 percent and 33 percent, and so there is 100 percent exclusivity, that becomes more difficult, but Jefferson Parish for practical purposes has introduced a quasi-safe harbor of about a third.

MR. VITA: Okay, Howard?

DR. MARVEL: That is an awfully small harbor, but on top of that I wanted to ask you about the exclusive -- the exclusive -- which side did you put it on, seller is --

MR. STEUER: Exclusive selling and sometimes it is called an exclusive distributorship, "You will be my only dealer in the State of Maryland" or something like that.

DR. MARVEL: Yeah, but then turning that around, how do you regard an agreement extracted by a dealer like Toys 'R Us from seller -- a seller where he says, you know, don't sell to my rival the same product that you are selling to me. Is that okay?

MR. STEUER: It can be. Again, if it extracts that from every manufacturer, that becomes increasingly a problem. If Toys 'R Us were to enter into an
agreement with one manufacturer for one product and says
"I want to be the exclusive seller of this product," it
is rather limited what the impact is. In fact, I think
the decree that was finally negotiated specifically
provides for some limited exclusivity like that.

But if one chain were to become powerful enough
to sign up as the exclusive seller of all the toys for
all the major manufacturers, obviously everybody else is
frozen out, and I think there actually have been a
couple of examples like that.

DR. MARVEL: So, in Toys 'R Us, what happened,
if I recall, was that the Seventh Circuit of all people
said that the Toys 'R Us arrangement was not okay, and
that is because Toys 'R Us did have this sort of
monopoly position in the toy business, and it was
unassailable -- because of their unassailable position,
they really needed to protect the other poor souls like
Sam's Club from the depredations of Toys 'R Us. So --
is that right?

MR. JACOBSON: Well, another way to --

MR. STEUER: Well, Sam's Club or consumers. I
mean, the classic example, there was a wholesaler on an
island, I think St. Thomas, that was the sole
distributor for, it turned out, every single brand of
liquor, so that it basically created a bottleneck and
had monopoly at the distribution level, and to the extent any of these examples approach that almost textbook model, then you have a situation where consumers really do not have other options at which to shop for those particular products.

DR. MARVEL: So, is it an advantage to consumers when Toys 'R Us contemplates getting out of the toy business?

MR. JACOBSON: Because of WalMart? Look, there were a lot of things going on in the case. One of them was that the facts supported a finding of a horizontal arrangement that was facilitated by Toys 'R Us, and I think that is what concerned Judge Wood most --

DR. MARVEL: Right, absolutely.

MR. JACOBSON: -- in terms of the significance, but looking at it purely on a vertical basis, at the time there was a credible theory that it was raising prices. Even though Toys 'R Us had a 20 percent market share nationally, there were pockets of the country where the share was in the high 40s, low 50s, and where they were a must-have retailer for Mattel and Hasbro and those other toy stores, and the result of this was that the real, you know, the real discounters were cut off by it, and you could make an arguable case that consumers were paying higher prices as a result.
So, it was not -- it is not a crazy case. I think it is a tough case, but I do not think it was a crazy case.

DR. MARVEL: Well, I brought it up because it is a tough case, but it is not a crazy case that what they were doing was actually in the interest of consumers. In fact, to have reasonably broad distribution of the lines of the toy manufacturers -- and, of course, we have also seen that not only has Toys 'R Us gone belly-up and KB Toys and FAO Schwartz, but also the toy manufacturers are rapidly fading into the sunset. Maybe that is because only one Tickle Me Elmo was -- one variety of Elmo was sold every Christmas at Sam's Club, maybe not, but it does not appear that that industry is a model of good health, and it may possibly be that that is because a vertical restraint that was contributing to not the monopoly behavior, but the good health of the industry, was expunged.

MR. JACOBSON: Well, it may also be that our analysis of monopsony power/buyer power is in its infancy and that we really do not understand the ramifications of WalMart, and I think that is the larger issue, and I do not think anyone has a good answer to that.

DR. MARVEL: I think that is right, because if
you look at Conwood, for example, and what Josh was
talking about, the Conwood case seems to me to have
turned in part upon the, shall we say, hyjinks of the
UST representatives who were trashing the Conwood
racks --

MR. JACOBSON: Right.

DR. MARVEL: -- but what it really turned on was
what was going on at WalMart, and that was a different
tale entirely. They wouldn't dare trash the racks at
WalMart, and so it kind of conflated those two things.

I mean, I have come up with a number of sort of
hair-raising anticompetitive activities that firms used
to engage in, and it is easy to come up with these
things, but that one is tough, because you start
conflating these things, and then you get a decision
that is made more on emotion than on what the economics
of it are.

MR. VITA: Let's go to the next slide, Brandon, and
let me just again read this, but this discussion
that Howard and Jonathan have been having I think sort
of leads into this next proposition and some of the
questions surrounding it. Let me just read it.

This is a quotation from Posner's Antitrust Law,
propose the following standard for judging practices
claimed to be exclusionary: In every case in which such
a practice is alleged, the plaintiff must prove first
that the defendant has monopoly power...all the
plausible cases of exclusionary practices involve
defendants that have monopoly power."

And so let me pose two questions, two related
questions, you know, should monopoly power be a
requirement for challenging an exclusive dealing
arrangement under Section 1 of the Sherman Act and
Section 3 of the Clayton Act, and related to that is,
can exclusive dealing involving a non-monopolist result
in substantial lessening of competition?

And I think you two were already starting to
discuss that. Let me see if anybody else wants to have
any thoughts on that. Richard, Mary, Josh?

MR. STEUER: Well, clearly I think one of the
toughest areas is that space between 33 percent and 50
percent, because when you get above -- where you are in
the realm of Section 2 cases, the legalities change. I
know this means nothing to economists, but it certainly
does in terms of where you can get into court and
whether you can stay there.

The Microsoft case is an interesting example,
because there, in terms of browsers -- and I don't want
to dwell on this one case -- but certainly the share at
the time the case was brought was very low, and that may explain why there was talk about monopoly power in operating systems, but if you look at it purely as a Section 3 type case and not searching for monopoly power, but even at a low market share, was there a danger -- an anticompetitive effect from the types of exclusivity that was being entered into? Purely on the numbers, you would say, no, the share is much too low, and come back when it gets higher, but we all know where that ended up.

MR. VITA: Well, let me ask this, and this may be a question more for the economists, although the lawyers are free to jump in, too.

Can we articulate or identify necessary conditions in the downstream market that -- conditions that are necessary for the exclusive dealing arrangement to have an anticompetitive effect? Are there certain things that have to be there before we have any ability to infer anticompetitive consequences from an exclusive dealing arrangement?

Josh, got any thoughts on that?

MR. WRIGHT: Sure. One -- I mean, let me make sure I understand -- I understand the question.

MR. VITA: Yeah.

MR. WRIGHT: So, when you say competitive
conditions in the downstream -- you know, the downstream market, so I am envisioning a manufacturer with exclusive deals to a retailer --

MR. VITA: Think about that, that's a good scenario.

MR. WRIGHT: That's what I would think of as an example.

MR. VITA: Yeah.

MR. WRIGHT: I mean, substantial foreclosure on -- I mean, the sort of well-known conditions from the literature are that substantial foreclosure of the rival so he can't achieve minimum efficient scale is a necessary condition of most of these models, if not all of these models, and so I think that that is -- you know, in the legal analysis, we can have certainly, you know, in the economics literature is a necessary but not sufficient condition, and, you know, we know in the cases, there are cases that end up on both sides. We have a large foreclosure share but no liability because of short duration or entry conditions or some such, and so I think it is appropriate to use foreclosure as a necessary but not sufficient condition.

MR. VITA: What about things like scaled economies in the downstream -- when you talked about scale economies, you were thinking about upstream, but
what about downstream?

MR. WRIGHT: So, in downstream, you can have -- there are cases where if you have large economies of scale in distribution, you get -- you can have these exclusionary effects as well.

MR. VITA: I mean, if there weren't substantial scale economies downstream, or maybe some other factors as well, do you think it would be possible in the kind of long run or medium run for exclusive dealing arrangements to have an anticompetitive effect? I mean, why wouldn't -- you know, because if you don't have substantial scaled economies and/or sunk costs at the retailing level, why can't the -- supposedly the foreclosed manufacturer get around the --

MR. WRIGHT: Right, so if you have -- at the retail level you have -- I am going to frame this a slightly different way, but if you have -- even if you have the manufacturing scale economies but the retail level you have free entry condition, then you are going to have retailers who will re-align the supply contracts, new entrants into the retailers who will re-align the supply contracts, and so you need it at some level, and the theory is you can do it with economies of scale at the manufacturer level, but if you have free entry at the retail level, I think that is
another problem for the exclusionary dealings.

MR. VITA: Jonathan, you looked like you might have had something to add there.

MR. JACOBSON: No, I actually agree with that, but it led into one of my sort of favorite topics in the space, which is let's not talk about foreclosure, because if we look at the percentage of distribution or retail outlets foreclosed without examining entry, for example, we may get a large number that's meaningless, and that is why I think we are a lot better off if we get rid of the word "foreclosure" and think about the impairment of the rival, because that is the mechanism that is going to lead to the consumer harm, not the foreclosure, as such.

Foreclosure is a part of the analysis, but I think it is only part of the analysis. You have to look at the broader picture. Clearly there have to be impediments to entry downstream.

And incidentally, I would agree with Posner's book depending on the definition of "monopoly power." You know, I think if you change it to market power, I think, you know, a lot of people would subscribe to it. I certainly would.

DR. SULLIVAN: Yes, I have one comment to make on the -- following up on Josh's comment about free
entry in the retailing level. I agree that if there is
free entry in retailing, this is problematic for
theories of exclusion, because the excluded manufacturer
can more easily go to one of the new entrant retailers
to obtain distribution, but on the other extreme, if you
have, say, a monopolistic retailer, then I think that
the exclusive dealing arrangements, it is very hard to
prove that they would be harmful just because of the one
monopoly rent problem. So, I think you need to -- there
may be more potential for harm from exclusion in the
more intermediate market structures.

MR. VITA: Okay. Brandon, let's move on to the
next slide.

Here's another -- this is yet another quotation
from Justice O'Connor in Jefferson Parish Hospital
District Number 2 versus Hyde, and the proposition here
is, "Exclusive-dealing arrangement 'may be substantially
procompetitive by ensuring stable markets and
encouraging long-term, mutually advantageous business
relationships.'"

Let me put a couple of questions out. You know,
what are the -- empirically, what kinds of efficiencies
do the panelists perceive to be most likely to be most
significant in one of these exclusivity arrangements?
And think about this, you know, are there efficiencies
that are sometimes discussed maybe in the academic
literature in connection with exclusivity arrangements,
but in all likelihood, really aren't likely to exist or
likely to be very important empirically in real cases?

So, let me put that out there. Anybody --

DR. SULLIVAN: Yes, I will take that one just in
the sort of specialized area of slotting allowances. In
the academic literature, people make a big deal out
of -- one of the efficiencies of slotting allowances is
that it signals the product quality to retailers of
manufacturers' new products in cases where product
default is uncertain, and based on a lot of the
empirical studies that have been done by people in
marketing, that is simply not one of the efficiencies
that pops up, and I think the reason is there are quite
a few tools that manufacturers use to introduce their
products in addition to slotting allowances, and that
just -- so, I would feel comfortable ruling that out as
an efficiency, although there are plenty of other
efficiencies involved in slotting allowances.

MR. VITA: Howard?

DR. MARVEL: One of the cases that Richard
mentioned is the first nuanced case of exclusive dealing
I think was Beltone, and I think it is fair to say that
if there had not been some very un-nuanced evidence in
that case, that Beltone would have gone down in flames,
because by the time Beltone came up before the
Commission, its four principal rivals in that particular
channel that it was involved in had all met their
demise, and so Beltone was left as the monopolist --
thank you very much, FTC -- and at that point, they
didn't really have a good explanation for why they were
engaging in the exclusive dealing that they were
engaging in, but -- and so I don't see how they really
could have prevailed in that case unless there was this
evidence that was pretty clear that the companies that
had to give up the exclusive dealing practice had gone
belly-up.

So, in some ways John's paper talks about how
there probably is not a case that you can find where you
cannot determine that there are some advantages, but the
real difficult problem is to figure out how important
they are, and that is an incredibly difficult trade-off.
It is very hard to measure these things.

MR. VITA: Let me ask a follow-up on that point.
What significance, if any, should be given to observing
a challenged exclusive dealing arrangement in a similar
but somewhat more competitive market? So, you know,
that is sometimes an argument you make or you hear,
that, well, you know, this particular arrangement must
have some competitive benefits, because we see it over here in these other markets that are structurally competitive and where there is no plausible anticompetitive theory of harm. How much -- how powerful are those arguments and what weight should they be given?

MR. JACOBSON: I think it is a much more powerful argument if a small company is doing it than if a large company is doing it in the same market. I think looking at comparable markets and saying exclusive dealing works efficiencies there, therefore they must in this other market, really depends on how similar the markets are. I would not make that leap without, you know, a good deal of comparability evidence.

MR. VITA: Josh?

MR. WRIGHT: A related point, I mean, the nature of the exclusive deal to facilitate some sort of contract or performance, in the slotting example, again, where the contract is over some sort of form of promotion, and you see this a lot in exclusive dealing cases where the underlying relationship between the manufacturer and retailer relies on some sort of promotional effort of the retailer and, in fact, is contracted for, but the nature of performance in these different markets varies a great deal, whether we are
talking about putting a product on an eye-level shelf
space or giving a product demonstration or some other
form of promotion.

So, the contracted-for conduct varies so much
market to market, I think the best you can make out of
seeing exclusive in a more competitive but different
market is sort of one of a cautious inference that we
generally know that exclusives can be procompetitive,
which I think there is not much disagreement on anyway.

MR. VITA: Okay.

MR. JACOBSON: I have a question for Mary. If
we renamed it payola, from payola to music leaders or
retail music program, do you think we would get a
different result?

DR. SULLIVAN: No. I think the people at FCC
and Elliott Spitzer would figure it out in a second.

DR. MARVEL: Why don't we call grocery store
slotting allowances payola?

DR. SULLIVAN: Well, I think we could, and one
thing you could do --

MR. JACOBSON: Because we would like to win the
cases.

DR. SULLIVAN: -- if the FCC regulated slotting
allowances, they would require the cashier at the
checkout counters to tell the customer each time he or
she was buying a product for which a slotting allowance had been paid, then say, do you still want to buy it?

MR. WRIGHT: Well, as funny as that is, California had proposed at one point -- I think it is still kicking around in committee --

MR. JACOBSON: No, it was killed.

MR. WRIGHT: It was killed now?

MR. JACOBSON: Yeah.

MR. WRIGHT: Senate Bill 582, which would have made -- it would have been illegal for -- essentially a retailer would have to tell Pepsi exactly what Coke was paying in terms of its promotional allowances, in terms of the slotting fees, and if you conceive of these things, these payments, as I do, as part of the competitive process, I mean, this is a statute that is a -- it is, you know, a legislatively enforced collusion, right? And so it is silly, but, you know, not silly enough to write down in a bill.

DR. MARVEL: Was it going to be the California Raisin and Coca-Cola board? Is that --

MR. JACOBSON: It was proposed by a coalition of the same people who represented the plaintiffs in the Gruma case and the Harmar case. I mean, it was serious, and it did get some traction, but it got killed fairly early on in committee.
MR. VITA: Okay, let's move on then. The next proposition is from Dennis Carlton from his article in the Antitrust Law Journal, "A General Analysis of Exclusionary Conduct and Refusal to Deal -- Why Aspen and Kodak Are Misguided," and Carlton's proposition is as follows:

"In the presence of scale economies, exclusive dealing can be a way of depriving Firm 2 (or its distributors) of the necessary scale to achieve efficiencies, even though, absent the exclusivity, Firm 1 and Firm 2 would both be large enough to achieve efficiency."

So, two related questions for the panel. One, do you agree with Dennis' statement, and secondly, other than its potential to deprive competitors of scale and the resulting effect on prices, are there any other theories of harm from an exclusivity arrangement that should be the subject of antitrust concern?

DR. SULLIVAN: I will try the second question. There is a theory -- and this is one I referred to in my presentation -- by Greg Shaffer, a 2005 theory, and he had a theory of exclusion in which scale economies did not play a role, but what was going on is the retailing segment was very, very competitive, and essentially retailers, without exclusion of a manufacturer, would
earn almost no profits because their segment was so
competitive, and they could easily be coerced into going
along with an exclusivity deal that would exclude one of
the manufacturers because it simply would increase the
industry profits, and he developed conditions under
which this was true. One might argue that that would be
fairly unusual, but it -- you know, it is there.

MR. VITA: Anybody else? Dan, did you want to
add something?

MR. O'BRIEN: I would just like to ask, Mary,
following up, in that kind of a theory, if a
manufacturer could secretly get to a -- get with a
retailer, okay, assuming that everybody else was being
coerced into this exclusive with the manufacturer, and
negotiate something on the sly, wouldn't they be able to
undercut what, you know, the monopoly price that was
presumably being set by the other guys?

DR. SULLIVAN: I think so, and I think there was
something in particular about the nature of the game
that Greg set up that allowed him to get this outcome,
so I agree that might be -- it might not be that
problematic in reality.

MR. STEUER: There are a lot of assumptions in
here obviously. It makes a huge difference whether the
exclusivity is with end users and for how long. If this
is simply competition for the contract, clearly if one manufacturer can get exclusive arrangements with the bulk of the end users and freeze out the other, that is going to have a profound impact, but if the second manufacturer can survive long enough to go and bid the next time and try to get the contract back, that is very different. We do have some situations in defense, for instance, where there is only going to be one winner of these contracts. They are always exclusive, and yet you do have some back and forth bidding as long as both companies can survive. Here, I presume the assumption is, with economies of scale, that there is a danger that one of the companies disappears off the face of the economic map.

MR. JACOBSON: I think this identifies a case -- there are certainly exceptions, as Richard points out, but I think this identifies the exclusive dealing case that you ought to worry about, you know, if these conditions are holding, this is the case you ought to worry about. There may be other cases you ought to worry about. There may be cases where this is not a problem because it is competition for the contract, but in terms of our analysis, this is where I think we should focus most of our resources.

I would add that this is an excellent article,
although Aspen I do not think was misguided, although that is debatable, and Kodak was clearly correctly decided.

MR. VITA: Whoa.

MR. O'BRIEN: Okay, we will try -- if we have got time -- we have got time for one more, I think. Oh, one more on this? On this proposition or one more proposition?

MR. VITA: One more proposition, I think.

MR. O'BRIEN: I think we can go a little longer.

MR. VITA: All right, Brandon?

Okay, this next proposition is from Herbert Hovenkamp, Antitrust Enterprise, 2005, and I will read it.

"Exclusive dealing is a rule of reason offense, requiring a plaintiff to show that the defendant has significant market power, that the exclusivity agreement serves to deny market access to one or more significant rivals, and that market output to consumers is lower (or prices higher) as a result."

A couple of questions for the panel. As to significant market power or some indicator of significant market power, is there or should there be a safe harbor? And does anybody have an -- you know, it says here in my notes that Jonathan in his writing
suggests courts apply a 40 percent market share safe
harbor, and if that -- you know, is that actually true,
and does anybody have an alternative minimum requirement
that they would prefer?

So, let me put those two out, those two
propositions out there and see what the panel thinks.

MR. JACOBSON: Well, I generally agree with what
I said.

MR. VITA: Glad to hear that.

MR. JACOBSON: I think this is a pretty good
quote. I think "market access" needs a little bit of
definition, because I do not think you need -- this was
one of the other questions that we had talked about
before the program -- I do not think you need total
foreclosure. Again, I think the test needs to be the
degree of impairment of rivals. So, as long as denying
market access is read in that context, I think this is a
pretty good analysis.

I think 40 percent is a pretty good rough
screen. I think Richard's correct to point out that
Jefferson Parish is a 30 percent number, but it does not
say anything about a screen here or there, but if you
look at the subsequent cases, you are not going to find
any where the defendants have liability with less than
40 percent unless you consider Toys 'R Us an exclusive
dealing case, and there, you know, there were extenuating circumstances given the horizontality of the agreement.

MR. STEUER: And the term in here "significant rivals" is significant, because it really raises the question, who should have a cause of action here? At some point, if there is ample competition in a market and there is exclusive dealing going around, there may be some marginal players who claim that they are being excluded, and those can be emotionally appealing cases in terms of jury appeal, and yet in terms of what the actual effect is on the market, it may be very marginal indeed, and there are not very clear tests right now as to who should be able to bring a claim.

MR. O'BRIEN: If I could follow up with that, John, earlier you had said that one of the areas in which there was an agreement, you listed four points, one of which was we want to prevent the enhanced -- you know, practices that enhance market power. I am wondering if you would agree with the last part of this proposition, which is that plaintiffs have to show to successfully bring a case that market output goes down and/or prices go up.

MR. JACOBSON: Well, I think what he means is that market output is likely to go down, and if you show
there is a significant enhancement or creation of market power, I think you have done that. So, I do not think this is inconsistent with that proposition.

MR. VITA: Okay, let's move on then.

This next proposition is from United States versus Microsoft, the D.C. Circuit en banc decision. The quotation is as follows:

"If the monopolist's procompetitive justification stands unrebutted, then the plaintiff must demonstrate that the anticompetitive harm of the conduct outweighs the procompetitive benefit."

A couple of questions, and again, this may be a little more for the economists, but anybody can step in. First of all, does economics supply tools that would assist courts in making this kind of assessment, and do courts have the ability to apply these kinds of tests?

Let me stop right there and see what the reaction is from the economists on the panel.

DR. MARVEL: How about no?

MR. VITA: Say again?

DR. MARVEL: Do the courts have the tools? No.

MR. VITA: Actually, the proposition was, can we as economists supply tools that courts could use? I mean, what kind of analysis, if any, can we provide that
will allow noneconomists to make the kind of
determination that the Court called for in this case?

DR. MARVEL: I think that you really need to be
very careful about if you show anticompetitive harm, it
is pretty clear that you have got anticompetitive harm,
then I guess once you have gotten to that point, unless
convinced that the procompetitive benefits you are
trying to demonstrate will be easily enough measured and
ready available in such a way as to make it possible for
the courts to do the trade-off, I just think they are
awfully hard to prove what they are.

So, if you can really show that somebody is
locked out by the nature of the arrangement -- and that
means from the market, that does not mean from the
channel that the manufacturer in question controls, but
from the market as a whole -- then it is going to be
hard to do this trade-off, but if you have got the
anticompetitive harm and people are absolutely convinced
that it is there, then I think that that might be
enough.

MR. VITA: Yes, Josh?

MR. WRIGHT: Well, I think in this particular
quote, we have to -- there may be differences with
respect to what economists can do before and after -- in
the first and second clauses, right? The economist
might have tools to supply with respect to understanding a monopolist's procompetitive justifications. Something we can do is understand why we might see exclusives, understand why conduct might be procompetitive, and the conditions under which those explanations are likely. That is something we can do and should be doing.

It is a lot tougher, the challenge of doing the balancing is much tougher, and I guess the part that is not in this quote is that the first step of requiring the plaintiff to show the likelihood of some anticompetitive effect is also an area where economists can contribute by explaining the conditions for anticompetitive effects are either satisfied or they are not.

MR. O'BRIEN: Do you want to follow up, John?

MR. JACOBSON: I mean, this is what my article is all about, so I do not want to leave this one untouched.

A, most cases do not reach the level where you need balancing. The number of cases where you really need to balance it are few and far between. Usually the case will fail because a prima facie case of anticompetitive effect will not be shown. If that is shown and the defendant shows a significant justification, usually the plaintiff gives up at that
point. So, it is a very rare case that requires balancing.

But if balancing is required, I think we need to do it, and to say -- to throw up our hands and say it is too complicated is just completely the wrong answer. We do it every day. This building is filled with people doing that in merger cases. It is done at the Justice Department in merger cases all the time. This is exactly what we do. So, to say that we are not going to do this, it is too complicated, we might as well just get rid of antitrust, because this is the guts of what hard antitrust cases are all about, and we not only want to do this, but we have to do it. This is one issue I feel very strongly about.

MR. O'BRIEN: So, I wanted to follow up with Howard, and, John, you may want to chime in on this, too. You are concerned that if we can establish that there may be an anticompetitive effect, that it is often very hard for defendants to come in and argue, well, no, in fact, there are efficiencies and that they offset the anticompetitive effect, and I --

DR. MARVEL: No, what I am saying is that if you can really show anticompetitive harm and --

MR. O'BRIEN: That may or may not be offset by efficiencies, okay, so that is what I am saying. It may
or may not be offset, and what I took you to be saying
was that --

DR. MARVEL: That would make it really tough
for -- once you have a compelling demonstration of
anticompetitive harm -- and that is compelling for me,
not for you --

MR. O'BRIEN: Right.

DR. MARVEL: -- then I am not so sure that -- it
reminds me of the original merger guidelines when they
did not allow efficiencies as a defense, and I do not
think that that was absolutely nuts. So, if there is a
strong demonstration of anticompetitive harm -- and that
is not just locking up a channel, that is locking up the
market -- then I am not sure how much balancing I want
to do at that point.

MR. O'BRIEN: I see.

MR. JACOBSON: It is a rare case, Dan, it is a
rare case where you need to do this, but there can be,
at least in theory -- I will tell you, I have never seen
one -- but there can be one, at least in theory, where
the effect of the exclusives is to create a market
structure such that the defendant can raise prices to
some extent.

However, there may be sufficient dealer focus as
one traditional efficiency or other effects that overall
output of the product is increased. Think about your resale price maintenance cases, the same -- it is the same type of analysis, and if you can show -- first of all, the burden is on the plaintiff, not the defendant, but if the defendant can put in evidence to say that notwithstanding the price increase, we are going to have a significant overall market output effect that is going to be procompetitive, I think you have got to entertain that defense, and then I think you have got to see whether that is true at the end of the day. Is the net effect going to be to increase output or not?

MR. O'BRIEN: I guess I -- I am sorry.

DR. MARVEL: I think maybe if I can go, John's point, I think part of the disagreement with -- the implicit disagreement here is in my determination of what constitutes an anticompetitive effect, because I certainly would not agree to that parenthetical remark that Hovenkamp had that said that prices are higher than they would have been if the restraint was taken away. Well, you cannot do that, because all of these explanations talk about setting up a property right that allow you to get a return on your investment which could very well take the form of, you know, if you shift up the demand curve, you are going to get a higher price and greater output. If you get more output, end of
story. If it is a higher price, that does not really
tell you much of anything, and so that is I think part
of what we are -- we may be agreeing, somehow have a
different setup.

MR. O'BRIEN: So, following up on that, Howard,
I am curious how you feel about something like the no
economic sense test as a way to, you know, ask is there
a plausible efficiency rationale and, you know, maybe
short-circuit this balancing some.

DR. MARVEL: Sorry, but I -- it hurts me, but I
would have to agree with John on that one. I do not
like the test.

MR. O'BRIEN: Okay. Why don't you like the
test?

DR. MARVEL: I think your explanation is that
there is always economic sense in these practices, and I
think that that is right, that there will always be some
plausible argument that could be made. Unless we are
talking about gunning down your rivals or some such,
anything short of that, you are probably going to be
able to come up with some plausible argument on behalf
of that.

MR. JACOBSON: One convert, not a bad morning.

MR. VITA: Well, with that, then, we will bring
the morning session to a close. I would like to thank
the panelists. This was a really great discussion, and I think everybody got a lot out of it. So, thanks very much.

(Applause.)

(Whereupon, at 12:19 p.m., a lunch recess was taken.)
MR. O'BRIEN: Okay, let's get started. Well, welcome to the second exclusive dealing panel of the day in what is part of our ongoing series of public hearings on single-firm conduct. My name is Dan O'Brien. I am the Chief of the Economic Regulatory Section at the Antitrust Division, and I will be moderating this session along with Mike Vita, who is the Assistant Director in the Economics Group, the Bureau of Economics at the Federal Trade Commission.

The Department of Justice and the FTC are jointly sponsoring these hearings to help advance the development of the law concerning the treatment of unilateral conduct under the antitrust laws. Transcripts and other materials from the prior sessions are available on the DOJ and FTC web sites, and I just wanted to advertise that upcoming panels include a panel on bundled loyalty discounts on November 29th, obviously a practice that is somewhat related to exclusive dealing, which is the topic for today, and then there is a panel on misleading and deceptive conduct on December 6th.

So, today's session concerns the law and economics of exclusive dealing. It was 40 years ago in
the Brown Shoe case that the Supreme Court made a very strong statement against exclusive dealing, asserting that it conflicts with the central policy against contracts that take away the freedom of purchasers to buy in an open market.

Since that time, the treatment of exclusive dealing by the courts has changed fairly dramatically over time, and the economics of exclusive dealing has progressed, identifying both procompetitive and anticompetitive aspects of the practice depending on a range of circumstances.

We have a very distinguished group of panelists here this afternoon to talk about these developments and the current state of affairs from both the legal and economic perspectives. My goals from today's panel are, first, to highlight some areas hopefully where there is some consensus on the effects of exclusive dealing and how to treat it, but also maybe identify questions that remain unsettled so we can have some consensus about the questions that need to be addressed as we move forward.

So, before introducing the panelists, I just wanted to thank my colleagues at the FTC and at the Antitrust Division, particularly June Lee and the economics staff at the Antitrust Division and Joe Matelis in Legal Policy. The two of them together did a
lot of the work in putting together this panel.

The organization of the panel is going to be as follows: We have four panelists. They will give presentations of approximately 15 minutes. Then we will take a short break. Then the panelists will have a few minutes to respond to the other presentations if they so desire, and then we will have a moderated discussion, and we can go until around 4:00 p.m.

So, the order of the panelists, in case people are wondering, will be Steve Calkins first, Tad Lipsky second, Joe Farrell and then Ben Klein. So, let me introduce Stephen Calkins. He is our first speaker.

Stephen Calkins is Professor of Law and Director of Graduate Studies at Wayne State University Law School where he teaches courses and seminars on antitrust, trade regulation, consumer law and torts.

From 1995 to 1997, Steve served as General Counsel of the Federal Trade Commission. Steve lectures widely throughout the U.S. and abroad, most recently in Europe and New Zealand. He has authored many publications on competition and consumer law and policy, and he has served on the editorial boards of well-known journals in antitrust.

Stephen?

DR. CALKINS: Thank you. Thank you for the
introduction. What was not said is that I am actually
the most novice of all the people who are speaking here
today. I mean, you go over everybody else, and they
have been an expert witness in one or more of the
leading cases, they have litigated one or more of the
leading cases. Richard Steuer, in the previous session,
got up and proceeded to point out that he had published
three articles specifically on exclusive dealing. I
have never been an expert witness on exclusive dealing,
I have never litigated, I have never done an article
about exclusive dealing, as such, you know, we are
talking about somebody who is just not in the same
ballpark. So, with great humility, let me just tell you
that I am trying to sort out my own thinking and to
learn from all these geniuses.

To do that, we need to start somewhere, and so I
found one interesting case that I thought I would begin
just looking at a little bit, and here is a court
opinion that talks about how exclusive dealing "may well
be of economic advantage to buyers as well as to
sellers, and thus, indirectly of advantage to the
consuming public," and these advantages may often
explain why there are exclusive dealing contracts, and
if you wanted to go and understand whether they were
harmful or beneficial, you would look at a series of
tests.

You would look at "evidence that competition has flourished, despite use of the contracts," or you would look at the conformity of the length of their terms to the reasonable requirements of the field of commerce, or you would look at the status of the defendant as a struggling newcomer or an established competitor or the defendant's degree of market control, and you would go through all this sort of stuff, but the opinion goes on and says that to do this would just be extremely difficult and to sort everything out would be an immense challenge and, using words very similar to sort of the basic sort of Areeda Hovenkamp mantra, we need to have tests that are administrable by courts, we need to have rules that can be enforced without wasting a lot of societal resources on hopelessly complex litigation that can't lead to any predictable outcomes, and so for reasons of administrative efficiency, exclusive dealing contracts should almost all be illegal, because this was the original Standard Oil/Standard Stations case with those thoughtful observations about the procompetitive benefits of exclusive dealing, but the conundrum, the difficulties, of litigating.

So, when I sat down and took a look to start my sort of thinking about this and went back in time, I
said, golly, what an interesting beginning place, and I then decided to pull out key dates in exclusive dealing history, and we began with the classic Supreme Court cases, which have been reviewed a little bit in the morning session, and I will not mention them except that Standard Oil you know, Brown Shoe was just referenced, the classical Supreme Court cases were certainly important moments in exclusive dealing history.

That led us to the key year of 1977 when all of antitrust, as we know it, changed with Continental TV, and then along came Robert Bork and the antitrust paradox -- actually, along came all of the Chicago School -- but Bork in particular is associated with exclusive dealing, because he said so emphatically that, by golly, there is only one monopoly profit. Exclusive dealing cannot increase a monopolist's monopoly profit, and so, therefore, "if Standard finds it worthwhile to purchase exclusivity, the reason is not the barring of entry but some more sensible goal such as obtaining the special selling effort of the outlet," emphatically saying that one cannot increase the profit of the monopolist, and so there must be a procompetitive justification, and those Supreme Court cases were just dead wrong, a really clarion call for a different way of looking at exclusive dealing.
As mentioned in the previous session, that call was picked up first in the courts or the adjudicative bodies in the Beltone Electronics opinion, where the Court specifically relies on Bork and the antitrust paradox to take a different approach to exclusive dealing, the Federal Trade Commission, leading the way to a new day of exclusive dealing decision-making, even if we learned in the last session at the cost of having sacrificed four of the five competitors, but nonetheless, having led the way, that was followed shortly thereafter by Jefferson Parish. Of course, it is always cute, we refer to the Jefferson Parish exclusive dealing holding, and it wasn't a holding at all. It was part of the concurrence of Justice O'Connor, but we all think of it as the holding from Jefferson Parish where she emphatically said exclusive dealing is judged more permissively than tying, it is rule of reason, and "exclusive dealing is unreasonable restraint on trade only when a significant fraction of buyers or sellers are frozen out of a market by the exclusive deal."

And since then, if you look at things that have happened and you sort of parade through the exclusive dealing cases that we know, which I throw up on the screen in front of you or I throw up more of the
exclusive dealing cases that we know or I throw up more
of the exclusive dealing cases that we know, the one
great unifying principle is, of course, that the
defendant always wins. There are a few exceptions, but
overwhelmingly, the judicial treatment of exclusive
dealing ever since Beltone Electronics came down has
been that defendants win these cases, and you can find
support in the case law for all sorts of pro-defendant
propositions, with exclusive dealing being strongly
presumed to be legal if there is a market share of less
than 40 percent, if the restraint is of less than a
year, the contract is of less than a year, if the
contract is easily cancellable, if we do not have a
complete and total foreclosure, see the words in
Jefferson Parish, if there are no entry barriers, and
on, there are probably other ones as well, a whole
series of different principles, standards under which
defendants have won these cases, and that's a whole lot
of the exclusive dealing story, and then there is the
"but" part of the whole thing that makes our life
slightly interesting here.

There are three things to mention. The first,
the post-Chicago literature, I have reason to suspect,
although I did not look at his slides, that Joe Farrell
will reference a little of this, and it can be done in
all sorts of wonderful mathematical sophistication. I think of the lesson as a common sense story of collective action.

There was recently a case that Tad knows dearly, the Coca-Cola case just decided by the Texas Supreme Court. I do not know anything about the facts of that case, and I have no opinion on the case. I do not know what happened down there, but one of the things that allegedly happened was that Coca-Cola paid retailers not to allow 7-Up in its stores, and if you think about that for a minute, you know, it sort of sets out the collective action story very crisply. Why would a retailer agree not to carry 7-Up when it knows that if in the long run there is no 7-Up, that is probably bad for retailers? And the answer is, of course, that if a payment goes to a single retailer, that single retailer can collect the payment knowing that its excluding of 7-Up is not really going to make a difference in the long run, and you do not have all the retailers getting together and agreeing that they will resist Coca-Cola, because that would be illegal under the antitrust laws, and so each separate retailer looking at its individual self-interest can quite reasonably say, I will agree not to allow 7-Up in my store, even though in the long run, that is against the collective interests of all of them,
and it is because of that kind of a collective action problem that exclusive dealing can sometimes harm competition in the long run because one can have an exclusive dealing arrangement that helps someone today, with all the benefit going to that one entity, in the long run, there is harm, but the harm is shared widely, and so, therefore, you have a mismatch between the benefit of the harm, a collective action problem, and therefore, mischief can be worked.

Two cases have come along that have sort of set out the -- sort of the other ways of thinking about exclusive dealing, being Microsoft and Dentsply. People in this room know those cases far more than I do, but just mentioning a couple of points quickly, Microsoft is -- you can find several different points in the Microsoft opinion on exclusive dealing. This is one where the District Court had said that there must be complete and total exclusion before there is a violation, and the Court of Appeals wrote that "even assuming the holding is correct," and went on to say there could still be a violation, thereby suggesting that that holding may not be correct.

It went on and said there could be a violation because there is a different standard under Section 2 than under Section 1, and even if something might be
lawful under Section 1, it could be unlawful when engaged in by a monopolist. The Court asked rather tough questions about the justifications for the practices going on there, specifically saying that with respect to one practice, where 14 of the 15 top Internet access providers had contracts to work only with Microsoft, the justification was to keep them focused on Microsoft's product, "which is to say it wants to preserve its power in the operating system market, that is not an unlawful end, but neither is it a procompetitive justification," thereby raising nice questions about the difference between a benefit to the seller and a benefit that qualifies as a procompetitive justification.

Also of interest to the Microsoft case is we had a very economically sophisticated court unable to resist quoting some language indicating subjective intent. "Kill the cross-platform Java by growing the polluted Java market," so on and so forth, finding some comfort in the words that business people had used to describe what they were doing, and then finally being troubled, even though we did not have total exclusion. So, we have a whole series of interesting points that come out of the Microsoft case.

In the Dentsply case, what did we have in
Dentsply? You had something where you had an at-will contract, and yet the Court of Appeals said that was not reason for the defendant to prevail, because realistically, wholesalers are not going to give up $22 million in sales in order to pick up $200,000, and so an at-will contract does not really give a new entrant realistic access to the market. So, also, there was talk about monopoly maintenance as a separate kind of problem, and once again, we had reference to subjective intent evidence.

So, where am I at that point in terms of, as I end, little lessons that I draw from my sort of going over things, and they are very tentative, because I really have not thought these things through all the way. I am learning, okay, but tentative things that I might throw out as propositions.

One, it should be possible for a short-term contract or contract that is cancellable still to be found to be unlawful. It should be possible for there to be illegality without total exclusion. Section 2 standards should be tougher than Section 1 standards. It does not make sense to take all of the teaching of Section 1 exclusive dealing cases and then import them unthinkingly into the world of Section 2. If you have a firm with a 75-80 percent market share and entry
barriers and lots of power, it ought to be tougher than on a smaller, less powerful firm.

I hesitantly think that it is -- this will not be popular with some of my panelists -- sometimes it is interesting and possibly informative, if done very carefully, to look at subject intent evidence to help you sort through these difficult things. Clearly it makes sense to scrutinize the procompetitive justifications that are being offered up in a case that otherwise looks troubling. The classic procompetitive story is that the manufacturer has expended resources to bring a consumer into the store who will then be bait and switched off to another product. Well, you know, do the facts fit that story or not? In Dentsply, the Court thought they did not fit that story but went on to try to really sort of sort through what is the justification. It should not be enough just to say it is a nonprice vertical restraint.

I personally would not think that one should require a plaintiff to prove that prices have increased. I mean, think again about your classic exclusive dealing situation would be something where we are trying to cause problems in the future. Go back to my Coke paying to have 7-Up not around. The reason to do that is so that things will be better for Coca-Cola in year two or
three or four or five, and one can have a lessening of competition without prices today being affected. The hard question here is the long-run competitive effects, though, can't be a complete defense to say that current prices have not gone up.

So, also we would say that the legal standard really does matter in these cases. Going back to previous sessions that you have had, you heard a lot about the no economic sense test in the last session. Another standard that can make a big difference in exclusive dealing cases is whether you choose to adopt the Posner "Exclude an equally efficient firm" test. Were you to adopt that, which I would not favor, that would make it much harder for a plaintiff to win an exclusive dealing case.

And finally, in closing, pretty much on time, it is interesting as you survey the landscape that there is a whole lot of theory, not a great deal of empirical evidence, and so I hope that this program, if nothing else, inspires some people to go out there and get their hands dirty and bring forth more empirical evidence.

Thanks very much.

(Applause.)

MR. O'BRIEN: Okay, our next speaker is Tad Lipsky. Tad is a partner at Latham & Watkins and a
former Deputy Assistant Attorney General at DOJ. Tad's 30-year legal career has been devoted mainly to antitrust, and it spans virtually every facet of competition law.

From 1981 to 1983, Tad served as Deputy Assistant Attorney General at DOJ under William Baxter. Following government service, Tad developed a broad U.S. and international antitrust practice, successfully managing a variety of important antitrust matters.

As chief antitrust lawyer for the Coca-Cola Company from 1992 to 2002, Mr. Lipsky conducted and supervised competition matters before courts and antitrust authorities in the U.S., Canada, the EU, EU Member States, and dozens of other jurisdictions. He is a frequent author and speaker on antitrust topics.

Tad?

MR. LIPSKY: Thank you very much. Until a few moments ago, I had forgotten how stupid it was to follow Steve Calkins to the podium, because he knows more about whatever he speaks about than anybody else and expressed his interesting views so trenchantly and with such great humor that that is a very tough standard, but I will do my little bit and see if we can find something to agree on. I think we can find a few things to disagree on, and we will see where it goes.
Exclusive dealing is a very elastic label. It applies to a lot of different kinds of things. We have already heard mention of the fact that tying, certain kinds of bundling and price discounting can have effects very similar to exclusive dealing, and therefore, when you talk about exclusive dealing, you also need to be considering a bunch of its very, very close relatives, and so we are talking about implicitly, at least, a very broad category of business conduct and competitive phenomena.

Now, on the plus side, for our policy evaluation of exclusive dealing, it has never been a per se offense, which is a very good thing. It is a little like saying, well, in Eastern Europe, they have a little better luck re-adopting capitalism, because they were capitalists within living memory, whereas in the old Soviet Union, in the heart of Mother Russia, that was not the case, and so there is no great body of learning, there is no familiarity in the culture, and similarly, with exclusive dealing, although it is true that back in the Standard Stations days and when we were dealing with the International Salt comment, that under Section 3 of Clayton, you could condemn exclusive dealing either if the defendant had market power or if there was not an insubstantial amount of foreclosure, that is coming
within an eyelash of saying it is per se, but we never quite got there.

There was always a little bit of procompetitive culture left in exclusive dealing, and so -- as a matter of fact, even in the dark ages, between the decision in Schwinn, all vertical agreements are illegal per se, until the release from bondage in 1977 with Sylvania taking the nonprice verticals out of that category, I am not aware of any decision going whole hog and saying, well, that because of Schwinn, now we have to say that exclusive dealing is per se. Even in those dark days, we never had a rule for exclusive dealing that said basically shoot on sight.

So, now, having escaped per se condemnation, I think it was easier for exclusive dealing cases to kind of re-absorb the economic learning, to talk about procompetitive justifications, to insist upon genuine proof that the process of competition had been obstructed before liability could be imposed. We went from Standard Stations, we went to Tampa Electric, which basically said, well, even quantitative foreclosure does not really give us the story that we want to hear when we are talking rule of reason. And so, in effect, this evolution is kind of a testament to just how thoroughly the microeconomic analytic approach has been absorbed in
the antitrust enforcement industry, the enforcement agencies, the courts, counselors, what have you, and this is all very much to the good. This is as it should be.

But one result of this emergence into the more full-blown consideration of justifications and actual competitive effects is that the role of market power and monopoly power have been pushed to the fore, and for most kinds of exclusive dealing claims, you need to have market power or monopoly power at one level in order to have any kind of a plausible theory of restraint, and so now it has become a topic that is addressed more under the Section 2 standards than under Sherman 1 or Clayton 3, and that is fine. So, that focuses, to the extent that these issues come up under the Section 2 rubric, that focuses you on monopoly power, because it is a required element of proof in every Section 2 case, or in an attempt case, of course, the reasonable likelihood of monopoly power being attained -- and it also means that -- it really brings us down to I think the main discussion, the main subject of discussion, which is the definition of monopolizing conduct, and, of course, that is a much broader area, and let's see what light we can shed on the exclusive dealing aspect.

Well, one of my colleagues, Steve Calkins, has
already alluded to the fact that if you look at
exclusive dealing cases, there are not many in which
plaintiffs win, and it is interesting that some of those
cases are really not Section 1 or Clayton 3 cases
anymore, they are Section 2 cases, oddly enough, in
which the decision-maker for one reason or another
failed to condemn exclusive dealing under Sherman 1 or
Clayton 3, but only under Section 2, and that would
include U.S. v. Microsoft, LePage's v. 3M, sort of in
the margins of exclusive dealing, one of those forms of
bundling, and then we have heard about U.S. v. Dentsply.

Now, within the broader debate about legal
standards for monopolizing conduct, exclusive dealing I
think is more or less kind of a classic example. What
do we have to go on when somebody is challenged for
their conduct under Section 2? Well, we have Grinnell,
we have Aspen, exclusion on the basis of something other
than efficiency; we have Image Technical Services, not
the part that everybody has had seminars about and
talked about for years and years and years, and Salop
said this and somebody else said that and it is
post-Chicago -- no, it is pre-post-Chicago -- okay, it
is post-modernist Chicago, but the point is there is a
second part of Kodak versus Image Technical, which say
what you will about the tying part, the first part of
the Supreme Court opinion, there is that second part
that makes some extremely broad characterizations of
what it takes to -- broad and vague characterizations --
of what it takes to prove monopolization. That part of
the opinion was so good that when Image Technical got to
go back and have its trial, it did not even bother with
all the hard post-Chicago stuff in the first part. It
just relied on that great language in the second part of
the opinion. So, it is really a question of
deconstructing and coming up with a monopolistic conduct
standard that can be applied sensibly to the generality
of these cases.

Now, I will put all my cards right on the table
and say I am not one of those who says there is
salvation to be had in taking the vague language of
Grinnell and the vague language of Aspen and the vague
language of the second Section 2 part of Image Technical
versus Kodak and trying to put some kind of a
microeconomic overlay on it, whether it is no economic
sense, profit sacrifice, exclusion of equally efficient
competitor. I think all of those things can come in
very handy. I mean, if you see a monopolist doing
something that causes it losses, you are entitled to
inquire, is it an eleemosynary motive, was it a mistake,
or was the monopolist taking money and paying for
something, and was it a competitive restraint? So, I do
not want to suggest that those concepts are useless, but
I think they are not going to get us the distance to a
standard under Section 2 for judging exclusive dealing.

As a matter of fact, I am prepared to say that
as a general matter, any standard that is simply stated
and purported to apply to the generality of exclusive
dealing cases cannot possibly give you specific enough
guidance to decide any particular case. This is just
one of those situations where we are kind of stuck with
the dilemma that Steve referred to in the initial part
of his remarks when he was quoting from Standard Station
saying, well, you know, we would love to consider all
these justifications, but, you know, it would not be an
administerable rule of law, there is nothing you could
do with it. Therefore, we are going to have a per se
rule based on quantitative substantiality.

It is a little bit like my favorite footnote in
Topco. Remember United States v. Topco, which was a
horizontal case, and it was a bunch of independent
grocers who had banded together and had arranged to have
their own private label line of products to offer in the
grocery store so they could compete with A&P Ann Page
and Safeway's whatever, and the District Court had said,
well, this is very procompetitive as a rule of reason,
case dismissed, and the Supreme Court said, oh, no, oh, no, when you are talking about a horizontal restraint -- and it was a territorial restraint in that particular case -- what the Supreme Court said is you don't consider all that stuff, it is per se, and then they dropped a footnote that said, well, look, if Congress would like to adopt a rule of reason for this kind of restraint and send the courts off into the wilds of economic theory -- that's the exact phrase they use in that footnote in Topco -- Congress can go to that, but we are not going to, per se illegal, next case. So, we have got a similar situation here.

Exclusive dealing could be good, could be bad, depends on a lot of different factors, very hard to formulate a different -- a reformulation of a general standard that is going to apply in all circumstances, and so I have very little faith in any such reformulation. I think we are just stuck, you know, courts do what they do. You have got a difficult area where it is hard to make a judgment. Actually, as I think as I am going to talk about toward the end of my remarks, which will be soon, what I am basically saying is if the courts find it difficult to take such an amorphous standard and apply it to this practice, what we have to have is better courts.
Now, we have mentioned that defendants almost always win. So what? So what? I have no great faith in the numerology of one loss statistics. The real question is whether anticompetitive conduct gets struck down in these cases and procompetitive conduct is exonerated, and by that standard, as I read the same cases that Steve has obviously read -- and he has probably spent a lot more time reading them than I have and has read a lot more cases as well -- but I find it very difficult to say that something is seriously awry.

I have cases where I would disagree with what is going on, but there are two cases in the -- well, I have talked about Microsoft, U.S. v. Microsoft, Lepage's v. 3M, U.S. v. Dentsply. I have listed -- have I listed in my -- well, anyway, three cases I could name where the defendants won, three recent important cases where the defendants won, Pepsico versus Coca-Cola, this is the New York case affirmed by the Second Circuit where basically the Second Circuit said you do not get a trial on the proposition that the reason quick-service restaurants do not buy Pepsi-Cola is that Pepsi-Cola cannot figure out a way to deliver the syrup to the restaurants. Whatever reason there is for the relevant market shares in quick-service restaurants for carbonated soft drinks, it is not that Pepsi-Cola could
not figure out a way to get its product delivered.

Omega Environmental versus Gilbarco, I do not know any more than what you, the average case reader, knows. I had no involvement with that case. Then we have Harmar Bottling, which is, again, a case that I do know something about. I am not sure the facts bear the characterization that Steve was giving it. I do not want to get into a cat fight with him over that, but I will just say that I think the result in that case was correct, and so of the cases I know, of the cases I have read about and tried to understand, I do not think you can say that defendants are winning in cases where they should not win.

So, you know, we need to figure out a way to assess exclusive dealing efficiently, and basically, as I say, my message is there is some exclusive dealing that is good, some exclusive dealing that is bad. Harmar took about 14 years to tell one from the other, and my main message is that there has got to be a way of getting to an efficient resolution of these cases much more quickly. As a matter of fact, I would consider whether -- I might regret this if it became a sound bite, but if there is a sound bite I would give you, let's have the antitrust enforcement mechanism, let's adopt as a policy objective, that in the area of
exclusive dealing, we want to reduce the duration and
the expense of deciding whether exclusive dealing in a
particular case is good or bad. Let's reduce the
duration and expense by an order of magnitude so that a
Harmar, which took 14 years to litigate, takes, say, 14
months to litigate.

Now, in this column, I have very high praise for
the Ann Bingaman suit against Microsoft which resulted
in the 1994 consent decree. I know that there was some
investigation prior to the time that the DOJ got the
file in that case, but I remember being incredibly
impressed for two reasons with that effort. Number
one -- well, other than feeling that the result was
right. It was a consent decree, but I think it did the
right thing.

Number one, it was about exactly one year
between the time that the Department of Justice got the
file in that case and the date that the decree was
entered, and number two, it was a very specific,
targeted form of relief. It was a doable form of
relief. So, if you can do an exclusive dealing case
that quickly and come up with a result that concrete in
a year, it forgives almost any other defect that you can
find in that case, because on that time scale, you can
correct for your mistakes. You can, you know, do in
year two what you failed to do in year one, or vice
versa. So, litigation efficiency is an extremely
important consideration, and we ought to figure out ways
for a great increase in litigation efficiency.

One minute, that is exactly what I need.

So, here are some ideas for enhancing the
efficiency of this process, and I think a lot of the
tools are already at hand. Daubert, it has already been
used in an exclusive dealing context. Let's have more
of it. Let's make sure that expert testimony is forced
to go through and survive a plausibility test, the
Daubert standard. Let's make sure that the plausibility
formulation in Matsushita and Brooke Group, even though
that is relative to predatory pricing, a plausibility
test should also be applied to other types of antitrust
claims, including exclusive dealing, help filter out
losing claims early, and focus remaining claims on all
phases for the remainder of the litigation, so you are
not carrying forward speculative theories and going
through the wasteful discovery and legal motions and so
forth that that involves.

Second, expand the use of neutral expert or
expert panels, and I want to emphasize here, it is not
just in a strict Rule 706 sense, in other words, an
expert witness providing economic testimony to a judge
in a matter in litigation, like Fred Kahn's testimony in the New York versus -- the Nabisco Brands case. That was a very effective use of a 706 expert, but we need ways to bring specialized knowledge about antitrust cases, discovery, theories, the nature of the market, we need to put those resources at the service of the courts that are having these exclusive dealing litigation things litigated before them.

And the last one I won't go through due to the shortness of time, but the Manual for Complex Litigation does contain a few things about antitrust, but perhaps of the ideas that we could expand, the sort of helpful guidance, the identification of issues, the suggestion of efficiency-enhancing methods of resolving complex litigation, expand it specifically in the area of monopolization and exclusive dealing for the use of the courts.

So, just to sum up, I do not think that our exclusive dealing jurisprudence is in crisis. I kind of like where the law is. Some exclusive dealing is good, some exclusive dealing is bad, it is not per se legal, it is not per se illegal, but if we could reduce the time it takes to tell the difference between good exclusive dealing and bad exclusive dealing by an order of magnitude, I think that would be a very worthy goal
for the antitrust policy.

(Applause.)

MR. O'BRIEN: Thank you, Tad.

Okay, our next speaker, shifting gears to a couple of economists, is Joe Farrell. He is Professor of Economics at the University of California, Berkeley, and he is a Fellow of the Econometric Society, former editor of the Journal of Industrial Economics and former President of the Industrial Organization Society. Currently he's the senior consultant for Charles River Associates.

Joe's published widely articles on a broad range of topics in industrial organization and microeconomics, including exclusive dealing. He has substantial policy experience as well, having served as Chief Economist at the Federal Communications Commission from '96 to '97 and Deputy Assistant Attorney General for Economics at the Antitrust Division from 2000 to 2001.

Joe?

DR. FARRELL: Well, I am an economist. I am going to talk about economics for a few minutes, and then I am going to talk about the law. I feel all right about this because I hear a lot of lawyers talking about economics.

So, economics for the most part in antitrust
analysis has focused on the question, what should we do if we knew really quite a lot about the case, okay? And in the area of exclusive dealing, I think a bland and very fair summary of economics in this area is both efficiency and anticompetitive effects and explanations of exclusive dealing are very possible, and on both sides of that, the analysis is really quite subtle, and I am going to spend a few minutes on this. In terms of the efficiency explanations, I am going to focus on the investment incentive theory, which I think Ben Klein is also going to talk about a form of. In terms of anticompetitive effects, I am going to talk about what I think is the leading example, though not the only example, of an economic structure to understand anticompetitive effects of exclusive dealing.

So, in terms of the investment incentives, you will often hear it said that exclusive dealing is efficient if you have to motivate relationship-specific investment or some such phrase as that, okay? As far as I know, the state of the art in the economics literature on these arguments is the article by Elias Segal and Michael Whinston in the Rand Journal, 2000. They start out by showing that in what appears to be quite a general model, relationship-specific investments, that is, investments that have no value outside the
relationship, are not -- repeat, not -- an efficiency
rationale for exclusivity.

They then continue to show that investments that
are not in that strict sense relationship-specific, that
have a spillover to deals between the customer and the
potential entrant, might or might not be an efficiency
rationale for exclusivity. It depends on quite a number
of things. It depends on who is doing the investment.
Is it the buyer or the seller? It depends on how it
spills over. Is it a complement or a substitute with
the efficiency of potential deals between the buyer and
an entrant? It depends on the bargaining structure
between the buyer and the seller. It depends on what is
the nature of any investment by us absent the exclusive
dealing. And that is all within their model. If you
step outside that model, it also depends on whether
their model sort of applies or sort of does not apply.

So, I am going to leave you for the moment with
the thought, how is a court likely to be able to
disentangle all this in addressing an asserted
efficiency rationale along the lines of investment
incentives?

Now, what about the other side of the courtroom,
divide and conquer exclusion, Rasmussen and Ramseyer and
Wiley, 1991, corrected, beefed up and radically improved
by Segal and Whinston in the American Economic Review, 2000, show that exclusion can profitably and harmfully work against end users; however, although I think that is very well understood and accepted, the fact is their models involve buyers who are end users.

In most cases that I am aware of, exclusive dealing is not a deal struck with end users. It is a deal struck with retailers or distributors or someone else intermediate in the value chain between the manufacturer and the end users. That makes a lot of difference.

So, interestingly, a year or two ago, there appeared to be economics literature, two broadly parallel articles, papers, one by Fumagalli and Motta, which I believe has been published or is about to be published in the American Economic Review, and one by John Simpson and Abraham Wickelgren, and within the last 24 hours, I have learned about other articles by Yong and Shaffer that may be somewhat along the same lines, and both of these articles address the question, how does the RRWSW theory of anticompetitive exclusive dealing change when you recognize that the buyers in the model, in practice, should be replaced by buyers who are not end users?

Well, there are two forces, okay? One force is
that intermediate buyers, nonfinal buyers, actually do not care that much if the price goes up or stays high, provided it goes up or stays high to all of them, because then it gets passed through downstream, okay? How much that is true depends on the details of the market structure and so on, but that tends to be true. That lowers their resistance to things that maintain monopoly upstream relative to what it would be if they were end users. So, that you would expect would make anticompetitive exclusive dealing easier.

Another force, however, is that if you have a nonfinal buyer who holds out and does not sign the exclusive deal, then an entrant can come to him and say, "Aha, I will give you a lower price than all your tied up rivals will be getting. You can expand. You and I can meet my scale requirements, and you will make a bundle of money." So, that dynamic potentially makes it harder to have anticompetitive exclusive dealing.

Well, Fumagalli and Motta found conclusively that it went one way, and Simpson and Wickelgren found conclusively that it went the other way, and which way Yong and Shaffer come out, I do not know yet. Which of them is right and when? Well, I attempted to diagnose this in my Antitrust Bulletin article last year. My attempted diagnosis is that it depends on whether in
that last situation where you had one hold-out buyer,
the incumbent is then able to or does adjust the price
that it charges the tied buyers. So, I believe
Fumagalli and Motta assumed that it does not, and
Simpson and Wickelgren assumed that it does, or maybe it
is the other way around, okay?

When I put this tentative diagnosis to one of
the four economists -- and I will not say which one --
the response I got was, "Ah, that is interesting, I am
not sure." That is telling, I think, because it says
that it is kind of unlikely that a court is going to do
a very good job of disentangling all of these difficult
concepts. Now, the optimistic view is this is just the
beginning of the economic exploration of this topic, and
come the year 2010, we will understand it well and in a
way that is good enough for us to brief courts on it,
and maybe that will happen, okay, but I take from this
two things.

One is economics is making progress, that is
great, I hope to participate, but the other is, it is
pretty subtle and it will probably stay pretty subtle,
if not get more subtle.

All right, so we are doing antitrust under
uncertainty. We are not in the world where we can say
exactly what is going on and work out the welfare
consequences, okay? Let's take that as an assumption for now.

Well, traditionally at this point economists plunge into Bayesian mode and talk about type one errors and type two errors and so on. Underlying what I am going to say, there certainly is a Bayesian framework, okay, but I am not going to talk explicitly in Bayesian terms. I am going to talk in jurisprudential terms, because my lawyer colleagues on this panel have been talking economics, so I want to get back at them.

So, I am going to talk about the role of presumptions and burdens of proof, and I am going to talk about two presumptions that should be extremely important in antitrust policy and about what I personally think -- although I cannot prove -- is a very worrying trend that has been taking place in the relative strength of these two presumptions.

So, what are these two presumptions? Number one, in economic policy generally, in market economies, we have a laissez-faire presumption. The Government should not intervene in stuff unless it is reasonably sure that intervention will help. I think that is a pretty good idea.

Number two, in antitrust particularly, we should protect competition unless we are reasonably sure that
some alternative is better, okay? So, I think at a very
grand, 40,000-foot level, you can view a lot of what
goes on in antitrust jurisprudence as being a tug of war
or back and forth between these two presumptions.

Now, I put competition in quotes on this slide
for a reason, and that reason is when you look at it too
closely, things get a little out of focus, and you do
not exactly know what that word means, okay? And that
has led us, I believe, over the course of the decades
towards the tempting solution of redefining the word
"competition" to mean what is good. So, here is a test
of that, okay?

What happens when you hear someone refer to the
possibility that a merger to monopoly would reduce
marginal costs so much that it would be good for
efficiency and consumers? Well, if that were true,
let's say you knew it was true, it would be a good
thing. Would it be procompetitive? I think a lot of
people would say yes, because it is a good thing, but
that is ridiculous. It is not procompetitive. It is
pro-consumer, it is pro-efficiency. It is not
procompetitive.

So, if we are going to use words in their real
meaning rather than redefining them so that the
definition does our policy analysis for us, we have got
to be a little careful about doing stuff like that.

Now, of course, the antitrust law protects
"competition," so tautologically, redefining the word
would be a good idea, it would lead us to do good
policy, if we always knew what was going on, okay? So,
given that the law protected competition, it would be a
very smart move on the part of benevolent antitrust
enforcers and courts and so on to redefine the word
"competition" so that the law then protects whatever is
good, okay?

However, there is a problem with doing this. A,
we do not always know what is going on exactly, and B --
B only applies given A -- attempting to have a
presumption in favor of protecting competition makes no
sense if you define competition to mean what is good,
okay, because if you knew that something was good, you
would want to do it, and that is not a presumption in
favor of protecting competition. So, for there to be
any meaning to the presumption in favor of competition,
it has to be a presumption in favor of something that
has not yet been proved to be good, okay?

So, this I think casts an interesting light on
the slide that I heard this morning -- and I was not
taking notes on who said it -- but somebody said
something along the following lines, or if I misheard
it, it has certainly been said within the last week -- that because there are perfectly plausible efficiency justifications for exclusive dealing, plaintiffs should be required to prove that there is an anticompetitive effect, okay? That, of course, would be obviously right if we could always prove what is true, but if we cannot always prove what is true, it is not obviously right. It might still be right, but it is not obviously right, okay?

So, in order to explore this, let me, with tongue in cheek, put the shoe on the other foot, okay, and let's suppose that we applied the same redefinition to the laissez-faire presumption, okay? So, we have this presumption that says the Government should not intervene unless it is pretty sure that intervention is a good thing, okay? So, now let's suppose that we defined laissez-faire as the good outcome, and we defined intervention as the bad outcome.

Now, if the Government wants to come along and insist that you paint your bedroom walls blue, not white, you can't say that is intervention, because you have not proved that it is a bad thing, okay? Well, that is obviously pretty stupid.

So, I come out of this thinking it would be a good idea for us to make sure that words go on meaning
what they mean, and it is very dangerous -- it has had
some good consequences, but it is nevertheless very
dangerous -- to redefine words to make them do your
policy analysis for you.

So, antitrust intellectual history, to the
extent that I understand it -- in less than one
minute -- in the bad old days, anything that could be
presented as a reduction of competition was illegal.
That was bad, because quite often, things that can be
presented as a reduction of competition are actually
good. The good new days, we have got to analyze the
effects of things that seem to be capable of being
presented as a reduction in competition, because you
would not want to ban those things if they are actually
good, okay?

What I am worried about is the possibility that
we are drifting into the not so good new days where it
is difficult to prevent things that are in some sense
reductions of competition unless you can actually prove
that those things are bad. Now, of course, you would
not want policy to prevent those things unless they are
bad, but that is very different from unless you can
prove that they are bad.

Now, the final bullet on this slide, which is
quite important, I talked about these ideas very briefly
with some people in Europe over the summer, and they
were aghast. Why were they aghast? Because they said
we have spent years trying to move away from a
descriptive basis of liability towards an effects-based,
economics-based concept of liability, and now, you are
coming from over there and trying to undo that. Well, I
take that seriously, so I am not going gung ho on a
policy proposal here, but it does seem to me that if too
much burden of proof is being imposed, that is a
problem.

Let me finish with this slide, dark matter, do
the physics, okay? It is a good idea to intervene only
if intervention benefits efficiency or consumers. It is
maybe not such a good idea to intervene only if you can
specifically prove that and how it would do so, okay?

There are multiple benefits of competition in
most circumstances. Often, there are concrete,
predictable, provable price effects, okay? Merger
simulation has been a very powerful tool in exploring
that. There is also the much vaguer and harder to pin
down possibility that having a bunch of different firms
doing different things and independent of each other can
lead us to benefits that are much harder to prove or
even define or even point to ex ante, okay? I call this
the dark matter of competition policy, because as in
astrophysics, if it exists, it is quite likely to be a
lot bigger and more important than the stuff that you
can see. So, watch out when you are imposing burdens of
proof.

(Applause.)

MR. O'BRIEN: Thank you, Joe.

Our final speaker is Ben Klein. He is Professor Emeritus of Economics at UCLA and a director at LECG. Ben is an internationally recognized expert on antitrust economics. He was a Professor of Economics at UCLA for 34 years where he published numerous articles on a range of topics, including antitrust, contracts and intellectual property.

He currently serves on the board of editors of five academic journals. Over the past 25 years, he has consulted extensively on antitrust issues and has made numerous presentations to state, federal and foreign regulatory agencies and courts.

Ben?

DR. KLEIN: Thank you, Dan.

I am going to be talking mostly about economics, and although what I am going to say is subtle, you should not reach the conclusion from what Joe said that because the arguments are subtle that, therefore, anything goes. Just find the economist that is going to
make the argument you want to hear. I think there is
truth out there. This is moving us along on coming up
with what is the economic foundation for some commonly
used procompetitive justifications.

This is a paper that I am working on with Andres
Lerner. The paper is posted on the web site, and I
think it is important to go through these procompetitive
justifications in terms of the economics, because the
danger I see is the exact opposite one. I think that we
are moving in the direction that if you find a practice
that does not have efficiencies, it is becoming a
sufficient condition, if it is something that is being
used by a firm, a large firm, it is a sufficient
condition for antitrust liability, because the very
nature of an exclusive dealing contract is
"exclusionary," and then when you get to the balancing,
you have nothing on one side of the scale.

Although the paper discusses many exclusive
dealing cases, we concentrate on Dentsply, and that is
what I am going to concentrate on today, and it is
because the court in that case used economics to reject
two very common procompetitive justifications, both free
riding and this undivided dealer loyalty justification,
and the principles that I am going to be giving you here
can be applied to a number of very different claimed
justifications, and we do it in the paper.

So, in terms of Dentsply, as I said, Dentsply illustrates that actually the economic foundations for procompetitive justifications are actually pretty narrow, and the Court rejected Dentsply's claim, in particular, that exclusive dealing was used to prevent dealer free riding on manufacturer-supplied promotional investments. This is the classic Howard Marvel rationale, where the manufacturer makes investments in a dealer, you know, like they build out a dealership or engage in dealer training, and then the dealer uses those manufacturer investments to sell a rival product, and that is the classic free riding argument. The Court rejected that, and the Court rejected the undivided loyalty argument, that somehow you give somebody an exclusive so they will more actively promote Dentsply's product.

The Court rejected the free riding rationale basically because the Court found it was contrary to the facts, that number one, Dentsply did not make any investments in the dealers that they could then free ride on by using them to sell rival products. There was no evidence, essentially no evidence in the case, that the Dentsply dealers were actually switching buyers to rival products. And finally, that there was testimony
by Dentsply executives that if there was not an
exclusive, they actually would have invested more -- you
see, the usual economic argument is the purpose of
exclusive dealing is to encourage the manufacturer to
make investments, and one way it is encouraged to make
investments is to prevent free riding that it knows that
these investments are going to be used to sell its
product, and the Court said, you know, the Dentsply
executives actually testified that if we did not have
exclusive dealing, we would have had to make more
promotional investments.

In terms of the other argument, the Dentsply
Court rejected the undivided loyalty argument, and here
it was not really just the facts. It was basically the
theory that this theory about enhancing dealer services
cannot be a justification for exclusive dealing, because
in general, competition between dealers is going to lead
them to supply the desired quantity of promotional
services, as the Court said, the dealers have the
incentive in competing with other dealers to make sure
that they supply the right kind of services.

See, basically the problem that Dentsply ran
into is although this undivided loyalty argument has
been accepted by a number of courts, Judge Robinson in
this case knew a lot of economics, and in particular,
she knew Howard Marvel's argument and had read the article, and Howard Marvel was the expert that Dentsply had hired for this, and she said, no, even in your expert's article, he says that you can generally leave it up to competition to put dealers to supply the right services. It is only when you have this problem, this inter-dealer free riding problem described in Sylvania, you know, and that is a problem where the customer goes to one full-service dealer and gets some kind of dealer services and then goes to another dealer and buys the product, you have that inter-dealer free riding problem, and in that circumstance, maybe competition among dealers will not give you the right quantity of dealer services, but that is a problem that would not be corrected with exclusive dealing, because even if you had exclusive dealing and you had this kind of problem, the exclusive dealer would say, no, get the services from somebody else and then come and buy the manufacturer's product from me.

So, as I said, although this rationale has been accepted by a number of courts, Judge Robinson said, you know, basically you can leave it up to competition, and this undivided loyalty makes absolutely no economic sense.

In contrast to basically the established
economics, I think the expanded economic framework that I am going to present here shows that these arguments make sense, that free riding is much more general than you would think, and the dealer undivided loyalty makes sense, and it is based upon two common sense business propositions.

Number one, that manufacturers often want their dealers, even dealers that are competing with one another, to supply more promotion than the dealers would independently provide on their own, and number two, that exclusive dealing by creating this undivided dealer loyalty actually increases the dealer's incentives to supply these desired services and to more actively promote the manufacturer's products.

So, in terms of the logic of what I am going to do, first I am going to discuss the first proposition, and hopefully people have been here in the morning and heard Josh Wright, who has done this already, but basically the first proposition is manufacturers, in general, cannot leave it entirely up to the dealer competition to get the quantity and the type of services they want supplied, and the logic of the argument is there is another step where, therefore, they have to contract with their dealers, either explicitly or implicitly, to solve this problem and to make sure that
they adequately promote their product. That leads to these free riding problems, which I will discuss are much broader than the classic Marvel free riding problems. And then finally, that exclusive dealing is commonly an element in those contractual arrangements that gets the individual dealers' incentives then aligned more with the manufacturer's incentives.

So, let me do the first proposition first, that manufacturers often want their dealers to supply more promotion than the dealers would independently decide to provide, and the basic reason for this is that the dealers do not take account of the manufacturer profitability on incremental sales, that the dealer does something that increases the manufacturer's sales, and the dealer gets only a part of that incremental profit, in many cases only a very small part of the incremental profit.

Now, in general, this is not a problem for dealer price and nonprice competition that has significant inter-dealer quantity effects. So, in general, when a dealer provides a desirable service like free parking or lowers its price a little bit and makes a little bit more sales, even though they might have a small margin in terms of the total profit being earned by the manufacturer and retailer together when they make
that extra sale, because they are getting consumers to
switch from other dealers, because there is large
inter-dealer effects, you get an equilibrium where you
get the desired quantity of the services provided, but
with promotional activity, the primary effect is not
really inter-dealer, but it is primarily inter-brand,
that you just make an extra sale for the manufacturer,
and there are no significant inter-dealer quantity
effects. Then you have this problem where the dealer,
by not taking account of the incremental profit, is
going to supply less than the desired promotional
services of pushing the manufacturer's product. In
addition, dealers cannot charge consumers directly for
those services, because the promotion is, in effect, a
price discount.

So -- I am going to have to go faster --
manufacturers solve this problem -- although I am going
to be talking about violating these contracts, I can
always violate, you know, this one --

MR. O'BRIEN: There is no red string we can pull

DR. KLEIN: No, there is no self-enforcement
problem here, although -- anyway, I am wasting my time.

Manufacturers solve this problem of insufficient
dealer promotion by contracting with and compensating
dealers for providing increased promotion, and the contract may be explicit or it -- you know, in plenty of the cases, like in Standard Fashion, they explicitly said you have to have a certain amount of display space, you have to have a "lady attendant" there full-time, they used a few words like that. Most of the times it is really understood that you are going to make your best efforts, and they compensate dealers in these things by giving them a valuable distributorship in the sense that if they get terminated because they are not pushing the product adequately, they are going to lose this future rent stream, and the threat of termination is what gets them to perform as desired.

However, because dealers are contracting to supply more promotion than they would otherwise, you know, do in their own independent interests, there is an inherent problem in that they have an incentive to violate the contract and free ride on the manufacturer's compensation arrangement, basically because you are getting a valuable dealership, like in Beltone, they gave them an exclusive territory. In Standard Fashion, they had minimum resale price maintenance. Whatever it is, you have something valuable, but you are getting it on all your sales, and you therefore have an incentive just to do that pushing at the end and save the cost if
you are a dealer, and still you are getting most of the
compensation.

In terms of this contract, dealers may violate
the contract and free ride in three distinct ways, and
the first way is the standard case where the dealers use
the manufacturer-supplied investments to sell rival
products, and that is part of the contractual
arrangement. Look, we will give you these complementary
assets to help you push our product, and that is one
that you know about, but there is two other free riding
problems.

Second is the dealers may just use the
manufacturer paid for promotion to sell rival products,
that they are being compensated with this valuable
dealership, and on the margin, they are just going to
switch, and the profit incentive is really the same as
one, but you do not have to find these manufacturer
assets there.

And the third one is the dealers may just
under-supply the manufacturer's paid-for promotion, as I
said, because on the margin, they are getting paid on
all these inframarginal sales, and on the margin, it
really does not pay for them to spend all this money on
pushing the products on the margin if it was not for
this contract.
Dealer free riding need not involve manufacturer investments or dealer switching. That is the implication of this. So, for example, in free riding one, which is the one you all know about, that one involves manufacturer investments and dealer switching. That is what the Court in Dentsply said, there is no free rider problem here. But free riding, too, the dealers are just using the paid promotion to sell the rival products, and that one can occur without any manufacturer investments whatsoever. They are just free riding on the compensation arrangement.

Free riding number three, where dealers are undersupplying what the manufacturers are paying for, that one occurs without any manufacturer investments or without any dealer switching, okay, and exclusive dealing may be used to mitigate all thee forms of free riding, and it prevents free riding types one and two by just preventing the switching of sales to rival products, and it prevents free riding number three by creating this undivided dealer loyalty by promoting the incentive of the dealers to promote the manufacturer's product more intensively that aligns the incentives.

So, how does exclusive dealing, that third type, how does the exclusive dealing increase the dealer's incentive to promote? And remember, we are operating in
the context, you know, why did the Dentsply Court reject this as making absolutely no economic sense? And that is because there is all this competition between dealers, and that is all that is necessary to get the services provided unless there is a Sylvania type problem, and the example that we go through in the paper is this.

Consider this case where a customer is thinking about buying a car and is leaning towards the purchase of a Honda, and he goes into a Toyota dealership to check out the Toyota, but really, you know, it is -- but just to make sure, let me just check out the Toyota. So, that is the hypothetical example.

Then I have this -- look at that. So -- and under that -- there is a Honda and there is a Toyota, and Mdh is the profit margin that the dealer earns if it sells a Honda, and Mdt is the profit margin for the dealer if it sells a Toyota, and the Toyota dealer is deciding, what about this, even though they are leaning towards the Honda?

Well, a nonexclusive dealer will not make its best efforts to sell the Toyota if it has both cars there, and basically -- now, do not get scared -- but the dealer is going to choose a level of Toyota promotional service as $S$ that maximizes its
profitability. So, it chooses $S$, that maximizes the profitability, which is the difference between the margin on the Toyota minus the margin on the Honda, times the probability that they will make the Toyota sale if he starts telling them how great the Toyota is, whether they will buy the Toyota, and that probability, $p(S)$ is a positive function of how much $S$ the person chooses, minus the cost of supplying $S$, and obviously there is a positive marginal cost. The more $S$, the higher those costs.

And since it costs the dealer less to sell the Honda in this nonexclusive context, the dealer can earn a higher net profit margin on selling the Honda, the dealer goes to the one where the marginal cost of providing additional services is equal to the probability -- increased probability, as you supply -- of making the Toyota sale as you're supplying more services, times the difference in the margin between the Toyota and the Honda, and you can assume that they could sell the Honda -- the customer comes in and sells -- and wants to buy the Honda, and the salesperson can at a zero cost sell the Honda and say, you know, you are right, Honda is much better. Come here, I will get you a good price.

So, under these circumstances -- for example, if
the dealer's margin on the two cars were the same, so
that Mdt and Mdh were the same number, that difference
would be zero, and clearly the dealer would supply
absolutely no services in trying to sell the Toyota. It
would be cheaper for the dealer to just write up the
sale for the Honda. But by selling the Honda rather
than promoting the Toyota, the dealer is free riding.
He is engaging in that third type of free riding that we
were talking about. The dealer is not switching. The
dealer is not actively promoting the rival Honda brand
as an alternative to Toyota, you know, for customers who
come in and want Toyota, as occurs in free riding one
and two. Instead, the dealer is violating the implicit
dealer contract for the Toyota by failing to actively
promote the Toyota automobiles.

Alternatively, if it was an exclusive, you know
that undivided loyalty is going to lead dealers to
expand their promotional efforts, and it is just going
to go to the point where the marginal costs of
additional efforts in pushing the Toyota is exactly
equal to how much it can make on the Toyota, times the
increased probability that the promotion makes it more
likely that they will make the sale. So, undivided
loyalty is clearly in that case going to lead to that,
and that is what you sometimes see courts saying, you
know, that if you do not make the -- you know, what happens if you are an exclusive Toyota, basically it means if you do not sell the Toyota, you do not make any sale, and so it is common sense -- and, you know, this is the business people who understand this -- it is common sense that undivided loyalty is going to give you an incentive to promote more, and in the paper, it is a function of -- you still do not get to the point where the dealer has the right incentive in terms of maximizing the total profit of the manufacturer and dealer together. That is the last thing on the left-hand side. So, they still have to have these -- the manufacturer still has to have these implicit self-enforced contracting and -- to go all the way to the end, but basically the role of exclusive dealing is that it aligns the incentives that are here.

So, I am done. The lessons, other than that I put too much down here, okay? Lesson one, the Court's rejection of Dentsply's procompetitive rationale is an example of a common error that I think occurs in cases of trying to fit the facts of a case into a preconceived economic model rather than developing a model to fit the facts of the case, and the preconceived theory, economic theory here, that the Court adopted was basically, you know, interdealer competition will lead dealers to
supply the type and quantity of promotional services,
unless you had that Sylvania type free riding problem,
and -- you know, because there are more likely to be
valid procompetitive justifications for exclusive
dealing, one of the implications I think is that this no
economic sense test is less likely to be a useful test
for antitrust liability, that there may be efficiency
justifications for exclusive -- people talk about the
Dentsply case as an easy case because there is nothing
on one side of the scale. There is obviously something
on one side of the scale is what I am trying to say, but
clearly, even though there is an efficiency
justification, you may have anticompetitive effects.

I think that the facts of that case, there were
significant anticompetitive effects, and Jonathan
Jacobson makes this point in his excellent latest
article in the Antitrust Law Journal. What he doesn't
do is he does not answer the Court's finding that there
was absolutely no economic basis for Dentsply's
undivided loyalty and free riding justification. So, in
that case, you would not get the wrong answer if you
used the no economic sense test, but the only reason you
do not get the wrong answer is because you do not really
understand the procompetitive justifications.

So, as I said in the beginning, I think the
greater danger is not that -- you know, the way some people are advocating this no economic sense test as a necessary condition for antitrust liability. I think the danger is that the courts are going to use a no economic sense test as a sufficient condition for antitrust liability when a large firm uses exclusive dealing, and it is not only that I am giving you that there are other valid procompetitive rationales, but I think as economists and as regulators we have to be more humble that just because we have not figured this out yet, there is lots of other procompetitive efficiency justifications, and we cannot assume that the purpose of a restraint is anticompetitive.

How much did I violate the contract by?

MR. O'BRIEN: Ten minutes.

(Applause.)

MR. O'BRIEN: Okay, we are going to break until about five past 3:00, okay?

(A brief recess was taken.)

MR. O'BRIEN: Okay, let's get started.

Okay, I would like to start out our sort of post-speech session here by asking folks if they would like to comment on the remarks of others on the panel, and I guess I will ask for a volunteer first rather than being systematic about it. We will find out who has the
most burning comments to make about what someone else
said.

Okay, Joe.

DR. FARRELL: Well, I have one question for a
fellow panelist, which is relatively specific, I think.

Ben, in your model, you didn't have time to
present all of it, but I would like to ask, have you
offline, as it were, closed the loop and shown actual
harm to buyer, or is it just that the buyer who was
leaning towards buying a Honda ended up buying a Honda
and, of course, the Honda -- Honda likes that, the
dealer apparently likes that, the customer seems to like
that, although the welfare economics of this promotion
stuff, of course, are a little subtle. Toyota, of
course, does not like it.

Where does this go and how does the whole thing
play out with and without exclusive dealing as opposed
to just Toyota would like S to be higher in the short
run?

DR. KLEIN: All we do in the paper is present
the procompetitive efficiency justification. We do not
do the other side of the scale in terms of is there any
anticompetitive effect. In some cases, there will and
in some cases there will not be an anticompetitive
effect, and, you know, and as I suggested in Dentsply,
even though there may have been a legitimate procompetitive rationale, forget undivided dealer loyalty in that case, that does not mean that arrangement was not, on net, anticompetitive and harmful to consumers ultimately by creating a barrier to entry to competitors.

But there are so many cases out there where we know -- I mean, the case I love is this Joyce Beverages case that I am certain Tad knows about, where you have -- you have RC Cola having their distributor only have one cola, the RC Cola, because they want undivided loyalty. Well, in that case, RC Cola has 5 percent of the cola market and a lot smaller share if you define the market more broadly to have all carbonated drinks. So, in that case, we clearly know there is no anticompetitive effect.

But basically there was this mystery in the literature, why are they really having an exclusive dealing arrangement there, because there does not seem to be any specific investments, and there does not seem to be this dealer switching, but what they want is when the salesman goes into the supermarket, that they are going to push RC Cola and not any other brand.

So, if you want to get the ultimate question, that would depend upon the particular case, and you
would have to examine that particular case.

DR. FARRELL: But you say you only do the procompetitive justification. What do you demand of it in order to call it a procompetitive justification, just that Toyota would like it?

DR. KLEIN: Well, look, I do not want to get caught up in a language thing about --

DR. FARRELL: Okay, sorry, no.

DR. KLEIN: -- you know, we will do linguistic philosophy later. My feeling -- all I mean by it is that somebody doing what you would consider the right thing or the good thing or something and balancing it, I am just looking -- I am just presenting an economic foundation for this legitimate procompetitive justification.

I mean, the crazy thing is if you look in the marketing literature, people are talking about this all the time. It is just economists, you know, a little bit of economics can be a very dangerous thing, and it is only the economists that say competition should give you the services, everything is fine. So, if you talk to business people, marketing people, they all know that this makes -- and it makes a lot of common sense.

So, in some sense, as I said, Dentsply was unlucky enough to have the judge that knew economics,
and that is the only reason they got into problems in terms of the procompetitive justification, plus they were unfortunate enough to choose an expert that explicitly wrote in his article that the argument makes absolutely no sense. So, he could not present -- he did not -- Howard did not present the argument at trial, but the company did in terms of answers to interrogatories, and they said, what are you talking about? Your own expert says this makes no economic sense.

And then the other interesting thing about it, and this is the connection between anticompetitive and procompetitive justifications is strange, because the Justice Department -- and Gail would know this -- the Justice Department, in trying to demonstrate the anticompetitive effect, spent all this time in their findings of fact to show how important this dealer channel was to promoting the Dentsply products and how rivals would be at a competitive disadvantage because they did not have access to that channel.

So, you just look at all the findings of fact, and it not only demonstrates that there was a significant potential anticompetitive effect, but it also demonstrates that there is a significant procompetitive justification for motivating the dealers to do a good job. So, you have that tension, but
basically -- well, maybe I should not monopolize this thing.

MR. O'BRIEN: I mean, I have a follow-up for Ben on this point. I mean, in talking about Dentsply and just more generally your theory, there were two types of free riding beyond the traditional one that you cited. Dealers can free ride, effectively, on their own promotion on behalf of a manufacturer, right, which maybe they are doing in conjunction with the manufacturer or somehow they have arranged a contract to get that done, and the other one was that dealers may violate this implicit contract by just under-investing rather than free riding by steering customers to a rival.

I am wondering if you have any specific evidence that you can cite from the Dentsply case, if your knowledge of the cases is deep enough, that one of these two types of free riding that you identify in your paper was actually present.

DR. KLEIN: Well, I do not think -- well, I think the Marvel type free riding was not present, and he did try to present an argument, and I think the facts made it very difficult for him, and it is too bad that he is not on the panel, because he would disagree, so I think the first free riding did not exist, and I think
the second free riding did not exist basically because there was no switching to rival brands. I mean, I think there was one example where there was some disagreement about whether they tried to switch it to someone else. So, I do not think those other two were there, but in terms of the third one, all the evidence you need for that is that promotion is important for the manufacturer to make sales, and as I said, the Justice Department went to great lengths in terms of trying to demonstrate the anticompetitive effect to demonstrate the existence of that, so that is there, and then all you need in addition to that is that incremental sales are profitable for the manufacturer, and those two conditions were clearly met in Dentsply.

DR. CALKINS: The great thing about the Howard Marvel theory is that it is one that we lay people can understand, namely, that it is good for everybody for a manufacturer to run ads saying you can have your hearing improved by getting it tested and going to a dealer and getting this new improved kind of technology to use for your hearing aid, and that drives consumers to go to the dealership to try it out, and that is good for consumers because they are finding out information.

It is good for the overall industry because total sales of hearing aids will go up, because all
these consumers are being driven into the dealership and are getting their ears tested, and it is all sorts of wonderful stuff. And then, if, when the consumer gets there, there is the old bait and switch and they are sent off to buy the el cheapo discount brand, well, the bad consequence of that is there will be less of that advertising about the new, improved technology and, you know, science of hearing aids and such, which is something that is good for the whole industry, good for consumers, good for everybody, it will now be lost, because the manufacturer will not spend money on that.

So, you can easily tell a simple layperson story, if you let everybody get switched off, you will no longer have those ads being run, and I look forward to reading the article, but merely saying that -- I mean, if you then say that if you have exclusive dealing, it is good for RC Cola because they are going to make more money and have more sales, well, I can have a warm feeling about that just because they have got a 5 percent share, and God knows, if you are RC Cola, you are going up against people that you need all the help you can get to go up against them. So, we can see there.

You know, if you were to tell the RC Cola story where you had somebody that had an 80 percent share and
climbing, before I then sat back and said, boy, I am really concerned about maybe intervening and causing harm here, I would like to at least make sure I understood what is the equivalent of the lost nice advertising that is going to happen if you intervene in that type of situation.

DR. KLEIN: Well, Steve -- can I answer it, then? I mean, I agree with you on your main point, Steve, that, you know, with RC Cola, that we can be pretty much assured that inter-manufacturer cooperation or competition is going to pass on these benefits to consumers, but if you are talking about -- the analogy is really identical about lost advertising, because it is either lost advertising by the manufacturer or lost advertising by the dealers. It is just in some cases, it is efficient for the manufacturer to do the promotion, and in some cases, it is efficient for the dealer to do the promotion, and if you do not have the exclusive in one case, you do not get the manufacturer advertising, and in this case, you do not get the dealer pushing the product, and if you think that there is a benefit from lost advertising, then it is totally analogous in the two cases.

You know, if you start to do a calculation -- and you -- even in the standard case with the
manufacturer, you know, when the consumers are switched
to the discount brand, they almost always pay a lower
price. It is not -- you know, they are not being
deceived, that they think they are getting the higher --

DR. CALKINS: I understand. I think my problem,
and I will confess, I was sitting here with my back to
the screen, but I understood the Marvel advertising of
hearing, you know, development is a good thing. When
you hold out as your public good having a used car
salesman sit there and harass you into switching from
this model to that model, and I being a kid from
Detroit, noticing that you are using entirely Japanese
brand models, I...

MR. O'BRIEN: At the risk of allowing Ben more
monopolization time here, I just want to push it just a
little bit further on the Dentsply, and if others do not
have a question right off the bat here, and you said
that this third type of free riding, which is that you
would under-invest as a retailer --

DR. KLEIN: Right.

MR. O'BRIEN: -- you think was present, but the
evidence that you cited for that was that investment was
important, and that does not seem to demonstrate to me
that they actually would have necessarily under-invested
but for the exclusive dealing arrangement. You know,
was there another way for them to ensure that investment? I mean, it seems to be a bit of a leap to me.

DR. KLEIN: Well, that's --

MR. O'BRIEN: You know, and that sort of statement strikes me as, you know, it might not be hard to argue that that efficiency is there in almost every case.

DR. KLEIN: No, that is a problem that you have with these cases. That is why I said you cannot adopt --

MR. O'BRIEN: A no economic sense test?

DR. KLEIN: Yes, you know, because I think the efficiency is -- I would not say universally present, but it is a motivation. I forgot what your other question was, but, you know, it is important -- if it is important to the manufacturer, we just know from the economics that if there is an exclusive, the incentives are going to be aligned, and if they do not make the sale of that product, they are going to not make any profit. So, you do know that they are going to push it more.

So, I mean, it just follows logically, but you would need to see what they adopted -- oh, yeah, so you -- there may be a less restrictive way, and then we
can talk about a less restrictive standard here if that is the question you want to move to, but in cases where it looks like the practice might have also some foreclosure problems and anticompetitive effects -- I hope I am using the right language -- you may impose this burden on the manufacturer to come up with a less restrictive way of doing it, and, you know, maybe they chose this not just because of the efficiency effects but also because of the -- it increased their market power, so...

MR. O'BRIEN: Okay.

DR. KLEIN: I mean, it makes it very, very difficult in terms of this balancing. The important point is, you know, you are not going to have these easy cases anymore where there is nothing on -- I mean, you will still have easy cases where you do not have the anticompetitive effect on one side of the scale, but you are not going to have these cases, I think, if you accept this where there is nothing on the other side.

MR. O'BRIEN: Okay. Do any other panelists have any questions for any of the other panelists?

(No response.)

MR. O'BRIEN: If not, we have a series of propositions we would like to walk through to see where we might be able to reach consensus, where we have open
issues, and hopefully this will spawn some additional
collection about both what was said during the session
and perhaps some new things.

So, let me start with -- where is our -- oh, you
have got it, okay. Let's go to the first proposition.
Okay, I am going to read it, because we need to read it
for the transcript here.

Exclusive-dealing arrangements are analyzed
under the rule of reason.

First, does everybody agree -- and this is
really more for the lawyers -- that that is the way the
analysis of exclusive dealing goes today?

DR. CALKINS: Yeah. I mean, that -- yes -- yes,
I'll agree to say that, and B, for a whole lot of the
cases, it is consistent with the general idea that under
the rule of reason, the defendant always wins.

MR. O'BRIEN: Okay. So, nobody disagrees with
that point. Well, perhaps the point that was just made,
but nobody disagrees with the proposition, correct?

Does anybody think that there are exclusivity
arrangements that should be per se illegal?

(No response.)

MR. O'BRIEN: No, I guess that is the answer.

DR. KLEIN: Move on.

MR. O'BRIEN: No.
Does anybody think there are exclusivity arrangements that are always or nearly always procompetitive and thus good candidates for a safe harbor?

DR. CALKINS: Well, presumably a very small exclusive would be -- would fit anybody's idea of a safe harbor.

MR. O'BRIEN: And when you say "small exclusive," you mean a small percentage of the market or --

DR. CALKINS: Yeah, it is very -- it is hard to imagine a court or an enforcer being concerned about an exclusive below -- choose your figures. Some might choose 20 percent, some might choose 30 percent, some might choose 40 percent, but I think everybody would agree that below some percent, no agency should worry about it, and no court should find illegality unless, you know, you have some reason to think that that number is just, you know, totally misleading and the real number will be totally different in six months when the contracts kick in or something.

MR. O'BRIEN: Okay, fair enough.

Anybody else? That one was --

DR. KLEIN: I would like to -- I would like to ask Steve a question on this one. You know, your
opinion about the foreclosure standard somehow being lower when it comes to Section 2 rather than Section 1, I mean, if somebody is a monopolist or is likely to be a monopolist, I could see that it is more likely that they are going to meet the critical share number, but why should that critical number, whether you say it is 40 or whatever, why should somehow it be lower? It sounded like that is what you said from your presentation, should be a tougher standard.

DR. CALKINS: If I did, I misspoke slightly. What I meant to say is that -- well, specifically, is that in the Microsoft case, the defendants argued that because this practice is lawful under Section 1, it must, as a necessity, be lawful under Section 2, and I was just saying that I do not think that is correct, that, you know, take your extreme of a dominant firm that everybody would agree is a monopolist on the one hand, and on the other hand, your RC Cola kind of a thing. I am not saying whether or not, you know, exactly where one would say there is a difference, but I would think that one should be much more likely to be concerned about something being done by a dominant firm that is --

DR. KLEIN: Right, obviously, but why should there be a different standard under Section 2 than under
Section 1? I mean, I think we are in trouble here basically because Justice did not appeal the Section 1 no liability in Microsoft and Dentsply, and if you read the Court, you know that the appeals court would have overturned both of those things, but -- you know, and then I think we would be in a lot better shape, but the idea that somehow we should have a different standard and principle when you are doing the first step of a Section 2 -- I agree, if somebody is a dominant firm, they are much more likely to have anticompetitive foreclosure under Section 1 and under Section 2, but why should there be a lower hurdle showing the anticompetitive effect under Section 2?

DR. CALKINS: Well, part of this goes -- I mean, in all of this, it is trying to make a judgment about how likely a particular practice is to be harmful to competition, and I was just saying that -- well, specifically, is that there are a whole series of sort of ways that firms with fairly modest market shares have been able to persuade courts to get rid of exclusive dealing cases, but where you have a dominant firm, I am not saying that there is a magic difference. I am just saying that, as you recognized, you would think longer and harder about something being done by a dominant firm that is a clear monopoly than by some firm that is a
trivial firm, and so just because you are told that
something would be lawful under -- you find some Section
1 case out there where some foreclosure level was a
motion for summary judgment for a defendant, that does
not mean that in every case with the most extreme
monopolist you would grant summary judgment without
thinking long and hard about it.

MR. O'BRIEN: Okay, let's move on to the next
proposition.

Okay, I think this one will be easy, too. The
proposition is from Posner's Antitrust Law.

I propose the following standard for judging
practices claimed to be exclusionary: "In every case in
which such a practice is alleged, the plaintiff must
prove first that the defendant has monopoly power. All
the plausible cases of exclusionary practices involve
defendants that have monopoly power."

First, does everybody agree with that?

MR. LIPSKY: Uh-oh.

MR. O'BRIEN: Can exclusive dealing involving a
non-monopolist result in a substantial lessening of
competition?

DR. KLEIN: Yes.

DR. FARRELL: All statements containing the word
"all" are false except for this one and perhaps a
handful of others. I think there is a real problem with a subtle, complex and imperfectly understood topic having courts, judges, make grand and sweeping pronouncements. The law, as I understand it, in a precedent-based system tries hard not to change over time, and our understanding tends to change over time, and that creates a lot of trouble. So, it is not like I am out here saying, oh, and the following large category of cases, firms without monopoly power or without market power or something, can do a lot of harm with exclusive dealing. There have been some theories developed under which that can happen.

I think the consensus currently is that that is not such a big worry, but we do not really know yet, and freezing stuff in place by grand pronouncements that say "all," I am not sure it is such a great idea.

DR. CALKINS: The larger consequence, if that is the law, is that any time a -- well, any time a plaintiff has failed to hire one of these fancy economists and satisfactorily define a market in which the defendant has a well-defined market share of more than 75 or 80 percent, there is a very good chance that a Court would grant a motion for summary judgment or a motion to dismiss, because when you have rules like that, lots of courts operationalize it by saying, okay,
any market share below 70 percent, I grant a motion for
summary judgment and do not explore anything else about
what is going on, and that in my judgment is too
sweeping a broom to use. That was a bad way to phrase
that, wasn't it?

MR. O'BRIEN: Okay, Tad?

MR. LIPSKY: I think I can agree with the last
sentence there, that all the plausible cases -- I am a
little confused, though, whether this statement in
context, was it limited to exclusive dealing or is it
meant to be applied more broadly to other types of
exclusionary practices? I guess that there -- you know,
I am trying to recall. Wasn't there a -- there were
some Commission consent decrees in cases involving water
pumps for fire trucks. It was a multiple defendant
situation where there was actually a fairly plausible
theory of cartelizing, and I do not think you could have
found, at least not with any logical consistency, that
both of the competitors were monopolists.

So, I guess that is a limiting case, but I would
be closer to agreeing with this if you were talking
about cases other than those in which a cartelizing
theory for challenging the exclusive dealing was the
theory of liability.

Am I right about this FTC decree? Does anybody
remember that?

DR. CALKINS: There was a pump case. There was -- there was a case like that.

MR. LIPSKY: Okay, so it is actually -- it is probably real, presumptively real.

MR. VITA: It is called Waters Hale (ph).

MR. LIPSKY: Excellent, okay, thank you.

DR. KLEIN: If Posner had restated it in terms of market power instead of monopoly power --

MR. LIPSKY: That would be fine.

DR. KLEIN: -- I assume we could all agree, right?

MR. LIPSKY: Yes, that would be fine.

MR. O'BRIEN: So, this statement is about monopoly power or market power on the part of the defendant. I am wondering if any of you think that conditions relating to market power or market structure in the downstream market have an effect on the extent to which exclusive dealing can be anticompetitive. That was not stated well, but what should we make of the downstream market structure in terms of the likelihood that exclusive dealing can have an anticompetitive effect?

DR. FARRELL: Well, I mean, I talked briefly earlier about the developing economics of understanding
the role of downstream competition in that and, you
know, fairly plausible seeming analyses have come out
with very different answers so far, so watch this space,
and that perhaps should be a pretty strong warning
against making strong statements at this point.

MR. O'BRIEN: Would you be willing to say that
some kind of barrier to entry in the downstream market
is necessary for anticompetitive exclusive dealing?

DR. FARRELL: Well, I think -- see, you are
talking about a lot of abstract nouns here, and I am
sorry, I cannot put on a southern U.S. accent, but I
would like to.

DR. WERTHER: Can you do any U.S. accent?

MR. LIPSKY: I thought that was a Berkeley
accent.

DR. CALKINS: You have got such a lovely accent.

DR. FARRELL: I think Strunked White might have
said if you are getting confused, try to decrease the
abstract nouns and increase the active verbs, and I
think that is a pretty good proscription for thinking
straight. So, let's try that.

Instead of talking about market power and market
share and dominance and exclusive dealing and so on,
let's ask the following question: If I come up with a
better way of doing things than the incumbent is doing
or I am less greedy than the incumbent and I am willing
to give consumers a better deal, am I stymied in my
attempt to do so by these deals that people have struck?
That is the core question, and a lot of the time, the
answer will be no, I am not stymied if there are small
shares of this or that. Sometimes I will be.

So, for example, if you look at the Microsoft
case, Microsoft had no need to completely keep NetScape
out and wasn't trying to keep NetScape out and charge a
lot of money for Internet Explorer. They just had to
make sure that NetScape did not become sufficiently
widely distributed that people would start writing to it
and say, yeah, I -- that is a rather different case from
the one we would generically think of. You have to be
careful and I think should be pretty reluctant to kind
of lay down these firm rules.

Now, having said that, I also am very aware
that, you know, attempts to do full-blown rule of reason
analysis are also dangerous, right, given the subtlety
of what is going on and given the capabilities and
noncapabilities of courts.

I am a big fan in theory of -- I have never been
up close when it has happened -- of court-appointed
experts. I think that could probably improve the
process a lot quite generally, but especially when you
are dealing with subtle and difficult issues.

DR. CALKINS: Clearly everybody would say that it matters how easy our new entrant can gain access to the customers to whom it is trying to sell, and if it is very easy to do that, then exclusive dealing will not present any problems. As you phrased the question, you used the magic word "entry barriers," and as you know, that has lots of different definitions, and choose your right definition and defendants will almost always prevail; choose different definitions, and they might not.

It also raises the question as to whether you are looking at a total exclusion standard or at simply making it much more expensive, time-consuming and risky in order to gain access, and so you have staked out a position or the quote here has staked out a position which might mean things that I would not be comfortable with.

MR. O'BRIEN: Right. So, just one follow-up to that, I guess this is directed to Joe, the Fumagalli and Moto models and the Simpson and Wickelgren model, in the simplest cases, you have homogeneous producers downstream with no economies of scale or very small economies of scale, and it strikes me in the context of those models that it would be very easy for a firm to
enter at both levels and disentangle any anticompetitive effect that is being contemplated. I am wondering if you have thought about that, or maybe I am wrong.

DR. FARRELL: You know, it has been a while since I read the models, so I do not remember technically whether what you say is right. Clearly if you really have homogeneous products and fixed costs and sunk costs are very small, then you would think -- and you would want to know why not if somebody was claiming not -- that a firm could enter at both levels.

On the other hand, there certainly are industries where at any given time the industry may behave quite competitively involving the pass-through dynamics that we were talking about, and yet there are big sunk costs lying behind it, and that may be the more relevant case for that kind of analysis.

MR. O'BRIEN: Anyone else? Okay, next slide.

Okay, I think this is an uncontroversial slide as well. We will see. Maybe the questions will be more interesting.

"Exclusive-dealing arrangements --" this is a quote from Jefferson Parish. "Exclusive-dealing arrangements 'may be substantially procompetitive by ensuring stable markets and encouraging long-term mutually advantageous business relationships.'"
Yes, Joe?

DR. FARRELL: I hate to be a curmudgeon, but stable markets are not exactly what antitrust aims for. Actually, maybe we should try to encourage unstable markets where the status quo could be disrupted at any moment by some pesky firm that maybe has not shown up before, or maybe has, and is willing to take a lower margin or has a better way of doing things.

Now, I am not saying that the basic point here, that exclusive dealing arrangements "may be good" is wrong, but I do not like that language.

MR. O'BRIEN: Okay. Well, you pick the --

DR. CALKINS: And while you are complaining, you could complain about the mutually advantageous business relationship, because that could be good for consumers, and if it is just dividing up a surplus between two businesses, it could be bad for consumers.

DR. KLEIN: Yeah, I --

MR. O'BRIEN: Ben Klein, do you have a view on that?

DR. KLEIN: Well, who knows what Justice O'Connor is referring to, but if she means by encouraging long-term mutually advantageous business that it encourages people to make specific investments in the relationship, relationship-specific investments,
then I think she is correct and that she should not go through it now, but that is one of the problems I had with Joe's presentation, is that the Segal and Whinston criticism of that rationale for exclusive dealing is just wrong, and it is logically correct, but there is assumptions being made in that that are very, very unrealistic, and in particular, they are just -- well, I better not go into it.

But, you know, so if that is what she is saying, I would agree with her very much, but it is so vague, right, but if she is just saying there is -- it sometimes may be good...

MR. O'BRIEN: What efficiencies, which I assume are the second object of this sentence, there are numerous efficiencies that have been discussed about exclusive dealing that we might classify into that second phrase. What are the most significant and most likely in an exclusive dealing arrangement?

And similarly, what efficiencies have been asserted most often do you think are least likely to actually exist?

DR. CALKINS: Oh, the best is the classic Marvel free riding, manufacturers spending money, bringing in the customer, then there's the old bait and switch to the other product. That would be the classic and the
MR. O'BRIEN: So, what efficiencies are often asserted in exclusive dealing cases that you think may not actually exist very often? Anybody?

DR. KLEIN: I hope nobody says this focused dealer effort, but I guess one of the things I should say is the justification that Microsoft offered, the procompetitive justification for the exclusive dealing arrangement with the Internet access providers, sounded like a focus -- the way you presented it, it sounded like a focused dealer incentive, but what they wanted was -- the argument they presented was something to the effect that they wanted the developers to focus on the Windows APIs, which meant they wanted to have a monopoly in Windows so that when developers were developing their programs, they would only develop Windows programs, which is a very different argument than, you know, you want -- they did not want the Internet access providers to promote their product. That is not what they were doing.

They were talking about a different type of focus there, but that argument I think the Court correctly rejected as making no sense other than you want a monopoly. You want to maintain your monopoly.

MR. O'BRIEN: What significance, if any, should
be given to observing an exclusive dealing arrangement in a similar competitive market when you are analyzing a case where there is exclusive dealing, maybe in a market that exhibits some more market power in some ways than the other, but otherwise has similarities?

DR. FARRELL: Well, at a technical level, there certainly have been analyses that show that in some circumstances, exclusive dealing engaged in by, let's say, all members of an oligopolistic manufacturing sector, whether downstream industry, can soften competition and be in that sense anticompetitive, even conditional on, you know, a flourishing oligopoly structure, and let's face facts, we are never dealing with perfectly competitive industries when we are talking about these cases, so oligopoly is what you mean by the word "competitive" here.

There are other analyses that suggest that exclusive dealing can actually sharpen competition. I think it is fair to say that that literature is both unsettled and in a state of nonferment, the nonferment because nobody seems very excited about it. People are really more interested in the monopoly-preserving possibilities I think than the oligopoly-softening possibilities, and that may be a legitimate choice of emphasis, where to put our intellectual resources, or it
may just be, you know, what happens to be fun for assistant professors to do these days.

DR. KLEIN: I think we have to be very careful when we start talking about oligopoly-softening, and I guess Joe would say I have this bias, this laissez-faire bias, but I can imagine unilateral behavior -- you know, a gasoline company decides they are going to locate their station not next to another station but a couple of blocks away, because if they locate it next to the station, it is going to be more intensive competition. People are going to be able to compare the prices.

We do not want to go in and micro-regulate the competitive process. You know, you hire an economist, and let's assume they draw the welfare triangles, and they say consumers are better off if that person puts the station next to the other station, and even though it has -- let's assume it has the effect of sharpening competition if we do that, we do not want to regulate that behavior, at least I do not want to, even though the calculation would come out that way.

So, I think it is dangerous to start talking about oligopoly-softening of competition in general, and basically I guess I have a prior that we are just going to mess things up and we should just leave it up to the competitive process, unless there is a -- you know, you
have this first step where you need some major
anticompetitive effect in terms of foreclosure.

So, I guess my comment was not totally
irrelevant, because we are talking about Section 2
unilateral behavior, even though it has nothing to do
with exclusive dealing.

DR. CALKINS: Trying to psycho-analyze your
question, I think you were -- I am guessing that you
were referring to the argument you sometimes see made
that, look, over here in this market, which we all
stipulate is competitive, this practice is occurring,
and so, therefore, it must follow as the night follows
the day that when that same practice is being engaged in
by this complete and total monopolist, it deserves
summary judgment very promptly on that ground alone,
and --

MR. O'BRIEN: That is a good psycho-analysis.
Yes, that is what I was hoping somebody would address.

DR. CALKINS: And I myself do not buy into that
theory in the little that I have done thinking about it,
but my thinking is still at a preliminary stage.

MR. VITA: Well, it is not so much -- maybe,
Dan, a competitive market versus a noncompetitive
market, but the individual -- the size of the firm or
the mark -- the firm's specific market power. Like the
RC Cola example somebody alluded to before, RC has some exclusive relationship with its bottlers or something, I think it was, and you look at RC Cola, and they are a small fry. I mean, they do not matter anywhere. So, you look at that and you say, well, obviously they are doing that. They cannot possibly have any kind of foreclosure mode or some monopolization motive. It has to be some sort of value creation that induces them to do that.

Is it fair to say that when you do -- then you look at Coke, for example, maybe doing the same kind of thing, some other firm with substantial market share or market power possibly? At least it says you have got to consider the efficiency story. You can't rule it out. There is a possibility that there is value creation, that there is something inefficient about it, but not necessarily -- the fact that RC does it doesn't vindicate Coke's usage, that debate is not over, but that does say to you -- you know, we have got to take that seriously.

DR. FARRELL: Yeah, I think you said it right, you know, unless there is something about that industry or market that I do not know, you can presumably infer from RC's use of these exclusives that there is something other than monopoly preservation going on, but
that does not mean that there is not monopoly preservation going on.

DR. KLEIN: Exactly.

DR. FARRELL: It does not mean there is either.

MR. LIPSKY: Thanks.

MR. O'BRIEN: Okay, next slide.

Okay, so anticompetitive effects, this is a -- this is actually a quote from Dennis Carlton's paper on the Aspen and Kodak case.

"In the presence of scale economies, exclusive dealing can be a way of depriving Firm 2 (or its distributors) of the necessary scale to achieve efficiencies, even though, absent the exclusivity, Firm 1 and Firm 2 would both be large enough to achieve efficiency."

So, this is the standard scale economy argument about excluding your rivals so that it cannot reach efficient scale, and I guess my question is, does the panel see that as the primary anticompetitive theory of exclusive dealing that we ought to be focused on?

MR. LIPSKY: Well, I will take a stab at that. Certainly, you know, in a static sense, it is hard to argue with this proposition, and I think this is consistent with the notion that there are stories associated with exclusive dealing where you are trying
to compel two-stage entry basically, and I think some of those are good stories. Probably we would not agree on which ones were good stories.

I heard John Jacobson the other day talking about Pullman, and I disagreed with him on that one, and then Motion Picture, and I disagreed with him on that one, but it does not -- and also United Shoe Machinery, and I disagree with him on that one, but I think we could find -- I think we could find a two-stage entry story that held together, and so I would say I agree with this.

But I would also interject -- and I have said in other contexts -- there is kind of an endemic temptation or tendency in the system, in the investigation and the litigation system, to underestimate supply flexibility. I mean, you know, supply flexibility is not -- or new entry is not always an answer, and so I would hate for my remarks to be misconstrued. There are industries in which the barriers to entry are such that if you have a two-stage story, it is a serious problem, but I think there is a tendency to look at what is right in front of you, to, you know, fail to predict the rise of the Internet or the mobile phone, you know, falling in price by 75 percent over five years or, you know, some other alarming and unpredicted new technology or new
development, and because the dynamic aspect is so
important, I think this is a theme that needs to be
hammered again and again.

So, what I guess I am saying, yes, I agree with
this, but it is narrow -- I would like to make my
agreement as narrow as humanly possible.

MR. O'BRIEN: Anybody else?

DR. KLEIN: Tad, you sounded like an expert
witness there.

DR. CALKINS: I was hoping that Tad could tell
me how to get a mobile phone bill that is 75 percent
lower.

MR. O'BRIEN: So, Joe, based on your remarks, I
guess I would ask, do you think this is the primary
story of competitive harm that we should be focused on
in analyzing exclusive dealing, or should some of the
other theories that you mentioned, I guess in particular
Simpson/Wickelgren, maybe some of these two-stage models
of oligopoly where exclusive dealing can play a role,
are those things we should be concerned about, or is
this number one and number two?

DR. FARRELL: Well, I disagree with the
question. I think the primary focus should be based on
what is going on in the market at hand, and we should
adjust the tools to fit the facts and not prejudge what
the theory is going to be.

Having said that, I think I said in my earlier remarks that I believe this Rasmussen, Ramseyer and Wiley or Segal/Whinston theory, which is being referred to here, is the one that people talk about most. I tend to suspect that it is the main one. I would add -- I mean, you have to interpret efficiencies carefully, so, for example, scale to fully reward innovation, is that achieving efficiencies?

But broadly speaking, I think this is what most economists think of most of the time when they think about anticompetitive exclusive dealing, and I think that may well be right, but I think we should be open to whatever the facts of a particular case say.

MR. O'BRIEN: All right. Anybody else?

(No response.)

MR. O'BRIEN: Let's go to 7.

Okay, this is from the Microsoft case, and the quotation is:

"If the monopolist's procompetitive justification stands unrebutted, then the plaintiff must demonstrate that the anticompetitive harm of the conduct outweighs the procompetitive benefit."

I guess my question is -- well, first, does that make sense to you, and secondly -- this is maybe more
for the economists, although equally for the lawyers --
does economics supply tools to do this?

    DR. KLEIN:  Try Joe.

    DR. FARRELL:  Well, let's see.  I mean, clearly
in order to plunge into enforcement, we would not want
to go ahead if the anticompetitive harm of the conduct
is outweighed by the procompetitive benefit.  Using the
term "procompetitive benefit" in -- I am not sure
whether it is the same way or not as Ben uses it, but I
am using it to mean actual benefits to efficiency and
consumers, not just kind of non-anticompetitive
rationales.

    This, of course, is part of a bigger decision
tree that the Microsoft Court laid out.  In thinking
through a burden-shifting process like that, you have to
think about a number of things, and I do not know how
much the Court thought through these things.  I am
pretty sure I know how much they knew the necessary data
required to do it exactly right, which is not a
criticism, because nobody has that data either.

    You have to think both about whether in most
cases this is true or that is true, but also about if
this is true, is it going to be easy to prove, or is it
quite likely to be true but be hard to prove?  And that
really gets back to what I hope was the main theme that
came out of my talk earlier, that in my opinion, there are often benefits of open, free-wheeling competition that are very difficult to pin down and almost impossible to prove, and I think that needs to be kept in mind when we lay down these decision trees.

Did the Microsoft Court keep that in mind? To some extent. Did it do it the right amount? I have no idea, and I doubt that they really know either.

DR. CALKINS: If the question is should one think about the competitive harm that is likely, should one think about the procompetitive benefit, the answer to that is entirely yes.

On the other hand, can you read this statement to say that if there is any tiny procompetitive benefit, perhaps using anybody's definition of "procompetitive," does that mean that the defendant always wins unless the plaintiff is able, with great specificity, to precisely quantify the anticompetitive harm, precisely quantify the anticompetitive benefit, and then precisely calculate that one is more than the other?

Well, it may well be that if that is what one means, then what one is saying is that any time there is any benefit that can be characterized as procompetitive, the defendant will always win, and so if that is where you ended up, that might not be a good place, but that
does not mean that you should not think about the procompetitive benefit.

DR. KLEIN: Go ahead, Tad.

MR. LIPSKY: No, go ahead.

DR. KLEIN: No --

MR. O'BRIEN: Go ahead, Tad.

MR. LIPSKY: Well, I was just going to say that we always have to consider the fact, you know, there was a day not so long ago when you could expect a follow-on litigation from cartel cases that were litigated and won by the Department of Justice. You would get a guilty plea in a price-fixing case, and then we transitioned -- I am not sure exactly what the history is or how we got here, but then we got to the point where there was a story in a newspaper saying that there was a price-fixing investigation, boom, 80 private class action -- purported class action treble damage suits against everybody in the industry, and then we got to the state where there -- you get the same thing even in these conduct type cases, which are not cartel cases, and there are follow-on class actions for Dentsply, and there were follow-on class actions for this, that and the other outside of the price-fixing area, and that combined with, you know, indirect purchaser statutes and all kinds of things that happen in antitrust litigation
generally I think creates the fear that there are some
legitimate procompetitive practices that the perpetrator
cannot afford a defense, and I think that is a very
troublesome phenomenon.

I guess the thought is provoked by Joe's comment
that there are -- you know, there is sort of a -- maybe
we should indulge a presumption that when things are
loosened up a little, and there are fewer strong ties,
you know, partial vertical relationships, maybe that is
the way we want markets to function, but I think the
system in general works pretty well if we require -- you
know, we always have the ultimate burden of proof on the
plaintiff, so that if the defendant can come up with a
sensible justification, a justification that can be
persuasive with the fact-finder, then yes, the right
standard is, if the defendant has something good to say
for his practice, let's adopt a rule that the plaintiff
does not win unless the plaintiff persuades that the
negative effect on competition outweighs the
procompetitive effect.

And true enough, part of what I was saying
earlier is, yes, it is the wiles of economic theory. It
is the unadministerable, you know, battle between the
economic experts and all the other facts in the case,
but what is the alternative? The alternative is
Standard Stations, or worse, and we know that is wrong, so that is why I would like -- I keep trying to bring into the conversation this institutional element.

Let's not -- once we decide it is a balance, let's not just throw confetti in the air. Let's try to focus on what the applied micro tells us about what rationales deserve to be explored and what facts could rule various theories of efficiency or theories of restraint in or out. Let's organize that process so we do not just have a U.S. versus IBM every time there is, you know, a 13-year slog or a 14-year slog like Harmar versus Coca-Cola every time we have a difficult exclusive dealing issue.

DR. CALKINS: I really misunderstood you, Tad. I thought when you said you wanted to go to the 18-month model, you wanted to go back to the days of Standard Stations, and I just --

DR. KLEIN: Per se. But to answer your question about whether we have the tools to do this, I guess economists have the tools -- I was on a panel with Steve Salop where I said I -- even if I were the judge, I wouldn't know exactly how to do it, and he said, you know, that is all economists know how to do, you know, want to take away your doctorate or something, but when you -- obviously you have to go to balancing.
I mean, I am pretty cynical about this, because I do not know -- I do not think the courts have done this, and I do not know what to tell them to do. I mean, I think they go backwards, and they figure out -- you know, they do some kind of implicit balancing, and then they say -- they make it easy and they say it was not an anticompetitive effect or there is no procompetitive efficiency rationale, and I do not know what exactly we should have them do, other than we know we want them to hire more economists, right?

But it is a -- I think that is the ultimate question, because you do have to do the balancing, and I do -- I mean, it is a legal question, but I do think the burden should be placed on the plaintiff at that point, because I have this prior bias about the competitive process. So, I agree with the legal rule, but then what exactly are you doing -- and it should -- it should not be a close thing, because that is my -- and I think that is the way the law is or it should be, that it should not be a very close thing that we are balancing, and it should not be something -- you know, there should be this first step that you have to show a very clear anticompetitive effect before you go forward in any way, and that is going to get rid of most of the cases.

Steve will say that is why the defendants win
all the time, but they do not always win, because you
have the Dentsplies and you have the Microsoft, and I
think that is enough to get efficiency in the economy.

DR. FARRELL: There is this article by Priest
and Klein -- I do not know if that is you --

DR. KLEIN: Yes, that is me.

DR. FARRELL: -- saying that whatever the rules
are, the litigated cases are going to be close ones.
So, I do not think we can have a rule that litigated
cases are not allowed to be close.

MR. O'BRIEN: Okay, well, we have run past our
time, and I think it is Ben's fault, by about four
minutes. So, thank you very much everybody.

(Applause.)

(Whereupon, at 4:04 p.m., the hearing was
concluded.)
CERTIFICATION OF REPORTER

DOCKET/FILE NUMBER: P062106
CASE TITLE: SECTION 2 HEARING
DATE: NOVEMBER 15, 2006

I HEREBY CERTIFY that the transcript contained herein is a full and accurate transcript of the notes taken by me at the hearing on the above cause before the FEDERAL TRADE COMMISSION to the best of my knowledge and belief.

DATED: 12/4/2006

SUSANNE BERGLING, RMR-CLR

CERTIFICATION OF PROOFREADER

I HEREBY CERTIFY that I proofread the transcript for accuracy in spelling, hyphenation, punctuation and format.

DIANE QUADE