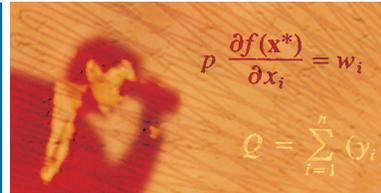


Antitrust Insights

Fall 2008



A Second Look at Section 2 of the Sherman Act

From the Editor

In September 2008, the US Department of Justice (DOJ) issued a report that tackled perhaps the most challenging and controversial issue in the area of antitrust and competition policy—business practices that are potentially subject to scrutiny under Section 2 of the Sherman Act. The practices are familiar: discounted pricing, tying, bundled discounts, single-product loyalty discounts, refusals to deal, and exclusive dealing. But determining their competitive effects is elusive because the exact same practice may be anticompetitive in one set of circumstances, but procompetitive in others.

In this issue of *Antitrust Insights*, Tim Daniel and Elizabeth (Liz) Bailey discuss and debate the key questions that don't seem to have any easy answers. Why is it so difficult to distinguish procompetitive conduct from anticompetitive conduct? When does harm to a competitor imply harm to the competitive process? What types of analyses and evidence should we be doing to get the answers? Their conversation is a preview of what we can expect going forward and a discussion that is filled with examples drawn from their past experience and expertise.

Tim Daniel is a Senior Vice President in NERA's Washington, DC office. Before joining NERA, he was an Assistant Director for Antitrust in the Bureau of Economics at the Federal Trade Commission. Liz Bailey is currently Clinical Assistant Professor of Economics at the W.P. Carey School of Business at Arizona State University and a NERA Special Consultant. Prior to that, she was a Vice President in NERA's Washington, DC office.

I hope you enjoy this issue.

—Lawrence Wu, Editor

A roundtable discussion with Timothy Daniel and Elizabeth M. Bailey

Lawrence Wu: In September 2008, the Antitrust Division of the US Department of Justice (DOJ) issued a report that articulated its views on the principles and standards that should be applied when assessing unilateral conduct under Section 2 of the Sherman Act.¹ What key themes resonated the most with you?

Timothy Daniel: Two key themes struck me the most. First, the DOJ seemed to stress that no one liability test can be or should be applied in all circumstances. Second, the DOJ strongly expressed the view that the estimated anticompetitive effects from a particular conduct would have to be “substantially disproportionate” to the conduct's estimated efficiencies and procompetitive effects before it would find that the conduct was in fact unlawful. The first proposition should not generate much controversy. The second proposition has already been subject to much criticism, which I think is fair because the DOJ Report does not provide a persuasive showing that current liability standards have produced systematic overdeterrence of procompetitive conduct.² I am not saying that the DOJ Report is incorrect in concluding that current liability standards systematically overdeter conduct that is ultimately procompetitive—but I do not see in the DOJ Report any empirical support for this critical proposition.



Elizabeth (Liz) Bailey: For me, the theme that resonated the most was that businesses need to be given clear and objective guidance on the conditions under which certain behavior is safe or unsafe. I remember working on a merger several years ago in which we were interested in collecting information on discounts. We were told the firm was very reluctant to offer any discounts because they were concerned about the potential antitrust repercussions. I remember thinking that this was a great example of potentially procompetitive behavior being stifled by antitrust enforcement. Now that I am teaching economics in a business school, I hear anecdotal stories all the time about firms deciding not to take certain actions that would have very likely been procompetitive because of a concern that the conduct would be subject to an antitrust litigation or investigation. Fear of litigation can dampen the competitive process. Providing bright-line guidance can mitigate those types of concerns, with the ultimate result being that consumers benefit.

Daniel: I agree that bright-line standards have the virtue of providing clear guidance. And the DOJ Report fruitfully explores areas where bright-line standards might be sensible. But I also think that the hunt for bright-line

standards in Section 2 matters will yield results only around the edges, and even those can stir up controversy. For instance, when discussing single-product loyalty discounts, one might have expected the DOJ Report to recommend a bright-line standard akin to the one that is typically applied to assess predatory pricing: the practice would be deemed lawful if the seller's revenues exceed the appropriate measure of costs. But even if a practice were to pass this test, the DOJ Report notes that competitive harm could occur if a "significant portion" of a customer's needs are "not subject to meaningful competition."³ While I agree that guidance is important, I am afraid that in this instance the DOJ Report does not give much or enough guidance. Perhaps this position reflects the current state of economic research, which has shown that predatory pricing can occur even when prices are, on average, above costs.

Wu: *In a number of different contexts, the DOJ Report stresses the importance of preventing conduct that harms the competitive process without discouraging actions that enhance competition. This is certainly right. Why do you think it is so difficult to distinguish procompetitive conduct from anticompetitive conduct, particularly in the context of a Section 2 claim?*

About NERA

NERA Economic Consulting (www.nera.com) is an international firm of economists who understand how markets work. We provide economic analysis and advice to corporations, governments, law firms, regulatory agencies, trade associations, and international agencies. Our global team of more than 600 professionals operates in over 20 offices across North America, Europe, and Asia Pacific.

NERA provides practical economic advice related to highly complex business and legal issues arising from competition, regulation, public policy, strategy, finance, and litigation. Founded in 1961 as National Economic Research Associates, our more than 45 years of experience creating strategies, studies, reports, expert testimony, and policy recommendations reflects our specialization in industrial and financial economics. Because of our commitment to deliver unbiased findings, we are widely recognized for our independence. Our clients come to us expecting integrity and the unvarnished truth.

$$\frac{[\theta(1-p)n_0/(n_r-1)n_s]}{n_0/n_r}$$

$$T_2 = \frac{Q^2/G}{Q_2/(N-K_1-2G)}$$

Bailey: What makes the distinction difficult is that the same behavior can be procompetitive under some conditions and anticompetitive under others. In some sense, a Section 2 case is really about inferring the reasons for why a firm might have adopted a particular business practice. Was the firm’s intent to harm rivals with the hopes of being able to raise prices ultimately? Or was the intent to compete more vigorously against its rivals, which, from an economist’s perspective, results in an increase in consumer surplus. In both scenarios, rivals can be harmed, which makes it unsurprising that rivals are often the ones raising Section 2 concerns.

Wu: *But if rivals are harmed in both scenarios, how do you distinguish when harm to a competitor implies harm to the process of competition?*

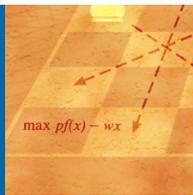
“When there is harm to the competitive process and therefore harm to consumers, efficient rivals may find that their ability to compete is or has been compromised. In contrast, harm to a competitor is a much broader category and can include ‘harm’ to inefficient rivals.”

Bailey: One key distinction is that when there is harm to the competitive process and therefore harm to consumers, efficient rivals may find that their ability to compete is or has been compromised. In contrast, harm to a competitor is a much broader category and can include “harm” to inefficient rivals, which is what one would expect under ordinary competition. The demise or exit of an inefficient rival is what should happen when the competitive process functions well, even though that may seem like harm to

the unfortunate inefficient rival who loses customers and/or ultimately closes up shop. The goal, then, is to be able to distinguish when a given behavior is likely to harm consumers and when that exact same behavior is likely to benefit consumers. And that is what many of the tests attempt to do: draw a bright line around the conditions under which a behavior is unlikely to result in harm to consumers and/or draw a bright line around the conditions under which a behavior is very likely to result in harm to consumers.

“Seemingly identical conduct—such as discounting or exclusive dealing—can be procompetitive under some circumstances and anticompetitive under others.”

Daniel: Liz is absolutely right that seemingly identical conduct—such as discounting or exclusive dealing—can be procompetitive under some circumstances and anticompetitive under others. Of course, this is also true for horizontal mergers. In this respect, the conceptual framework that we should apply to assess the competitive impact of a particular conduct is a broad one that takes us beyond the Section 2 context and into territory that should be familiar to antitrust practitioners. For example, one commonly applied test focuses on overall market output. This is the first place I look when I begin an analysis of competitive effects. Can we develop an empirical test to assess whether overall market output rose or fell due to the alleged violative conduct? If market output increased, then one could pretty comfortably conclude that the conduct was lawful and that consumers benefited. If market output fell, then the conduct might be anticompetitive and one would want to look at other corroborating evidence.



Bailey: In assessing the effect of a given conduct on competition, one also has to be careful to think about short-term effects and long-term effects of the alleged unilateral conduct. For example, Tim suggests looking at the effect on market output to draw an inference about competitive effects. That is a great example of the importance of being careful about the time horizon. With predatory pricing, for example, in the short run you would expect market output to rise and prices to fall, and thus, consumers to benefit. However, in the medium or long run, you would expect to see market output fall and prices to rise, with consumers being made worse off.

Wu: *Both of you focus on evidence that relates directly to competitive effects. But, as noted in the DOJ Report, establishing attempted monopolization requires proof of a specific intent to monopolize. What are your views on evidence that pertains to intent?*

Daniel: I have several concerns with placing considerable weight on evidence that relates to intent. First, a firm may have every intention of eliminating its competitors by embarking on a particular course of action. However, at the end of the day, if entry into the relevant markets is relatively easy, those intentions will be dashed. I would be hard pressed to argue that the unsuccessful effort should be viewed as unlawful, but I know that other commentators would disagree. On the other hand, a firm with both market power and good antitrust counsel could embark on a course of conduct that really would reduce

competition, but take careful measures to describe the procompetitive rationale for the conduct in its documents, thereby concealing the true intent of the conduct. Looking at economic effects becomes necessary to pierce through this.

Bailey: I agree with Tim that looking at the economic effects should be our primary focus. That is also where an economist's comparative advantage lies. I do, however, think that one interesting question is whether and how intent comes into play in a Section 2 case regarding an attempt to monopolize. Think about price fixing, a per se violation of Section 1 of the Sherman Act. A "smoking gun" document showing that the alleged conspirators attempted to conspire could trump any economic evidence on pricing or entry than an economist might marshal to demonstrate that any such attempt was either unsuccessful or unilaterally procompetitive. In the context of a Section 2 matter, would compelling evidence of a defendant's ex ante intent to drive out competitors using predatory pricing trump evidence put forth by the defendant's economist's analysis that, ex post, price was above cost or that, ex post, subsequent entry quickly took place such that recoupment of lost profits was unlikely? I don't know the answer to that question. Since compelling evidence on intent is hard to come by, and, as Tim points out, can be affected by good antitrust counsel, it would not make sense to rely solely on the presence or absence of evidence demonstrating intent.

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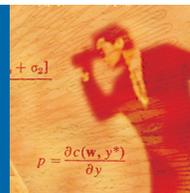
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Wu: *The DOJ Report offers a number of recommendations to the courts, including a suggestion on how the burdens of production and proof in litigation should be allocated between plaintiffs and defendants. As described by the DOJ, the plaintiff should carry the initial burden of showing that the conduct at issue harms the competitive process. If that burden is met, the defendant must then demonstrate that the conduct has a procompetitive justification. If that is shown, then the plaintiff must prove that the anticompetitive harm of the conduct outweighs the procompetitive benefit. If the courts were to adopt this approach, what kinds of analyses and evidence will be given more weight?*

Daniel: I think this approach makes good sense. The plaintiff should have a burden to demonstrate that the conduct at issue does more than harm a rival—it must be shown that the conduct at issue has harmed or is likely to harm the competitive process, which means there is the prospect that there will be or has been a reduction in output, an increase in prices, or diminished incentives to innovate. The Supreme Court decision in *Twombly* is consistent with the approach suggested by the DOJ—the plaintiff has to articulate a plausible anticompetitive argument.⁴ I also agree that the defendant will be in the best situation to articulate and defend the conduct’s alleged procompetitive impacts. What incentive issues are being addressed by the conduct? How do consumers

benefit when those incentives are more efficiently aligned, as claimed by the defendant? I think the focus on economic analysis makes a lot of sense at both stages, because the essence of a Section 2 allegation is that the market would work more efficiently if the conduct were prevented or modified—assessing such “but for” questions, both conceptually and empirically, is what economists do well.

Bailey: Which kinds of analyses and evidence are given more weight really to boils down to a question about which type of error you think is more costly to the competitive process. Giving more weight to the presence of a possible procompetitive justification means that you will probably miss preventing a few situations that are truly anticompetitive. Giving more weight to the possibility that a behavior could result in an anticompetitive outcome means you will probably block some situations that would have benefited consumers. The question of whether it is worse to miss a few situations that are anticompetitive or worse to block some procompetitive activities is normative rather than objective.

Wu: *To assess whether a given conduct is likely to have harmed the competitive process, what kinds of economic evidence would you want to see?*

Our Practice

NERA economists employ economic theory and quantitative methods grounded in a thorough understanding of the market facts to provide a full range of theoretical and empirical economic analysis and testimony in matters involving mergers and acquisitions, antitrust litigation, and competition policy. We advise companies and their attorneys, as well as governments and regulators, throughout the world on investigations of alleged monopolization, abuse of dominant position, and market power. We analyze the entire range

of economic issues that arise in antitrust cases, including market definition and market power, market structure and entry conditions, pricing, and other conduct affecting competition, profitability, and damages. NERA’s expertise includes assessing and, when necessary, testifying to the economic merits of allegations of foreclosure and exclusionary conduct, tying and bundling, refusals to deal, vertical restraints, collusive behavior, essential facilities, and anticompetitive pricing behavior.



Bailey: I worked on a matter several years ago in which a manufacturer of replacement auto parts brought a Section 2 case against a rival manufacturer. I was retained by one of the defendants. The plaintiff alleged that the defendant manufacturer, in conjunction with a retailer, had agreed to an exclusive dealing arrangement in which the retailer, which had formerly sold only the plaintiff's auto part, had ceased selling that manufacturer's auto part and began selling only the defendant's newly introduced competing auto part. In this example, it would be useful to have an estimate of the volume of business that was affected by the exclusive dealing arrangement. For example, if the retailer at issue sold only a minuscule fraction of that type of replacement auto part and there were a large number of other retailers offering consumers a variety of competing products, it is hard to see how that behavior would have harmed the competitive process. If potential harm to the competitive process cannot be shown, it doesn't make sense to have the litigation continue to play out.

Daniel: Liz is absolutely right that one should first look at the market share of the parties at issue to see if it is even plausible that the alleged violator has market power, which (as noted in the DOJ Report) is a necessary prerequisite for the conduct to have an anticompetitive effect. But what might you do if the manufacturer and retailer in Liz's example do have significant shares of their relevant markets? I have worked on a number of exclusive dealing cases that fit this description and, in each case, I proceeded along two fronts—one was conceptual and the other was empirical.

Wu: *What was the nature of the conceptual work that you did to assess the procompetitive justification of the conduct at issue?*

Daniel: Here is an example from work that I did on behalf of a firm that was accused of having an anticompetitive exclusive dealing arrangement. From the defendant's perspective, it is important to be able to explain how an exclusive dealing arrangement can foster consumer welfare. In that case, the downstream retailer had to provide considerable pre-sale and post-sale services to ultimate consumers. Company documents and testimony indicated that upstream manufacturers found that exclusive dealers had stronger incentives to provide these important services relative to multi-product retailers. So, there was a good story for why exclusive dealing could be procompetitive.

Wu: *How did you demonstrate this empirically?*

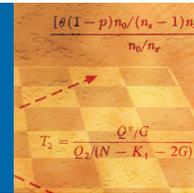
Daniel: Empirically, I looked for instances where the upstream manufacturer, perhaps for historical reasons, used a multiproduct distributor in certain local markets and an exclusive distributor in others. This allowed me to assess some interesting natural experiments. For example, were new product introductions more successful in expanding output in local markets with exclusive dealers compared to local markets with non-exclusive dealers? If so, the evidence would suggest that the exclusive dealing arrangement was, in fact, procompetitive.

Wu: *Do you put more weight on economic theory or empirical evidence when assessing the procompetitive rationale for a given conduct?*

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Bailey: It is important to start with good economic theory and a thorough understanding of the market at issue. For example, in assessing the rationale for the exclusive dealing arrangement that was at issue in the replacement auto parts case that I mentioned earlier, I found that the conduct was efficient from the retailer’s perspective and procompetitive—or at worst, competitively neutral—from the ultimate consumer’s perspective. The retailer wanted an exclusive relationship. The main reason is that it was extremely costly for the retailer to stock more than one brand of that replacement auto part. The retailer had limited shelf space, yet it had to stock a unique version of each product—and there was a different stock keeping unit (SKU) for just about every make and model of automobile out there. For this retailer, stocking more than one brand of this product meant, among other things, not having the shelf space to carry the full range of replacement auto parts that consumers were demanding.

“With regard to the procompetitive rationale for conduct that might violate Section 2, it is important to meld theory with solid empirical testing.”

Daniel: With regard to the procompetitive rationale for conduct that might violate Section 2, it is important to meld theory with solid empirical testing. For example, in the case of exclusive dealing, the economic literature has identified a number of possible rationales that would lead to an increase in consumer welfare. Liz has identified one above, that exclusive dealing can induce the downstream retailer to hold an efficient level and mix of inventories. There are other rationales, such as the proper alignment of incentives between a manufacturer and its retailers. The variety of possible procompetitive explanations lend themselves to a number of empirical tests, which means that the analysis will be complex, mainly because a number of possible procompetitive arguments must be addressed and accepted or rejected. All this just means that an economist has a challenging assignment. He or she has to look at a number of arguments before concluding with confidence that the conduct at issue, on net, harms competition.

Wu: *As this discussion shows, a competitive assessment of single-firm conduct under Section 2 of the Sherman Act will require significant economic analysis and evidence. The issues are certainly complex and controversial, and I thank you for a terrific discussion and for sharing your views with us.*

NOTES

- 1 DOJ, “Competition and Monopoly: Single-Firm Conduct Under Section 2 of the Sherman Act” (2008) (hereafter, the “DOJ Report”). Available at www.usdoj.gov/atr/public/reports/236681.htm.
- 2 The US Federal Trade Commission (FTC) did not join or endorse the DOJ Report, and a discussion of the issues can be found in a statement by FTC Commissioners Pamela Jones Harbour, Jon Leibowitz, and J. Thomas Rosch. See Statement of Commissioners Harbour, Leibowitz and Rosch on the Issuance of the Section 2 Report by the Department of Justice, 8 September 2008. FTC Chairman William E. Kovacic issued a separate statement as well. (Both statements are available at <http://www.ftc.gov/opa/2008/09/section2.shtm>.)
- 3 DOJ Report, p. x-xi (as cited in note 1).
- 4 See *Bell Atlantic Corporation, et al., v. William Twombly, et al.*, 550 US ____ (2007).

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