

# **Tying, Foreclosure and Section 2 of the Sherman Act**

Lecture Two: Alternative Standards

Daniel R. Vincent\*  
Department of Economics  
University of Maryland  
College Park, MD 20742

## Part II: Alternative Standards

- As in the case of predatory pricing, evaluating and identifying potentially anti-competitive conduct under Section 2 is extremely difficult.
- ...antitrust laws ought not condemn price-cuts lest

a rule or precedent that authorizes a search for a particular type of undesirable pricing behavior may end up discouraging legitimate price competition. (Breyer, *Reiter v. Sonotone*, 1979)

- Rule of Reason v. Per se standards:
  - Certain categories of conduct are judged under a "per se" standard. That is to say, simply showing a conduct took place is sufficient to show a violation of an antitrust statute. The standard example of this is price-fixing (a violation of Sherman, Section 1)
  - (Per se rules are sometimes justified in a decision theoretic context by arguing that the risk of "false negatives" – allowing conduct even when it is anticompetitive – outweighs the risk of "false positives" – prohibiting conduct when it is in fact pro competitive.)
  - Other types of conduct are judged under a "Rule of Reason". Under this standard, various explanations for the actions are

considered, pro-competitive defenses allowed, and typically a successively finer screen is used to come to a decision.

- At times, the distinction is not exactly obvious. (See for example the standards under tying arrangements.
- Section 2 actions are all considered under a Rule of Reason standard, however, ...
- Although courts usually express the Rule of Reason as a specific step-wise test for assessing the legality of conduct, the Rule of Reason generally provides a principle for generating antitrust doctrines in a common-law fashion ... Section 2's Rule of Reason so understood, asks: For the type of conduct at issue, which Legal test is likely to maximize consumer welfare over the long run? (Popovsky, p.2)

● The standards discussed here are all formally Rule of Reason, three different approaches might be distinguished:

- "No Economic Sense Test"
  - Below-cost pricing (Bernheim, Areeda Turner, Ortho)
  - Protecting an equally efficient competitor (Posner)
  - The Profit Sacrifice Test or The No Economic Sense Test (Bork, Werden, Melamed)
- The Consumer Welfare Standard (Salop)
- A Successive Screen (Popovsky, Spector)

## The No Economic Sense Test

- These tests have been proposed in order of increasing stringency.
- The idea can likely be traced back to Robert Bork, *The Antitrust Paradox* " ..if a firm has been attempting to exclude rivals on some basis other than efficiency, it is fair to characterize its behavior as predatory." (Popovsky, p. 4-5)
- It is sometimes thought of as "a predation test for non-price predatory conduct." (Salop p. 3)
- Note that although the test has a strong element of motive at its core, its goal is both factual *and* intent driven.
- A virtue that is often attributed to it, is its opportunity to provide firms with a "safe harbor" . Firms can determine on the basis of their own information whether their own behavior is sheltered from antitrust investigation.

## The Below Cost Test

- This was the standard applied in Ortho.
- Developed from a rule of Ordoover as expert witness and the notion of "compensatory pricing".
- Bernheim applies a similar point in his brief in VAA v. BA.
- It is a direct extension of predatory pricing logic. As such, it only condemns pricing under *some* measure of direct costs. (marginal, average variable). (Not opportunity costs.)
- Presumably, under this standard, as long as a firm prices above cost, it is in a safe harbor.
- Problem is that limit pricing models indicate that anticompetitive exclusion could occur even with prices above costs. (Suppose a monopolist, threatened by an aggressive but less efficient rival, cuts its price to a "limit price".)

## Equally Efficient Competitor

- A variant of this test, is to query whether the conduct has the property of excluding an "equally efficient competitor". (Posner).

The question, therefore, is whether a firm that enjoys a monopoly on one or more of a group of complementary products, but which faces competition on others, can price all of its products above average variable cost and yet still drive an equally efficient competitor out of the market.(Ortho Opinion)

- This is more general than above because it covers non-price conduct as well.
- The rationale is that while we cannot identify every possible anticompetitive problem, a policy geared to protecting an equally efficient competitor has the property of ruling out egregious conduct and also allows a firm to rely on its own data to determine legality.
- As a general rule, the exclusionary effect of prices above a relevant measure of cost either reflects the lower cost structure of the alleged predator, and so represents competition on the merits, or is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price cutting. (Brooke Group)
- Problem is that it seems too lax. What about differentiated products where product variety is an important welfare source?

## Profit Sacrifice Test

- The next version of these types of tests is the profit sacrifice test which is the natural extension of predatory pricing logic.

in the vernacular of antitrust law, a predatory practice is one in which a firm sacrifices short-term profits in order to drive out of the market or otherwise discipline a competitor (Justice Ginsburg, *Covad v. Bell Atlantic* (2005))

- Really a version of Ordover-Willig's definition of predatory pricing.

Predatory pricing is a response to a rival that sacrifices part of the profit that could be earned under competitive circumstances, were the rival to remain viable, in order to induce exit and gain consequent monopoly profit. (quoted in Werden p. 11)

- Consider the example offered by Salop:

Suppose the monopoly price is \$100 and at some point a new competitor enters the market. The monopolist cuts price. That action on its own cannot be anticompetitive, since we expect entry to lead to price cuts. However, how do we distinguish *too low* a price cut? Here is the role of the profit sacrifice notion. A price cut below marginal cost is clearly suboptimal (without exclusion). The profit sacrifice test asks, what price would emerge under duopoly competition? A price cut below *that* level would indicate that the monopoly is deviating from her static best response and would suggest that her motive is to induce exit from the rival.

## No Economic Sense Test

- This test generalizes the profit sacrifice test in the sense that sometimes, a pure measure of profit sacrifice might not be available or appropriate. Would apply to non-price behavior as well.
- "A finding of exclusionary conduct requires some sign that the monopolist engaged in behavior that – examined without reference to its effects on competitors – is economically irrational." (Stearns Airport Equip. v. FMC. 1999)
- "Conduct makes no economic sense unless it is expected to yield a positive expected payoff, net of the costs of undertaking the conduct, and not including any payoff from eliminating competition." (Werden, p. 3)
- "A short-run profit sacrifice also is not necessary for conduct to be deemed exclusionary ... because the anticompetitive gains from exclusionary conduct sometimes can be reaped immediately." (Werden, p. 13)

## A Consumer Welfare Standard

- Salop asserts that the primary focus of antitrust law is the impact of practices on consumer welfare (or total welfare?)
- Since the NES test does not directly address this impact, it is "fundamentally flawed".
- The NES test is really a "test of anticompetitive purpose and intent" (that is, not of consequence).
- Under his consumer welfare standard, exclusionary conduct is anticompetitive if it causes consumer harm.
- "This test focuses on the effect of the conduct on the market, that is, consumers and the competitive process. In contrast, the other standards – NES etc – are focused instead on the impact of the conduct on the alleged miscreant."

- " ... and there is no reason to think that the impact on the defendant's profits in the hypothetical world of the profit-sacrifice test would be a good proxy for the impact on consumers."

- Observe how this approach would alter the established predatory pricing standard in Brooke Group. (1. Are prices below cost? 2. Is there a chance for recoupment?) Could be more OR less permissive depending on the case.

- In order not to punish a perpetrator for an action that (because of random developments) turns out to harm consumer welfare ex post, Salop argues for applying the measure to ex ante calculations.

- But it is hard to see his basis under the logic of the primacy of consumer harm. Perhaps you would not want to *punish* someone for an action that is harmful only ex post, but would you not want to reverse the action? ie. enjoin the conduct?

- At heart, Salop is concerned that the NES tests are too liberal (yield too many false negatives) although he also argues it can also condemn conduct that is actually welfare enhancing.

- Is the consumer welfare standard too rigid? If it generates too many false positives then wouldn't it tend to stifle beneficial economic conduct because of the fear of an overactive judiciary.
- Even more problematic, doesn't it put too much faith in the competence of the courts to evaluate consequences of actions? (Particularly if it has to be done on a projected ex ante basis?)
- What about the role of intent? Grinnell required the "willful" acquisition of monopoly power. NES speaks to this, not CW.
- Areeda and Hovenkamp argue that intent is mostly a red herring but that "knowledge of intent may help the court to interpret facts and to predict consequences". (pp74-75)

Our focus is upon the effect of that conduct, not upon the intent behind it. Evidence of the intent behind the conduct is relevant only to the extent that it helps us understand the likely effect of the monopolist's conduct. (U.S. v. Microsoft 2001)

- Melamed argues that the Consumer Welfare Standard places too great a burden on firms who have to second guess complex decisions by the court. Profit sacrifice tests, on the other hand, only asks the firm to use its own internal reasoning to determining if conduct is permissible.
- Salop argues that most cases are pretty clear anyway (though his examples appear to be clear on the profit sacrifice standard too). He also asserts that the hypothetical but for reasoning asked for by the NES tests go far beyond standard business practices.
- Anyway, why shelter firms from the obligation to avoid consumer harm?
- Under a consumer welfare standard, should we punish firms for failing to take an action that increases consumer welfare? (or force them to take such an action)?

## Structural Screen Standard - Spector

- Spector suggests that a so-called Structural Rule of Reason approach is the only feasible standard in exclusion cases.
- He starts with proposing a "safe harbor" – marginal prices above some measure of cost should be considered per se legal. (The test should consider true, economically relevant marginal prices.)
- A price scheme inducing a discount applicable to all purchases conditional on total purchases would never benefit from the proposed safe harbor clause, because such a scheme induces a negative marginal price at every threshold (for small enough increments).
- Like Areeda-Turner, "the proposed safe harbor would not be fully grounded in economic theory: the possibility of above-cost predatory pricing is well-known."
- In order to be exclusionary the disputed schemes should deny the targeted firms a sufficient scale to enter, or stay in, the market or to make additional investments.

## A Checklist

1. What is the plaintiff's (ie target's) cost structure? (ie. are there economies of scale that make foreclosure a possibility?)
  2. What fraction of the targets addressable market is foreclosed because of the practices and is it large enough to induce a rational firm to exit or give up a cost reducing investment?
  3. Could the plaintiff have countered the disputed scheme (eg. by cutting price or by offering similar rebates?)
  4. Would the target's exclusion remove a significant competitive pressure from the defendant and allow it to exert market power?
- Under the proposed rule, pricing schemes which decrease consumer welfare without excluding rivals would not be challenged. Assessing the welfare effects of complex pricing schemes absent any exclusionary strategy would be very difficult indeed in practice because it would require one to have very precise information about the shape of each consumer's demand function. Since there are good reasons to consider that, absent any exclusionary strategy, nonlinear prices increase welfare more often than not, the best policy is probably to focus the antitrust handling of nonlinear pricing on the risk of it being used as an exclusionary tool.