Analytical Framework Teleconference
What Conduct Is Exclusionary?
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Transcript and Speaker Submissions

Teleconference Transcript

Greg Werden: Hello everyone. Welcome to this teleconference of the ICN Unilateral Contact Working Group. As one of the working group co-chairs, the U.S. Department of Justice is pleased to host this call. This is Greg Werden speaking, and I will lead the discussion today. This is the second and last of our two teleconferences associated the exploration of the analytic framework for evaluating unilateral conduct for competition law. Today's subject is: What Makes Conduct Exclusionary? The question is deceptively difficult, as our discussion today should reveal.

With me on the call are our speakers: Eleanor Fox is a law professor at New York University and formerly was a private practitioner. Carl Shapiro is an economics professor at the University of California, Berkeley and formerly served as chief economist at the U.S. Department of Justice. Mike Walker is chief economist at the UK Competition and Market Authority. They both taught and worked in consulting. On the teleconference today, our speakers will address questions that I have provided to them in advance.

As I said a moment ago, the subject of this teleconference is: What Makes Conduct Exclusionary. Competition law uses the word "exclusionary" in a specialized way, with legal significance, and my questions enlist our speakers in clarifying the meaning.

Competition law applies the word "exclusionary" only to conduct that adversely affects rivals, but the term is not applied only when a rival is forced out of the market or kept out of the market. So, my first question to our speaker is: What sort of impact on rivals is necessary to make conduct exclusionary?

Eleanor Fox: Ok. Thank you very much, and hi everybody. This is Eleanor Fox. Thank you for your question, Greg. So, you foreshadowed my first semantic point, Greg, because I wanted to say that antitrust does not prohibit just exclusionary conduct; it prohibits anticompetitive exclusionary practices. Because of that, there is in my view no particular impact on a rival that is required to make a case of an anticompetitive exclusionary practice. The main question is the effect of the practice on the market: Does it cause prices to go up? Does it cause innovation to be lessened? And depending on the nature and the probable impact of the practice, you could have varying degrees of impact on rivals that will suffice. So, for example, marginalization might suffice. Of course, the greatest impact is the squeezing out totally of the rival. The more blatant, anticompetitive, and unjustified the practice is, in my view, as I read the cases, the less the degree of exclusion, or proof of exclusion or probable exclusion, required. So, let me just draw an example from *Microsoft*, a practice dropped just before the litigation. Microsoft at one point would make its whole system crash if anybody put Netscape on the Microsoft operating system. That was such a predatory and unjustified practice that it would not be necessary for Netscape, if Netscape was suing, or for the government to prove its case, it wouldn't be necessary to show that Netscape would be totally excluded from the market. It wouldn't be appropriate, or sufficient, for the defendant to say, "Oh, let Netscape find its own path. Let it go to Apple. Let it make its own operating system." So that's basically my first point on degree of exclusion. Thank you.

Carl Shapiro: Hello everybody. This is Carl Shapiro speaking to you very early in the morning here from California. So, I think this is not something we could typically quantify; what is the nature of the impact on rivals necessary to make conduct exclusionary. I tend to think of something I would call a meaningful or significant impact, as opposed to minor. But the necessary impact for a violation certainly could fall short of entirely keeping a rival out of market. Many of my examples involve exclusive dealing, since I think that's one of the practices that crops up fairly often and can fall into the category of anticompetitive exclusionary conduct. So, for example, in the U.S., the DOJ brought a case against Dentsply, what, 15 years ago maybe. This involved artificial teeth believe it or not. There were certain distributors that were most attractive for the manufacturers and a dominant manufacturer who had an exclusive dealing arrangement with those distributors. The rivals or potential rivals could use other distributors, but they were not as attractive. They were small, or they didn't have the same ties to final customers, or whatever. Depending on how many distributors are subject to the exclusive dealing arrangement and how good the alternatives are of other distributors who have not signed those agreements, you could have a range of impact from total exclusion of competitors to simply some sort of weakening of competitors. I look for significant impact in that type of case, or some sort of significant difference between the distributors that are tied up under the exclusive and those that remain available.

The only other thing I'd add on this question is, when looking for impact, one type of pattern is where you have competitors who were, let's say, using certain distributors in this example, and then they could no longer use them. And you can see how they shifted to some inferior alternative. You can also have cases where the competitors are only potential competitors. They're not in the market because they can't get in because, in this case again, the distributors who would be most efficient and enable entry are not available to them. So it can make it very hard, as an evidentiary matter, to assess impact if the exclusionary practice kept the rival out of the market. It's a different fact pattern in terms of what evidence you're likely to have available. In that case, you have to assess the quality of these different distributors without seeing actual arrangements by rivals because they're not present.

Mike Walker: I think it's certainly right to say that foreclosure, when we talk about exclusion, we need then qualify that in some sense, which is the point Eleanor made. Certainly, in Europe, the European Commission always makes a distinction between anticompetitive foreclosure and foreclosure. Anticompetitive foreclosure is foreclosure that's actually going to harm consumers. So when I'm thinking about what level of impact does there have to be on competitors, on one level, I don't care what level of impact there is on competitors; I care about whether there is serious harm under which consumers are harmed, and is that harm going to be significant. The theory of harm might require complete exclusion of competitors, or it might actually require only quite mild harm to them. But I think my criterion for thinking about that is: what is the harm to consumers? And certainly, even if we are thinking just specifically about competitors, we certainly don't need total exclusion. I mean the exclusion could be partial. It could be partial in the sense of existing competitors are not fully excluded but they are weakened in some way that significantly harms consumers, or again it might be allowing entrants in but confining them to a niche. And just to pick up on the case Eleanor referred to, the *Microsoft* case. As I remember one of the comments that Judge Jackson made in his judgment in that case, one of the things that Microsoft did is use its market power to ensure that any new entrant didn't come in to compete directly against it. So it ensured that its behavior was such that no sane new entrant would come in and try to compete directly against Microsoft. They would go for a niche. So they were driven to just working in niche markets rather than competing directly against Microsoft. And I think like Judge Jackson thought, I think that would be a concern as well.

Greg Werden: Thank you. My second question is, do you say the conduct doing significant harm to rivals nonetheless is not exclusionary if it has legitimate business justification? And if that isn't what you say, what do you say when a practice has legitimate business justification?

Eleanor Fox: If the practice has a legitimate justification, in fact, if you're convinced that the defendant did this act to give something better to consumers than it could otherwise do, I think it's very unlikely for a plaintiff to succeed in that case. There is a huge amount of deference given to the defendant that is really responding to the market. This isn't exactly your question, but it seems to me that today there are very few practices that do have a legitimate reason, that really make the market better, and are caught by antitrust law. So even in the *Dentsply* case, of course it's proper to look at the degree of foreclosure but it also turns out that *Dentsply*'s tactic became pretty apparent. It was trying to keep other teeth makers from getting into the market. Purpose is not the end-game, but purpose really does tend to show effect. The purpose to keep out rivals is your illegitimate purpose, and then you move on to whether the conduct was not on the merits and had some impact.

Mike Walker: My starting point here again is that, when we talk about a legitimate business justification, I'm not entirely sure that that takes us very far because we still need criteria for what we think legitimate is. I think what Eleanor just said is a business practice, although it may have some anticompetitive aspects, actually providing a genuine benefit to consumers. That seems to me to be the right criterion, but it must be a benefit to consumers for which there is some sort of reasonable evidentiary basis. It is terribly easy for firms to claim some sort of efficiency defense. And, in fact, you probably have to be quite unimaginative not to be able to provide some sort of efficiency defense in some cases as a matter of theory. So, I think there should be quite a high evidential burden imposed on the party showing when they were thinking about undertaking whatever the behavior is, they actually were thinking about it in terms of how it would benefit consumers. Within European case law, the efficiency defense in monopolization cases, or abuse of dominance cases, is extremely rarely successfully invoked. That is my first comment. My second comment is that a useful test when we're thinking about a legitimate business justification is to think about the no economic sense test, so to think, is this a practice which doesn't make any commercial sense unless it in some way softens competition between rivals and hence harms consumers. If the behavior only makes sense commercially within that context, then I think that suggests that we probably don't have a legitimate business justification. Now, that's not a complete test, and it's subject to both Type 1 and Type 2 errors. And I think we're going to talk a little bit about that later. But I do think it's a good starting point for trying to understand whether firms have got some sort of legitimate efficiency defense.

Carl Shapiro: My comments are going to echo those of Eleanor and Mike that you've all just heard. When I think about legitimate business justifications, the other type of business justification will be something we would typically call pretextual, or just made up really. And as Mike said, if a company has good lawyers and a reasonably good economist, they can usually think of something. So I want to echo what the speakers have said about looking for contemporaneous evidence about what the business strategy was in adopting the practice in question. Certainly, an economist analyzing something like this type of practice must have a coherent view of what the company's strategy is, which then should fit with the other evidence of how this practice fits in. So, let me give an example of something that might be quite legitimate actually. So, suppose you've got a case of below-cost pricing, and it sure looks possibly predatory. I would want to look to see if the company is, let's say, selling one product below cost but that is going to lead to other sales. Maybe it's a foremarket, and the product being sold below cost is durable equipment, and profitable service and parts are going to be predictably sold later. Then, you would want to link those two together, and there could well be a legitimate business justification for the below-cost pricing. So, I want to understand what the company is doing. Maybe I'm a little bit more open to these business justifications than the other two speakers, and I know the US and European jurisdictions best, particularly the US. It can be quite hard for a company to mount a successful business justification if exclusionary effects are of concern. So, I just think it's very important for the agencies to make sure they really understand what the company's strategy is in an overall way, and not just look at one practice in isolation, but see how it fits with other aspects of what the company is doing. The other thing I would say here is that one should bring in the counterfactual, and I think we would be talking, particularly Mike and I, about the counterfactual in these type of analyses. I think the company might say: "We have to do this practice. It's part of our overall business strategy." One fair check on that is well, here's an alternative way you could have achieved a legitimate business aim that would be less restrictive or that wouldn't have the adverse effects, and that might be the counterfactual put forward by the agency. That would be a way of testing whether the proposed justification really holds up.

Eleanor Fox: I agree that one should listen seriously. I think it's really very important, really critical, to understand what the strategy is, but I want to mention a U.S. case where there was huge foreclosure, and the agreement was clearly justified and clearly had a legitimate business reason. That's our *ITT Grinnell* case where the product was a specialized kind of snubbers, or shock absorbers used in building pipe systems for nuclear power plants. Grinnell, the buyer, was trying to get a good source of supply and actually represented about 50% of the market of all purchases. So Grinnell invited a new entrant (Barry Wright) to come in and supply it. It wasn't satisfied with Barry Wright's performance and went back to taking more-or-less a requirements contract from its original supplier, and Barry Wright sued. Whenever it is the buyer who demands the exclusivity, that's a good clue that the exclusivity is needed for efficiency reasons. Grinnell clearly preferred two good sources of supply to one, but it really needed an assured good source of supply. The plaintiff had a presumptive case based on foreclosure from 50% of the market, and yet that wasn't enough. The plaintiff lost. Justice Breyer, then Judge Breyer, was the judge that decided the case.

Greg Werden: Thank you. I'm now going to ask our two economist to think back to cases they have worked on either in the agency or as a consultant and tell us, what was the basis when they had labeled conduct either exclusionary or not exclusionary? Was it the nature of the contract, its effect on the competitive process, impact on market performance, impact on customers or welfare? What were you thinking?

Carl Shapiro: Sure. Let me mention two cases, if that doesn't take too long. One case was about 5 years ago when I was a chief economist at the Antitrust Division at the Justice Department. The defendant in that case was United Regional Health. This is a hospital in a medium-sized city in Texas. The relevant customers in this case would be the commercial insurance companies paying the bills for many of the patients. They had an arrangement where, if an insurance company would not contract with competing hospitals, if it would be exclusive, basically, for certain services, then the rates would be significantly lower at United Regional Health. To make it more abstract, you've got a monopolist; they were really the dominant hospital in the area, and were charging explicitly a price penalty if an insurance company steered some of its business or has arrangements with the smaller competitors. Along the lines of what I think Eleanor said earlier, one looks in this case at why are they doing this pricing? What are its effects? And it was pretty clear that the pricing penalty for an insurance company dealing with another hospital was designed to weaken or exclude a smaller hospital in town. And it had that affect; it had been in place for some time, as I recall. So, that would be an example. So, what did I look for, Greg? Again, this is a quasi-exclusive, it wasn't a full exclusive because United Regional would deal with an insurance company if the insurance company dealt with for a business competitor, but they would charge a premium. So, I definitely look for the effect of the conduct on the competitive process. Did this really weaken the smaller hospital and its ability to expand? The small hospital had expanded some, but was trying to expand more and invest, and it was significantly harder to do so in the face of these practices. And there was also evidence explained in the DOJ complaint that this had an adverse impact on customers because they didn't have as strong of a competitor. It was pretty straightforward. The case was settled. So that's one case when I was at the government, and we saw this type of conduct as anticompetitive, and got it stopped.

The other case I will mention, on the defense side if you will, is work for Intel who's been a client of mine at times for a number of years. And again, some of you on the call may be familiar with the European Commission's case against Intel. I did work on behalf of Intel in that case. The key element of the conduct there that I thought was a legitimate form of competition, but the Commission did not agree, was discounts for contestable sales. Intel was facing competition from AMD, particularly in the sale of its microprocessors, and would negotiate deals with specific large customers, such as Dell, making computers using the Intel and AMD chips. And Intel knew full well that, while Dell could shift some of its sells to AMD, it could not shift all of its sales to AMD simply because that wouldn't be practical for Dell, and AMD only had a certain amount of capacity in any event. So Intel recognized that some of its sales to Dell were contestable or could be lost, others much less vulnerable from Intel's point of view. So Intel offered discounts for certain design-wins, or certain models of Dell, that it saw as vulnerable, if you will, or contestable. So my approach was to do a price-cost test for those contestable sales and look at actual facts, and I don't feel the Commission took that approach, so we had different conclusions about that conduct.

Mike Walker: I'm going to talk about a couple of cases. The first case is a pharmaceutical case the European Commission dealt with about 10 years ago now, which was *AstraZeneca*. AstraZeneca had a blockbuster drug, a stomach ulcer drug. I'm afraid I can't remember its name immediately. But what AstraZeneca had done is that they had managed to extend the length of the patent covering that drug illegitimately. I don't need to go into how they did that, but I think that was relatively uncontroversial. So, why is that behavior anticompetitive? Well, it had a very clear effect of the competitive process because, by extending their patent life illegitimately, they stopped generic entry being able to come into the market. It clearly had an effect in competitive process. It clearly had an impact on market performance because, as a general matter, we know that when generics come into the market, prices basically always fall significantly. We also knew in that case, because by the time Commission had got around doing the case, we had had generic entry and prices had fallen significantly. So we had clear evidence of the effects on the competitive process having an effect on market performance, and therefore, crucially, it was clear that that was behavior by AstraZeneca that adversely affected consumers relative to a fairly obvious counterfactual in that case, which was they didn't extend the patent illegitimately, and we did have generic entry earlier. So I think not just it's the nature of the conduct; it's not just the effect on the competitive process or on market performance. It's the cumulative effect of those on what happens to consumers, consumer welfare. That's one example.

Another example is a rebate case, but just for clarity, it's not the *Intel* case. This was a rebate case where the dominant company, fairly uncontroversially, had a significant assured base of customers. It faced entry, and as Carl put it, a contestable part of the market, and it used rebates in that part of the market. In itself, it's perfectly reasonable to use rebates. The issue, however is that those rebates were structured in such a way that effectively the price that the dominant company was setting in the contestable part of the market in effect was virtually zero over a competitively important range of sales. So that meant that any competitor, even if they were as efficient as the dominant company, was unable to compete for those sales, and was unable therefore to get a foothold in the market and potentially attack the dominant company's at that point assured base. This is different from the example Carl just used, the *Intel* example. What Carl has made clear there, a price-cost test suggested that Intel wasn't pricing below cost. Here, we had an example, I think it's pretty clear, that within a competitively important range of sales, the dominant company was pricing significantly below cost. So, again that restricted entry in that market, that meant prices remained high when they should've done, and that had an adverse effect on consumers. Ultimately, I'm always coming back to what was the effect on consumers. Those are my two examples.

Greg Werden: Thank you Mike. Some agreements among competitors, as opposed to unilateral conduct, are viewed as inherently anticompetitive. And in the U.S., some agreements among competitors are deemed inherently suspect. I ask each of our speakers to tell us what unilateral conduct, if any, they think is either inherently anticompetitive or inherently suspect, and why?

Eleanor Fox: I think there is a category that could be called hardcore monopolization. It is inherently suspect conduct. The defendant would have the possibility to justify. I will first give an old case as an example. The examples I'm going to give are situations in which you have a dominant firm, high barriers, and no apparent reason for the conduct except to keep the competitors at bay. Usually there's one competitor that is a real thorn in the side of the dominant firm, and it is trying to keep that competitor out. It might, as I said, be hard to muster the facts, but if the facts are there, that's hardcore monopolization.

I said I would cite an old case. *Lorain Journal* keeps being a gift in terms of its usefulness. It was a newspaper case and of course you have to think away modern technology; no internet, of course. *Lorain Journal* was the only newspaper in town and a radio station, WEOL, was coming online. WEOL competed for advertising. *Lorain Journal* said to all of the companies in town that advertised in the *Lorain Journal*: "If you take an ad on this radio station, I won't deal with you." The point was, of course, to have all of the local advertisers not deal with WEOL. So that's hardcore. There was no purpose except to keep WEOL from succeeding. The *Lorain Journal* offered a justification: "We want to protect our local business." Of course, that's not a legal justification. *Lorain Journal* is an easier case than most.

I want to go into what I think is difficult territory. I want to take a phase of the *Intel* problem, and I want to say this about it, because there were some facts that suggested this, but I might elaborate, and I might not have a grounding in fact, so I want to talk about it as partially hypothetical. In the *Intel* case, AMD had recently come out with a new very good chip that was challenging to Intel. AMD had not made such very good chips, and there was some evidence—I know Intel doesn't believe the evidence was correct, but I wanted to suppose this is true. There was some evidence that Intel sales people said to the customers and especially the big customers, "Don't deal with AMD for

6 months," knowing that that 6 months was the time in which AMD would probably get its traction or not. And if that is the strategy, and if that comes out as the strategy, and if those agreements were formed, it seems to me that just ought to be illegal, or at least to be inherently suspect and then listen to the justification. I also think, along those lines, that businesses ought to know that they can't do such things, that they cannot compete by having a strategy that doesn't give consumers anything. This is where the hard question comes in, but having a strategy that doesn't respond to consumers, that really is to put cost on competitors. So, I raise that as maybe a controversial subject to talk about.

Carl Shapiro: I don't want to get into a back and forth particularly about Intel and AMD. It's probably 10 years ago now. But I think I mostly agree with you, Eleanor. If you have a dominant firm that bully's customers and says, "If you buy from my competitor, I'm going to cut you off or impose some other penalty on you," let's say—I know you didn't specify that, but I think that was implicit in your story—then I think they've got some explaining to do. When we're talking here about inherently suspect conduct, as I understand Greg's question, at the very least, that shifts the burden to the firm engaging the conduct to explain themselves as a justification. And that might be a heavy burden. So on a general level, I would agree with you Eleanor.

Eleanor Fox: And then, of course, it might depend on what Intel offers. This might sound almost the same to an economist but might be different in law. Supposing Intel forms such a strategy, and it says to its sales people, we really don't want AMD to get traction in this 6-month period, which is very valuable to it, and do what you have to do. So then the sales person goes out and just charges a lower price. No problem. If it really is saying, "I give you this lower price. I want to compete." Conduct, to be illegal, has to be more than just a plain lower price.

Carl Shapiro: Well, I think, sadly for our audience, we are agreeing, so maybe a little less exciting.

Eleanor Fox: In terms of examples of hardcore, I also think of the U.S. *AT&T* case in 1980-81, even though, now given *Trinko*, the conduct is probably relegated to the sector regulator. AT&T was doing whatever it could to throw roadblocks in the way of MCI, which had a new long-distance technology. AT&T controlled the local loop, and it was giving lots of excuses and putting lots of noise in the system to make it much less likely that MCI would be able to get access to the local loop and get to the consumer. That to me is a hardcore monopolization violation.

Mike Walker: I'm not going to comment on specifics of the *Intel* case that has just been discussed. In terms of unilateral conduct, I certainly think there's conduct that's inherently suspect and where we would put a heavy burden of proof on the dominant firm to explain why it was engaged in that behavior. And in that category, I would put pricing below marginal cost, so predatory pricing. I would put some loyalty, exclusivity, rebates where we end up with pricing that seem to be very low compared to cost. I would put in a behavior where a dominant company is effectively paying rivals not to enter the market, so pharmaceutical pay-for-delay-type cases. And in all of those cases, I don't want to say that they are definitely anticompetitive because in all those cases you can have benign or procompetitive rationales in some circumstances. So, I'm not going to make an absolutely firm rule on any of those, but I do think you want to very significantly shift the burden of proof onto the dominant company. The ideal world is a world in which the competition authorities are able to say very clearly that we think those behaviors are inherently suspect, that they change the burden of proof, therefore, if you are going to engage in one of those behaviors, you really do need to make sure in doing that that you have a serious discussion as to why you're doing it and what the benefits are to consumers relative to plausible counterfactual, so that you are able to discharge that burden.

And all of this I think goes to an issue that is really important when we're thinking about unilateral behavior, the issue of speed and pace of enforcement. If you look at enforcement in abuse of dominance cases at a European level, one of the things you say is, "My goodness it takes a long time." So with the *Intel* case, which is still on appeal, I think the original complaint was 2003. *AstraZeneca*, the case I mentioned, which was really pretty straightforward, took more than 8 years. *Microsoft*, in Europe again, at least one of the complaints was pretty straightforward; I don't know how many years that took, but certainly 8 or 9 years. And, of course, the problem with exclusionary conduct is if we allow it to go on that long, then the damage is done. The relevant firm has been excluded or they've been significantly weakened. So anywhere where we can get quasi-rules in place, I think it's really beneficial to enforcement.

Carl Shapiro: Just to answer your question more generally, I would say that there are certainly modes of conduct that are inherently suspect, but I'm really thinking of a burden-shifting framework where certain types of conduct, and I tend to think of terms of exclusive dealing and certain types of loyalty rebates as in that category. But I don't want that to be over interpreted. If the conduct is in those categories, and there's evidence it's having effects on, I'll say, excluding competitors or weaken competitors, then I want to see some shifting of the burden to the defendant or the monopolist to explain why they're engaging in that conduct. How heavy a burden then rests on the company really depends on the nature of the conduct. So, the world is very complex. Let me read one of my favor lines from the *Microsoft* appeals court decision from 2001:

“Whether any particular act of a monopolist is exclusionary, rather than merely a form of vigorous competition, can be difficult to discern: the means of illicit exclusion, like the means of legitimate competition, are myriad.”

I really am hesitant to make generalizations here. If I had to put in something of a category, I would say exclusive dealing and loyalty rebates. Mike, you mentioned paying rivals not to enter, the pay-for-delay cases. I think that’s a fine category; that’s quite suspicious, actually. If that counts as unilateral conduct, as opposed to some other category involving agreements, then I’m with you. But I agree with you, those cases can be simpler than defendants would like to make out. Mike, you mentioned pricing below marginal cost, and I am not as quick to condemn that because I’ve seen, particularly in the tech industry, a lot of cases where there’s a free good: an app is distributed free with the hope that some other revenue stream will come later, some sort of upgrade. I bet you would agree with me then. When you’re comparing price and marginal cost before you do the burden shifting, you really want to look at not just the short-term revenue, but over a longer period of time, and you want to look at other sales, not just one product, that might be related to a complementary good. So this is somewhat of a note of caution: Don’t jump to conclusions too quickly if you see one price that’s zero, for example, or below marginal cost.

Mike Walker: I agree with all of that Carl.

Eleanor Fox: Carl would you include on your list procuring agreements not to deal with competitors? Of course, that’s also a phase of exclusive dealing.

Carl Shapiro: Yes, and I would agree with what you said before about your submarine case. If I’m a dominant firm, and I go to you and I say, “Look I’m going to give you a little better deal if you agree not to buy from any of my competitors,” then, I am somewhat suspicious of that. Why don’t I just offer you the deal I want to offer and then let the competitors make their offer? On the other hand, if you have your own efficiency reasons why you want to buy everything from one vendor, ok. There often can be technical reasons why a customer might want to do that. Then I wouldn’t see that as a requirements contract. I mean, I wouldn’t want the agency to see that as a requirements contract and jump to the conclusion that it was anticompetitive. So the customer’s view on that could be quite important, whether they actually welcomed something that, on its face, might look like an exclusive arrangement.

Greg Werden: Eleanor’s paper lists several types of unilateral conduct that she argues are inherently legitimate competition on the merits. They include invention and non-predatory low pricing. I first ask the two economists to tell us what if any unilateral conduct they view as inherently legitimate and critically why is it so?

Carl Shapiro: This will be quick. I agree with Eleanor. I think the literature generally lines up with what she said in her paper. So, take invention, let's say the introduction of a new and superior product by a dominant firm. Of course, this could exclude competitors. The product might be so good that competitors are struggling to continue to make sales. But I don't think of that as anticompetitive. So, on its face, that is a form of what I would consider legitimate competition, just in that simple form. By the way, in some of the drug cases, we've got a product introduced that might not be much better and then a withdrawal of another product for various strategic reasons. That's a more complicated fact pattern that's now being called product hopping. So that's trickier. I'm not going to include that. But simply introducing an improved product. Now, why do I think that is competition on the merits? I think the key thing is improving on products, introducing improved products, and lowering prices to meet competition, which is the other category I would include here. That's kind of at the heart of what we want firms to do when they compete. And the critical thing is that we do not want to stifle dominant firms from competing. We don't want to stifle anybody from competing. That would be directly contrary to what competition policy is supposed to be doing. And I do think it's useful to have some bright lines, not as many as business would like, but some bright lines, so that the companies can be confident that they won't be hauled in for an investigation or be found liable for monopolization if they are simply introducing an improved product or offering discounts to meet competition.

Greg Werden: I think what Carl just said is fairly much common ground. Do you have anything to add Mike?

Mike Walker: No, I don't. I agree.

Carl Shapiro: I thought about this some more, and I found it hard to come up with another category. Eleanor listed these two categories—invention and non-predatory low pricing. That's pretty much common ground, as you said. Is there another one that I would want to put forward? And actually, I had trouble because the world is complicated, and I didn't want to create another category on the fly. It sounds like the other speakers maybe felt likewise.

Eleanor Fox: I want to know what you two think about a simple refusal to deal: Should that be added to the list?

Carl Shapiro: Unilateral unconditional refusal to deal, at least for intellectual property, I would add to the list. Yes, a good point. But unconditional is very important there. So, if the refusal to deal is based on conduct that I will deal with some people but not others, or certain circumstances, then it should not be added to the list in my view. But if you meant by simple, I will interpret that as "unconditional," then I do think I will add it. But maybe you wouldn't Eleanor, I'm not sure, would you?

Eleanor Fox: Well I think it's much more complicated than *Trinko* because I think in the U.S. right now refusal to deal is on the list. I would wonder, for example, about *Otter Tail*. Otter Tail refused to sell electricity to a municipality because it was afraid the municipality was going to be a competitor, and replace it; so the municipality went to the Bureau of Reclamation, which had power but had to send it by way of Otter Tail's lines. Otter Tail refused to allow its lines to be used for the purpose; it refused to "wheel." The Supreme Court thought that was illegal, by divided opinion. I think under *Trinko* it might be legal.

Carl Shapiro: Weren't they wheeling other power? I feel like this was a conditional refusal to deal. They didn't want to wheel power, is that not true?

Eleanor Fox: So you're calling it "conditional" if they wheel it for other people that are not competitive threats?

Carl Shapiro: Yes, exactly.

Eleanor Fox: Yes, then I agree.

Carl Shapiro: Yes. That's the way I think about these things.

Greg Werden: This can be a little bit confusing because of your use of the word "unconditional." So, I would ask a clarifying question: Are you talking about a discriminatory refusal where you pick and choose who you're going to deal with, or a conditional refusal in which case you insist that the party do something, or not do something, if they want to deal with you?

Eleanor Fox: The latter is what I understood. I think that *Otter Tail* was a simple refusal because it didn't impose a condition. It would not supply the energy. You knew the reason was because the buyer wanted to be a competitor.

Carl Shapiro: If I have an input, and I will supply it to some people who I don't see as a threat, but I won't sell it to people I see as a threat, I would call that a "conditional" refusal to deal because my willingness to deal is conditional on the nature of the parties asking or their conduct. Either of those I would call "conditional," so I am accepting Eleanor's invitation to add this third category, but I'm keeping it pretty narrow by saying unilateral, unconditional refusals to deal in the manner I just described.

Eleanor Fox: Yes. I think you're saying unconditional and non-discriminatory, with the discrimination understood as based on whether the recipient is a competitor.

Carl Shapiro: That's fine. Yes. I agree. I don't want to get hung up on this.

Greg Werden: Now suppose that unilateral conduct by a dominant firm has requisite impact on a rival, and it isn't inherently legitimate, and it isn't inherently illegitimate. Is there any general test you would endorse for either determining whether the conduct is anticompetitive, or determining how the agency should go about evaluating the conduct?

Eleanor Fox: I would use the U.S. *Microsoft* case. I'd require the plaintiff to first show the significant adverse impact, then I would shift the burden. If the defendant shows that it was really just trying to get to the market and provide something better for consumers, most courts will not proceed to balance. This is usually not a balancing test because a lot of deference is given to the defendant that shows it was just trying to get to the market. But if a dominant firm was targeting a real competitive threat by conduct that did not look pro-consumer, the cards are stacked in favor of the plaintiff, and the defendant will have a hard time asserting a credible justification. Very few cases get to a balancing stage where the court can say, "Well, plaintiff made its case and defendant made its case, and now we want to see which is weightier." I say, use *Microsoft*.

Mike Walker: Well, no there isn't any one test that I'm going to endorse. I think where the behavior is neither inherently legitimate nor inherently illegitimate, then my vote would be to ask: Is there a theory of harm here for how consumers are harmed? Is that theory of harm compatible with the incentives of the dominant firm? If it is, is there evidence that the dominant firm has the ability to act in this way, and if it does have, then I want to think about it relative to the plausible counterfactual, which is where I think a lot of the analysis has to go; whether I've got a good theory of harm suggested, and there is likely to be harm to consumers.

I have just a couple of things to add to that. One is where we have behavior which is not clearly illegitimate, I think we need to be careful. I think we need to be careful in two senses: One, I think we need to be careful to make sure that dominant companies can legitimately understand whether their behavior is going to be found to be anticompetitive ex ante. So I'm not a great fan of exotic theories of harm or, in a phrase we use over in Europe, and I shudder every time I hear it, extending the boundaries of competition law. I think we need to insure that there's a degree of legal certainty to the companies. Secondly, I think where we have genuine uncertainty, I want to be really sure that I've thought about the dynamic aspects of the behavior. Static harm in the sense that price has been too high is all very bad, but the place where we get really significant consumer harm it seems to me is where we have a dynamic theory of harm when competition is damaged in the longer term. Or equally, where we get really good things for consumers is where firms are able to act competitively, introduce new products, so I want to make sure that my decisions don't adversely affect dynamic competition. So if I'm unsure, I'm going to go on the side of how do I protect dynamic competition.

Carl Shapiro: I'll be brief. I agree with Eleanor. I think the U.S. *Microsoft* appeals court decision provides a very nice framework in terms of the burden shifting. It put the steps you would go through in terms of: Is there an anticompetitive effect? Is there business justification? Do you do a balancing? I like that, and that's a powerful important opinion. That's a little bit legal though in terms of burden shifting and back and forth. I also took your question, Greg, to be "Is there a general test?" So I think in terms, what sort of objective are we trying to achieve, and I do go back to consumer welfare, consumer benefits, and trying not to be too short run about that. I don't quite want to say long run but you know not just a snapshot, reflecting what Mike said about looking at the dynamics. So, I would say a real focus on impact on consumers is important, and also just what Mike said about having a counterfactual. I'd go back to what I said at the beginning of this session. Having a coherent view of what the company's strategy is, how it fits in the market, and so we're really understanding that the challenged elements of its strategy really do harm consumers when viewed in context.

Greg Werden: It's often said that determining whether conduct is exclusionary can be difficult. And I would like to hear from our panelist on three related issues, which I will read out before I ask them to comment. First, is there significant potential for costly error in agency evaluation of whether conduct is exclusionary? Second, what unilateral conduct has the greatest potential for costly false positives? And third, what unilateral conduct has the greatest potential for costly false negatives?

Mike Walker: Ok, I'll be very brief. Is there potential for costly error in agencies' evaluation? Yes, there certainly is. And certainly agencies that over-enforce on dominant companies can chill competition and that can harm dynamic competition, and I think that should be a real concern. So what unilateral conduct has greatest potential for costly false positives? I mean when we're looking at the dynamic competition, so for instance something Carl mentioned earlier, if we look at a two-sided market, and we see that the product is free on one side of the market and expensive on the other side of the market, naïve assertions of predatory prices on one side and excessive prices on the other risk losing network economies to scale. So, I think that's a danger. And generally things to do with innovation, innovation is naturally exclusionary. If you have a good innovation you exclude your rivals, and that is a fantastic thing. It's important that competition authorities don't get in the way of that.

Carl Shapiro: Certainly, there are dangers of errors in both directions here, over- and under- and enforcement in the U.S. When I first went to DOJ, at the beginning of the Obama administration, with Assistant Attorney General Christine Varney, one of the things she did early on was withdraw the Section 2 guidelines that have been put out, just six months earlier I guess, under the previous administration. And there was some expectation that, under her leadership, the Antitrust Division would bring many Section 2 cases. I actually warned people at the time: don't expect that because historically there are very few cases. So in the U.S., we don't have many Section 2 cases, at least not filed by government agencies (there are various private cases). There's a reason we're talking about *Microsoft* or *Dentsply* fifteen years later. There's just not that many cases brought. So if anything, probably the error in the U.S. is under-enforcement. But I would also say, when I was at DOJ, we were looking systematically for a good Section 2 case. We found some, but not very many. So I think the concern, in the U.S. at least, of over-enforcement seems pretty unlikely given there's not that many cases, again at least brought by the, well I'll say the DOJ and FTC. We can include the FTC. I'm more concerned about the danger of over enforcement by the European Commission because, as I understand the regime over there, there is a much less rigorous requirement to actually show effect before a violation is found. So, I think it really varies by jurisdiction. In terms of your question about what type of conduct, I think that will just bring us back to what we've been talking about already, which is, at least from my point of view, various types of exclusive dealing or loyalty programs are more likely to cause problems. And some of the other pricing structures are more likely to be ok and can have over-enforcement. But the main thing is that different legal regimes and different requirements in different jurisdictions could lead to a tendency to over- versus under-enforcement and therefore errors of one type or another.

Eleanor Fox: I agree with Carl and Mike, and I'll just add this: I think sometimes there's too much conviction that there is one right answer. Sorry to raise *Intel* again, but I'm going to raise it again. You can call it hypothetical, but on the facts that the European Commission found, a rule of illegality could possibly deter Intel from some lower prices, but a rule of legality could deter AMD and other inventors from more invention. There are two sides of the coin. There are costs and benefits whichever way you do it. I think that Carl is exactly right for the U.S., under-enforcement is the problem. For the EU, it could be over-enforcement. For over-enforcement, I think it's useful for the enforcers to always ask themselves the question: what will be the result of this enforcement—even and especially after they've gone through the analysis and decided that the conduct is anticompetitive. Will the *enforcement* harm competition, innovation, prices? If enforcers systematically ask that question, and they're convinced that the enforcement itself is going to help and not harm competition, they're probably in a good ballpark.

Greg Werden: We've used our allotted hour, so I want to thank all our speakers for this interesting discussion. I remind everybody that this is part of a continuing process producing a chapter for the workbook. The chapter is on the analytic framework, and it will discuss what is exclusionary conduct and what is dominance. Don't look for it any time soon because this is a long and complicated process. But thank you all for participating today and goodbye.

ICN UNILATERAL CONDUCT WORKING GROUP

What makes conduct exclusionary?

Eleanor Fox, New York University, April 18, 2016

Session #2: What Makes Conduct Exclusionary?

• *What does it mean to assess the competitive effects of conduct? Can it mean different things in different cases?*

Please see below. I answer this incrementally and then frontally at the end.

• *Can the character of conduct ever be such that it necessarily constitutes lawful competition on the merits? If so, what conduct? Why?*

Yes. First, invention is lawful. If a dominant firm's conduct IS invention, even if it destroys all competitors, it is not a unilateral conduct violation. This rule does not cover predatory product change. When, in the complex IBM case two decades ago, IBM removed one prong from a computer spindle purely to disenable a rival's application from attaching to the IBM mainframe, this was fair game for a violation.

Second, simple non-predatory low pricing is lawful, even if it kills all competitors, in order to protect low pricing.

Third, refusals to deal of a certain character are lawful, in order to protect freedom of action. They fall into a possibly unlawful category only if, as necessary but not sufficient conditions, the firm with market power holds access to a critical source of supply or market outlet. Even then, exposure to US antitrust is rare.

Fourth, in the United States, margin squeezes are not unlawful (subject to a small footnote condition that may not exist). [Also in the US, excessive pricing is not proscribed, but excessive pricing is not exclusionary of competitors unless combined with a price squeeze.]

• *Can the character of conduct ever be such that it is necessarily abusive? If so, what conduct? Why?*

Yes. Certain conduct is hard core monopolization or abuse of dominance. This is conduct where the dominant firm takes strategic action only to disable or exclude rivals [where, presumably, the rivals would otherwise provide a good source of competition]. Alcoa's requiring the only suppliers of water power not to supply water power to any existing or emerging aluminum rivals, where water power was necessary for entry and survival in aluminum production and Alcoa did not need the water power it restrained, was hard core. Similarly: In the 1970's - AT&T's creating noise in the system so that new long distance competitors could not connect to the local loop, and Otter Tail's refusing even to wheel the power of the Bureau of Reclamation over its lines for delivery to towns that wanted to provide their own distribution of electric energy. (The latter two sets of conduct would probably not be US antitrust violations today, after *Trinko*, because the sector regulator could have ordered connections.)

• *Should a welfare standard be used in developing the rules or analytical framework for particular practices? Should an error-cost analysis be used, and if so, how are error costs evaluated?*

I am skeptical about using a welfare standard – consumer or total – because of its static quality. The US *Microsoft* case, for example, was in my opinion an excellent case because Microsoft barred all efficient channels for Netscape/Java to get traction, and purposely so without a good business reason; and Netscape/Java had strong potential to break the market power of Microsoft by commoditizing the operating system, even though it is not clear that Microsoft lessened consumer welfare as that term is used in economics. In *Lorain Journal*, good defense counsel "prove" no welfare loss. Even in *FOGA*. *Indiana Federation of Dentists* – the same. Dramatic and meaningful facts of a case are often lost by transposing the problems into welfare models, which can obscure the strategic dynamic of conduct. This does not mean that welfare models are not helpful. They often are.

I am skeptical about error-cost analysis where intervention is called an error if a transaction or conduct is not proved output-limiting. The intervention might not be an error. E.g., the by-laws in *California Dental.*

• *Should a welfare standard be used in assessing the facts of particular cases? Should this be done only in some cases? If so, in which cases? Why?*

See above. It can sometimes be useful, but the raw facts of the market and strategy are more useful.

WHAT IS ANTICOMPETIVELY EXCLUSIONARY UNILATERAL CONDUCT THAT COMPETITION LAW SHOULD PROHIBIT?

The answer to this question depends on perspective.

One point of view has been expressed by the US Supreme Court in cases such as *Trinko* and *linkLine*. That is: Prohibited exclusionary conduct seldom happens, and government should seldom intervene against unilateral conduct that tends to exclude. Such conduct seldom happens because market forces are strong, consumers are usually sovereign, alternatives exist, and if competitors complain they are almost always complaining about competition itself. Government should seldom intervene because it is hard to discern the line between procompetitive and anticompetitive unilateral conduct and errors should be made in favor of letting firms use their judgment as to what is best for (efficient) business. If government does intervene, it is probably protecting inefficient competitors against hard competition. A robust exclusionary conduct rule tends to drum up nuisance suits that are very expensive for firms and inefficient for the economy. This point of view would limit the scope for anticompetitive exclusionary conduct. A total welfare standard or a sacrifice rule is sympathetic to a hands-off approach. Also sympathetic is the rule in *Trinko*, footnote 4: To make a case based on leveraging (which means based on foreclosure), defendant must be en route to monopolizing the second market. That is, there is no violation based on merely *using* monopoly power to get advantages in the second market at the expense of meritorious competitors; violation entails *increase* in market power.

A second point of view has been expressed by the Court of Justice of the European Union. While judgments go in somewhat different directions, in general, conduct of a dominant firm that fences competitors out of important segments of the market is likely to be a distortion of competition and therefore an abuse of dominance unless the firm justifies its conduct by proof of efficiencies or innovation incentives, there is no less restrictive alternative, and consumers get a fair share of the benefits. This means that loyalty rebates and margin squeezes by dominant firms have a good chance of being held illegal even if the plaintiff cannot prove output limitation. EU law is sympathetic to a framework (consistent with the US cases *Aspen Ski, Otter Tail*, and *United Shoe Machinery* (D. Mass. Wyzanski)) in which one looks at purpose and effect of exclusionary strategies. One asks: Do the strategies seriously handicap the opportunities and efficiencies of the non-dominant firm, and if so, what are the efficiency justifications of the dominant firm? The law may back into effect on the market by taking seriously the fact that feisty competition from a smaller rival triggered the dominant firm's exclusionary strategy, and the prospect that the excluded or marginalized rival would have added something important to the market and consumers. (e.g. EU *Intel*; *Intel* was a much harder case in the US; how do we know if output was limited?)

The *Trinko* line of cases is more likely to make an error in the direction of preserving the power of the dominant firm, giving it too much space to fend off challengers, and thereby limiting rivals' innovation. The EU line is more likely to make an error in the direction of protecting competitors from hard competition. Both errors could be protected against, if the jurisdiction admits to the soft spot.

Proof and burdens are directly related to the question, What is exclusionary conduct that should be prohibited?, and so is intent and purpose. Proof and burdens are implicated in my comments above. This is another window. In court, plaintiff must make a prima facie case of harm to competition. Thereafter, the defendant has the chance to prove that the conduct was not in fact anticompetitive, or if the conduct had anticompetitive aspects it also had out-balancing procompetitive or efficiency aspects. If the defendant meets either burden convincingly, that is usually the end of the case, even though plaintiff theoretically has a right to rebuttal, trying to prove that on balance the conduct is anticompetitive or would be if defendant took a less restrictive route. If defendant's story is that it was trying to respond to the market or to bring to market something new, better or lower-priced, and if that story is believed, defendant virtually always wins. In other words, defendant gets slack despite what welfare models might show (and I think this is good). On the other hand, if the credible story is that defendant was trying to block the path of its challenger and doing so by acts not on competitive merit, the plaintiff virtually always wins, despite a gap in the welfare-loss story. *Microsoft* is such a case. I think this is good also. The observation tends to show some limits to the welfare model as the test or standard.

Exclusionary Conduct by a Dominant Firm: Quick Primer Prepared for the ICN Unilateral Conduct Working Group June 2016

Carl Shapiro[†]

This short note comments on what conduct by a dominant firm may be properly considered "exclusionary" from the perspective of antitrust economics. The notion of "exclusionary conduct" put forward here is based on the competitive effects of the conduct. No claims are made here regarding how these principles outlined here do or do not align with competition law in different jurisdictions.

Under the approach outlined here, conduct is evaluated based on its likely impact on the customers of the dominant firm and of its rivals. The impact of the dominant firm's conduct on its rivals can certainly be relevant, since exclusionary conduct is aimed in the first instance at those rivals. However, evaluating the impact of the dominant firm's conduct of rivals is only one step toward evaluating its impact on customers.

Exclusion vs. Exploitation

The discussion here is confined to unilateral conduct by a dominant firm that excludes actual or potential rivals. This discussion does not address purely "exploitative" conduct, such as setting a "high" price or extracting more surplus from customers by engaging in various forms of price discrimination. Most antitrust economists take the view that competition policy should not be used as a price-control scheme. If prices levels are to be regulated, that should be the job of a sector-specific regulator, not the competition authority. In part this is due to comparative institutional competence. And in part this is because of the drawbacks of using price controls to limit the financial returns to firms that have taken risks and made investments that generated substantial value for their customers.

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Pricing

Simple high prices may be exploitative but they are not exclusionary.

Simple low prices can, in a literal sense, "exclude" competitors by making it difficult or impossible for them to survive or to earn a sufficiently high rate of return on invested capital to warrant further investments. But low prices normally reflect competition in action, and simple low prices invariably provide some direct and immediate benefits to customers. In rare cases, prices can be so low as to exclude rivals and harm competition, causing greater long-term harm than short-terms benefit to customers. However, great care must be taken in pursuing such predatory pricing cases so as not to stifle normal pricing competition. Many antitrust economists would say that treating simple low prices are pro-competitive as long as they are above incremental cost is a reasonable way to avoid stifling price competition with "false positive" allegations of predatory pricing, while leaving room for true predatory pricing cases to proceed.

However, it is important to understand that even prices that are below some measure of incremental cost can represent legitimate pricing competition. This can occur for a number of reasons. For example, sales of the discounted item may generate additional revenue streams, as when a firm sells durable equipment below cost with the goal and expectation of making profits on aftermarket service, or when a firm gives away digital content with the goal and expectation of capturing advertising revenue as users view or listen to that content. The starting point in any case involving allegations of predatory pricing is to ask (1) whether the firm in question is pricing below incremental cost, and if so (2) *why* the firm finds this to be profitable pricing strategy. The case should proceed forward only if the firm finds it profitable to price below incremental cost due to the possibility of recouping its losses in the future with higher prices, after its rivals have exited the market or become weaker due to the low prices.

Volume discounts should be handled similarly, with lower prices for incremental sales generally welcomed as pro-competitive. However, discounts based on how much the customers buys from rivals, and discounts for exclusivity, are more problematic in terms of their competitive effects.

Refusal to Deal

Refusals to deal typically arise when a firm controlling an important input refuses to make that input available to its rivals. This normally happens when the firm in question is vertically integrated, controlling the (upstream) input and using that input to provide some (downstream) product or service.

Unilateral, unconditional refusals to deal are in general not anti-competitive. The term "unconditional" is important here: it means that the vertically integrated firm refuses to sell the input to anyone, regardless of their status or conduct. A firm that has developed a new product, protected by a patent, and refuses to license that patent to any others would be an example of a unilateral, unconditional refusal to deal.

Unilateral, unconditional refusals to deal are not a good target for competition authorities in part because competition authorities are poorly placed to establish and enforce price controls. If a competition authority were to declare a unilateral, unconditional refusal to deal to be anti-competitive, then charging a sufficiently high price would also have to be considered anti-competitive. But that would unavoidably take the competition agency down the slippery slope towards establishing and enforcing price controls. However, if a duty to deal has been established independently – such as when a patent holder promises to license its patent on "fair, reasonable, and non-discriminatory" (FRAND) terms, or when a regulatory agency mandates that the input be made available – then refusals to abide by those commitments or rules can become antitrust violations. Even in those cases, however, it is often best for the competition agency to leave the determination of the "reasonable" price to the suitable regulatory agency or perhaps to the courts or arbitrators charged with enforcing a FRAND commitment.

Unilateral, *conditional* refusals to deal cover a wide range of conduct. Evaluating the impact of such refusals to deal on customers is highly fact-specific. In general, however, it is important to construct a coherent counterfactual: if the firm in question cannot employ the unilateral, conditional refusal to deal, what price(s) would it set and what course of dealing would it pursue? Once one establishes a coherent and sensible counterfactual one can, at least in principle, compare consumer welfare under that counterfactual with the consumer welfare resulting from the firm's actual course of conduct.

Tying and Exclusive Dealing

Both tying and exclusive dealing can harm competition and consumers when used by a dominant firm. But there are no easy short cuts here: in any given case, the effects of the challenged conduct must be identified in comparison with a coherent and sensible counterfactual.

Tying can indeed extend a firm's dominance from one product to another by excluding rivals for the tied product, but tying can also facilitate pricing structures that benefits customers, or at least some types of customers. Furthermore, especially in industries experiencing technological change, the boundary between one product and another can be unclear or evolving, e.g., as products are efficiency integrated. Care should therefore be taken to account for the possible benefits of technical tying. Contractual tying also can generate efficiencies.

Exclusive dealing has obvious dangers, most notably when a dominant firm refuses to sell its product to customers unless they refrain from purchasing rival products. In some circumstances, such "naked" exclusive dealing can be very effective at blocking entry by would-be rivals to the dominant firm. This occurs if those rivals lack alternative customers or distribution channels to work around those who have agreed to deal exclusively with the dominant firm, and if the dominant firm's actual or would-be rivals operate subject to significant economies of scale.

However, there also exist fact patterns in which exclusive dealing is justified, e.g., if the direct customers of the dominant firm would otherwise free ride on information or services provided by the dominant firm or harm its reputation, and if there are no less restrictive alternatives to exclusive dealing that would work in practice. As with other forms of exclusionary conduct, exclusive dealing should be analyzed by comparing the firm's actual conduct to a coherent counterfactual in which the dominant firm is prohibited from engaging in exclusive dealing.

Investment and Risk Taking by the Dominant Firm

Dominant firms often argue that they made substantial investments and took considerable risks to achieve success, so finding them in violation of competition law would undermine such investment and risk taking. This argument, standing alone, proves too much. Taken at face value, it would imply that there should be no abuse-of-dominance cases. Adopting a standard based on consumer welfare helps avoid falling into that trap.

However, adopting a consumer welfare standard does *not* mean that a dominant firm has harmed competition just because it is earning high profits and its customers are paying a “high” price, even a “monopoly” price. Harm to competition involves conduct that disrupts the competitive process. The competitive process very much includes encouraging firms to make investments and take risks. But it does not guarantee them any level of return. Firms that stifle competition cannot defend themselves by arguing that they did so to achieve an acceptable rate of return on their investments, any more than cartel members can defend themselves by saying that they were only trying to establish “reasonable” or “stable” prices.

What makes conduct exclusionary: an economic perspective

Mike Walker and Alex Rutt, Competition and Markets Authority[1]

This paper outlines some high level considerations in relation to the question: what makes conduct exclusionary conduct? There are five sections. These are:

- What is the difference between exclusion and anti-competitive exclusion?
- The importance of specifying the counterfactual.
- Potential analytical approaches to assessing conduct.
- The importance of a clear theory of harm.
- Issues around actual exclusion, potential exclusion and weakening of competitors.

Exclusionary conduct

A fundamental distinction when considering exclusionary conduct is between exclusion in general and exclusion that leads to consumer harm ('anti-competitive exclusion'). Not all behaviour that leads to the exclusion of a competitor is anti-competitive. For instance, fierce price competition from an efficient firm might well exclude an inefficient rival. This is not anti-competitive exclusion as it is likely to be to the benefit of consumers. However, below cost pricing designed to exclude a new entrant who would otherwise have had the potential to lead to lower prices or an innovative new product would be anti-competitive as it would be expected to lead to consumer harm. The focus of unilateral conduct enforcement should be on anti-competitive exclusion.[2]

We assume that the correct welfare standard is consumer welfare not total welfare (i.e. consumer welfare and producer welfare combined). Whilst economists may sometimes argue for a total welfare standard, it is now accepted around the world that competition policy focuses on consumer welfare, not total welfare. We agree with this approach.

Distinguishing between exclusion and anti-competitive exclusion is often difficult. For example, when a dominant company charges low prices that exclude a rival, this could be part of an attempt to exclude rivals through predatory pricing. Alternatively it could be that the dominant company is competing strongly and the competitor is simply less efficient. Difficulties of this sort are at the heart of why unilateral conduct enforcement is more difficult, and has seen less international convergence, than other areas such as merger assessment.[3]

1 Mike Walker is the Chief Economic Advisor of the Competition and Markets Authority (CMA) and Alex Rutt is an Economist at the CMA. The views expressed are personal to the authors and all errors, omissions, and opinions are their own.

2 For example, see the European Commission's Guidance document which focuses on anti-competitive foreclosure. ***'****Communication from the Commission — Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings (Text with EEA relevance)',* http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52009XC0224(01)

3 For example, see J Vickers (2005), Abuse of Market Power, The Economic Journal, Vol. 115, No.504, Features (Jun., 2005), pp, F244-F261.

What is the appropriate counterfactual?

An important consideration in determining whether conduct leads to anti-competitive exclusion is the counterfactual used in the analysis as this is the benchmark against which the conduct and welfare is considered. It is not possible to analyse coherently whether a mode of behaviour engaged in by a dominant company is anti-competitive without having a clear view of what the “better” alternative behaviour might be. It is not always possible to specify a single clear counterfactual. However, it is important even in these situations for agencies to be clear as to what counterfactual, or range of counterfactuals, they have in mind.

Often, the counterfactual will be relatively clear. For instance, if the allegation is that a dominant firm has changed its behaviour and this change is anti-competitive, then the natural counterfactual will be the dominant firm’s original behaviour. Thus if a dominant firm was previously supplying downstream rivals but then starts to refuse to supply, the natural counterfactual is the situation in which the firm was supplying downstream rivals. Equally, there are some behaviours where the counterfactual is defined by an accepted rule. The accepted counterfactual in a predatory pricing case is that price is no lower than average avoidable cost or some similar cost benchmark.[4] The accepted counterfactual in a margin squeeze case is that the difference between the dominant firm’s retail price and its upstream supply price is high enough to allow efficient upstream and downstream firms to compete.

However, there are also occasions where the counterfactual is unclear. In these situations it is still necessary to develop a counterfactual or range of realistic counterfactuals against which to assess the conduct in question.

What analytical frameworks can we use?

There are a number of ways in which we can think about the alleged conduct and whether it is anti-competitive. In doing this it is important to ensure that the analytical framework used reflects the reality of the case such that it is coherent and compatible with a realistic counterfactual. Below we outline two tests that can be used in the assessment of unilateral conduct.

“*No economic sense” test*

One way to think about whether the conduct is anti-competitive is using general frameworks such as the ‘no economic sense’ test. This test asks whether the dominant firm’s behaviour can be understood as rational even if it does not lead to exclusion. If the firm’s behaviour is only profit maximising[5] if it leads to exclusion, then this implies that the behaviour has an exclusionary motivation. As noted above, not all exclusion is anti-competitive. However, if the exclusion allows the dominant firm to face less competition in future and to exploit this reduction in competition via

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4 Alternatives include marginal cost, average variable cost, long run average incremental cost and average total cost. We do not discuss the merits of the various alternatives here. A high level overview of different cost measures can be found in the ICN’s Unilateral Conduct Workbook Chapter 4: Predatory Pricing Analysis (April 2012)**.**

5 We note that in this context ‘profit’ can include a situation where the conduct in question reduces losses that would occur absent the conduct. For example, see the Decision of the Office of Fair Trading, Abuse of a dominant position by Reckitt Benckiser Healthcare (UK) Limited and Reckitt Benckiser Group plc, Decision No. CA98/02/2011, April 2011 (‘OFT Decision’).

higher prices or lower quality products or less innovation, then this is likely to be anti-competitive exclusion.

An example of the use of the "no economic sense" test in the UK is the Reckitt Benckiser case which involved withdrawing and de-listing a format of a drug in order to hinder generic competition. The OFT found that the withdrawal of the format tended to restrict competition or was capable of having that effect.[6] The OFT used the "no economic sense" test to show that the withdrawal of the product could only be understood as part of an anti-competitive attempt to exclude rivals:[7]

> '*Considered in the round, RB's [Reckitt Benckiser's] contemporaneous internal documents therefore demonstrate that RB's [Reckitt Benckiser's] decision to carry out the Withdrawal was, at that time, irrational but for the benefits that RB [Reckitt Benckiser] expected to derive from hindering the development of full generic competition. This analysis suggests that, other things being equal, RB's [Reckitt Benckiser's] decision to carry out the Withdrawal was expected to result in share, revenue and profitability decreases that would be sustained. This analysis supports the findings at sub-section C (i) (b) above in that it suggests that the purpose of the Withdrawal was to hinder the development of full generic competition, as it would have made no economic sense if this were not the case.*'

The "no economic sense" test is susceptible to Type II errors.[8] Just because the conduct or the profit-sacrifice it entails can be rationalised in a way that is not anti-competitive does not necessarily mean that the conduct in question was not anti-competitive. Therefore an over reliance on this test may lead to under-enforcement.[9]

"*Equally efficient competitor" test*

We noted above that the 'equally-efficient competitor' test is often used in the analysis of unilateral conduct.[10] The exact form of the test depends on the conduct in practice. For example, in relation to margin squeeze this test asks whether the supply pricing by a dominant vertically integrated firm is such that it would not itself be able to make downstream profits at that supply price (i.e. an "equally efficient competitor" would be excluded).

This framework has found particular traction in relation to price based unilateral conduct where, at a high level, it involves assessing whether the effective price of a product over a relevant range of sales is below the effective cost over that range of

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[6] See OFT Decision, paragraph 6.164.

[7] See OFT Decision, paragraph 6.42.

[8] A Type II error is where anti-competitive conduct is incorrectly found not to be anti-competitive (ie under-enforcement) while a Type I error is where conduct that is not anti-competitive is incorrectly found to be anti-competitive (ie over-enforcement).

[9] We note that there may also be limited occasions where these tests capture behaviour that is not anti-competitive. Examples of this may be in markets with network externalities and two-sided markets where conduct that fails these tests may be necessary for a firm to gain critical mass.

[10] Other frameworks include the 'profit-sacrifice' test and the 'consumer harm' test. For example, see J Vickers (2005), Abuse of Market Power, The Economic Journal, Vol. 115, No.504, Features (Jun., 2005), pp, F244-F261 and ICN's Unilateral Conduct Workbook Chapter 1: The Objectives and Principles of Unilateral Conduct Laws (April 2012).

sales.[11] However, it is unclear to what extent this framework can be extended to incorporate the assessment of non-price based unilateral conduct. Further, the implication of this test is that consumer welfare is enhanced by not protecting firms that are less efficient than the dominant firm. Whilst this may in general be correct, there are occasions when even less efficient competitors impose competitive constraints on dominant companies.[12]

Rules

There are some potentially anti-competitive unilateral behaviours that are covered by clear rules that competition authorities can follow. The predation tests and margin squeeze test are examples. These rules have the benefits of enhancing legal certainty and allowing quicker decisions, such that the alleged harm is addressed more quickly and with lower enforcement costs. This can be particularly important with exclusionary behaviour as enforcement that takes too long means that agency decisions may come too late to stop the exclusion or, therefore, the consumer harm. However, there is a trade-off with rules. Whilst they may improve the speed of decisions and enhance legal certainty, they may also lead to the wrong decision in some cases (both Type I and Type II errors). Our view is that research on the efficacy of further rules on the basis of an error-cost framework would be desirable.

The importance of a theory of harm

In its strictest form exclusion is where the conduct of a firm leads to a competitor or competitors exiting the market ('actual exclusion'). When enforcement is based on actual exclusion intervention is ex-post and this makes it easier to differentiate between exclusion and anti-competitive exclusion as actual (short-term) effects can be observed.

A concern with enforcing against a dominant firm before exclusion has taken place is that authorities may end up finding against behaviour that is actually legitimate competition (Type I error) and thus chilling competition. Over-enforcement can reduce the incentives of dominant firms to compete and this can harm consumers. For instance, a competition authority might incorrectly treat competitive prices charged by a dominant firm as being predatory and so require the dominant firm to raise its prices. This would be harmful to consumers. Enforcing only against actual exclusion will increase a competition agency's confidence that anti-competitive exclusion has occurred and thus reduce the risk of chilling competition.

However, if a competition agency only intervened in cases where actual exclusion had occurred then inevitably it would be taking cases when it is already too late and the competitor has been excluded. This is likely to be a seriously sub-optimal

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11 We note that in practice the as-efficient competitor test can be difficult to implement and there is not general agreement on its implementation, an example of this is in relation to the relevant cost measure that should be used as the effective cost. See footnote 4.

12 For instance, where a firm is less efficient than the dominant firm because it lacks the same scale, but where it has the potential to reach efficient scale, an equally efficient competitor test may allow the dominant firm to exclude the sub-scale rival and hence reduce long-run competition. In these cases, an alternative that is often used in telecoms regulation is to use the "reasonably efficient operator" test. This replaces the costs of the dominant firm with the costs of a firm that is efficient given its scale. In our view it only makes sense to apply this test if there is good evidence that the sub-scale firm is likely to grow to efficient scale if it is not excluded. The test should not be used to protect permanently sub-scale firms.

outcome for consumers.[13] Thus competition authorities need to intervene before exclusion has taken place if possible. This means that they will need to be making judgements on the basis of the likely effects of the dominant firm's behaviour. This provides agencies with a difficult dilemma. On the one hand, we need to be careful about intervening to address a perceived issue too early, at the risk of chilling legitimate behaviour or pro-competitive innovation. But as importantly, we must avoid acting too late, intervening only when the conduct's impact has become irrevocable, or not at all. This requires that we need to have a clear analytical framework for understanding how the behaviour might lead to exclusion. In particular, if an agency wishes to intervene prior to exclusion taking place, it needs to provide a clear theory of harm. This needs to:

- Be consistent with the known facts.
- Provide a clear explanation of how the behaviour will lead to exclusion and how that exclusion will harm consumers.
- Be consistent with the incentives of the dominant firm. For instance, an allegation of a margin squeeze needs to explain why it is in the best interests of the dominant firm to exclude efficient downstream distributors (i.e. why does the Chicago critique not hold).[14]

Exclusion or just weakening of a competitor?

Harm to consumers can occur not just from exclusion of rivals but also from behaviour that weakens rivals and thus causes them to compete less strongly. For example, the CMA's guidelines on unilateral conduct states that conduct can be categorised as exclusionary when '*it removes or weakens competition from existing competitors, or establishes or strengthens entry barriers, thereby removing or weakening potential competition.*'[15]

This raises the difficult question of how to judge whether a rival has been or will be weakened sufficiently for the behaviour to be deemed anti-competitive exclusion? The difficulty here is that much competitive behaviour has the effect of weakening rivals. A firm that prices very competitively will likely win sales from higher priced rivals and so potentially weaken them, but this would not be anti-competitive behaviour. Where the allegation is that the behaviour will weaken, but not exclude, rivals, it is even more important that there is a clear theory of harm as to how consumers are harmed.[16]

[13] This does not mean that there is no benefit to intervening at this late stage. A decision against a dominant firm that involved a large fine and damage to the reputation of the firm is likely to deter other firms from engaging in such behaviour in future. Also, there may be occasions where ending the infringing behaviour allows firms to re-enter the market.

[14] There is a sense in which this is similar to the analytical framework for the "no economic sense" test. In both cases we are requiring that the competition authority thinks about whether the theory of harm is consistent with profit maximising behaviour by the dominant firms.

[15] See OFT402, Abuse of a dominant position.

[16] Similar issues arise with partial exclusion. The question is whether the practice need to cover all customers or just a sufficient number? It may be that excluding a competitor from a small number of customers is enough to lead to actual exclusion, or is enough to weaken competition enough to cause significant consumer harm.