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Donald S. Clark
Secretary of the Commission

Meeting Before the Commission

Date: December 1, 1995
Docket No.: P951201

FEDERAL TRADE COMMISSION

I N D E X

WITNESS:

EXAMINATION

NONE

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FOR IDENTIFICATION

Commission's:

NONE

FEDERAL TRADE COMMISSION

In the Matter of:)
)
) Docket No.: P951201
 HEARINGS ON GLOBAL AND)
 INNOVATION-BASED COMPETITION)

Friday,
 December 1, 1995

Federal Trade Commission
 Sixth and Pennsylvania Avenues
 Room 432
 Washington, D.C. 20580

The above-entitled matter came on for hearing,
 pursuant to notice, at 9:00 a.m.

SPEAKERS:

ROBERT PITOFISKY
 Chairman, Federal Trade Commission

JANET D. STEIGER
 Commissioner, Federal Trade Commission

CHRISTINE A. VARNEY
 Commissioner, Federal Trade Commission

BECKY BURR
 Attorney/Advisor to Commissioner Varney

SPEAKERS (Continued):

SUSAN S. DeSANTI
Director, Policy Planning

DEBRA VALENTINE
Deputy Director, Policy Planning

MICHAEL ANTALICS
Assistant Director for Non-Merger
General Litigation I Division,
Bureau of Competition

WILLIARD K. TOM
Director for Policy and Evaluation,
Bureau of Competition

WILLIAM E. COHEN
Project Director for Innovation,
Policy Planning

JONATHAN BAKER
Director, Bureau of Competition

CHRISTINE A. EDWARDS
Executive Vice President,
Dean Witter, Discover & Company

AMY MARASCO
Vice President and General Counsel
American National Standards Institute

JANUSZ ORDOVER
Professor, New York University

ROEL PIEPER
Chief Executive Officer
UB Networks
Senior Vice President
Tandem Computers

THOMAS ROSCH
Latham & Watkins

SPEAKERS (Continued):

RICHARD SCHMALENSEE
Professor, Massachusetts Institute of Technology

DAVID J. TEECE
Professor, University of California, Berkeley
STEVEN SALOP
Professor, Georgetown University

ROBERT WILLIG
Professor, Princeton University

1 organization, economics, and its application to a wide range
2 of antitrust and regulatory issues. And, of course, he's
3 published numerous articles and co-authored several books.

4 He has also been a consultant for many private
5 firms as well as government agencies including the Antitrust
6 Division of the Department of Justice.

7 Dick, it's a pleasure to welcome you here.

8 MR. SCHMALENSEE: Thank you, Mr. Chairman.

9 You have my written statement, which is much too
10 long to read. So let me just go through some of the main
11 points.

12 I'm going to conclude -- this is the sort of
13 testimony when you realize you have become your father. I'm
14 going to conclude that networks are very interesting,
15 networks are very difficult, but that networks really do not
16 justify new rules. Networks raise difficult problems, but
17 they are not fundamentally new difficult problems.

18 A reason I think for confusion that I want to deal
19 with first -- and it's dealt with first in my written
20 statement -- is the tendency to use the term "network" in a
21 very broad way and then to attach a specific meaning to it.

22 If you think about the number of things that are
23 commonly called "networks," they range from the telephone
24 system to a new MBA set of useful friends and acquaintances,
25 to the set of suppliers serving a particular firm connected

1 by long-term business relationships, to the set of users of
2 a particular software product.

3 These, I contend, are very different animals.
4 Some networks have single sponsors, say the set of
5 individuals connected because they use a particular software
6 product. Some networks have multiple sponsors, say the
7 participants in bank credit card networks. There are a
8 range of differences.

9 I think the confusion arises, in part, because the
10 economic literature on networks deals with a particular
11 network phenomenon that doesn't characterize everything we
12 describe as a network.

13 The economic literature focuses on networks marked
14 by a particular kind of externality in which, roughly
15 speaking, the value of the network rises more than
16 proportionally to the size of the network. Networks like
17 the telephone system, in which the value of a telephone to
18 me depends positively on how many people have phones;
19 therefore, the total value of a million-person phone system
20 is more than a million times greater the value of a
21 one-person phone system, for instance.

22 Networks that have this feature, these network
23 externalities, show a sort of economies of scale on the
24 demand side as distinct from any economies of scale in
25 provision of the networks or its services.

1 Economies of scale on the demand side, like
2 economies of scale on the supply side, tend to point in the
3 direction of, although it may not carry the system all the
4 toward, natural monopoly or essential facilities status.

5 Not all things that we commonly call networks are
6 obviously possessed of that attribute. So simply to say
7 that something is a network is not to say that nature or
8 market forces decree that there should be only one of them
9 or of it. And I think that's important because we tend,
10 when we think network, to think essential facility, to think
11 only one. But as a logical matter, a network is something
12 that has nodes and links. It's not something of which there
13 is logically only one. So let me urge that distinction.
14 And also make the point that simply having networks
15 externalities by itself operating over some range of size of
16 the network doesn't get you natural monopoly either. It may
17 be important in a credit card network, let's us say, to have
18 national coverage or world coverage. It doesn't follow that
19 after that has been obtained there are further externalities
20 that cause economies of scale.

21 Well, let me talk, then, that general point made,
22 about some issues raised by single-sponsor networks and by
23 multiple-sponsor networks.

24 The single-sponsor network situation is one -- it
25 would be typified, say, by one that the Commission knows

1 well: The situation involving Microsoft operating system
2 products. That's a situation which one can argue for a
3 network, that there are connections among users.

4 One can argue there are externalities, that the
5 value of the system grows more than proportionally with the
6 number of users. And that the issue that's raised -- and
7 has been raised by a number of observers -- is whether one
8 needs, in situations like, unusually strict conduct
9 standards.

10 The argument, as I understand it, basically builds
11 on the economics literature. The economics literature in

1 in a situation involving scale economies.

2 It applies equally as well -- although, I don't
3 think this has been formally done, but it applies equally
4 well to scale economies on the supply side, which are very
5 familiar to us, or to learning economies, which are very
6 familiar to us.

7 Now, one wouldn't want to say, I think, that
8 because an industry has economies of scale in production
9 that we have to be very, very careful, unusually careful,
10 careful in ways that would otherwise be unjustified, to hold
11 the industry to the a standard of near perfection, because
12 after all, if we don't, then a small antitrust violation can
13 lead to huge social costs.

14 It seems to me, we tend to apply -- we tend,
15 obviously, to apply different set of standards -- and
16 appropriately so -- to dominant firms or firms that can be
17 arguably characterized as dominant. But I don't think that
18 it makes sense any more in the case of scale economies than
19 in the case of network effects to be obsessively concerned
20 about the possibility that, if we don't prevent someone
21 getting an illicit advantage, the world will end.

22 Let me also point out an important qualification.
23 The theoretical models that say, indeed, an inefficient or
24 undesirable standard or network can emerge as dominant
25 because of accidents, it's unclear how seriously to take

1 those models as an empirical matter. It is hard, as a
2 number of people have pointed out, to find examples. And
3 it's important to recognize that saying that standard X wins
4 when standard Y is better, means there is a profit

1 Again, it's important to understand that just
2 because a situation is properly characterized as a network
3 does not mean it is inevitably an essential facility,
4 inevitably a natural monopoly, inevitably only one of them.

5 That said, as a general matter, I think it's
6 useful -- indeed, I think it's important to distinguish
7 between conduct issues related to operations and conduct

1 effective as competitors in that market. Of course,
2 excluding a few firms without special advantages from a
3 competitive market, I know, can't have that effect. On the
4 other hand, inclusion of a large fraction of actual or
5 potential competitors may reduce or eliminate competition at
6 the network level, either by effectively merging two
7 networks or by reducing a network below critical size.

8 The familiar worry -- which we used to hear more
9 about than we do now -- of having a large fraction of
10 competitors in an industry in an industry making collective
11 decisions is, I think, still a valid one. There are dangers
12 from having a joint venture be over-broad.

13 Finally, I think there are broad policy issues
14 raised by -- of several sorts -- raised by requiring a joint
15 venture to admit members particularly if that joint venture,
16 as is the case in all interesting situations, has actually
17 created something of value.

18 That raises, first, the question of the
19 appropriate price of membership for a late comer. That, I
20 submit, is fundamentally a regulatory question of the sort
21 that courts have traditionally sought, properly I think, to
22 avoid.

23 The second broad policy issue is that, given
24 there's always some uncertainty about how access will be
25 priced if it is forced, the prospect of facing that sort of

1 uncertain outcome tends to disfavor the joint venture form
2 and tends to reduce incentives to create property in that
3 way, perhaps either leading to it's non-creation or it's
4 creation by a merger or a single-firm form.

1 venture should be required to admit a new member only when
2 it can be shown in doing so is essential for effective
3 competition or close to essential for effective competition
4 in some market.

5 That is to say, I think the presumption is that
6 refusal to admit a new member ought to be legal, just like
7 that's the presumption -- rebuttal, of course -- just like a
8 refusal to agree to a merger proposal is presumptively
9 legal.

10 Now, that's not a per se rule despite things
11 friends of mine have written. And various friends of mine
12 would take another view, would apparently condemn any
13 decision to exclude an applicant for membership in a joint
14 venture if exclusion would reduce the applicant's
15 effectiveness as a competitor, unless that exclusion could
16 be shown to be reasonably necessary to achieve efficiencies.

17 Well, the contrast between the two approaches is
18 what's to be proven and sort of what's the presumption.

19 My sense is it that a harmless exclusion should be
20 treated as harmless, even if you can't provide an efficiency
21 defense for it. That is to say, one could conclude -- I'm
22 not offering this is a conclusion. One could conclude that

1 have been our competitors, and now they want to join our
2 venture; no way.

3 Now, if that was the case, it's real hard to find
4 an efficiency defense. But in my view, that ought to be a
5 legitimate decision if it does not reduce, does not
6 appreciably reduce market competition.

7 I think to go the other way, to put the
8 presumption in favor of admission, makes sense only really
9 if you think that, as a general matter, refusal to admit a
10 new member tends to reduce competition. In light of the
11 importance of competition at the network level or among
12 joint ventures or between joint ventures and other firms, I
13 don't see how that presumption is justified.

14 In addition, I think it's not justified because
15 there are costs, potential competitive costs to having
16 over-broad joint ventures. I think to ignore that, that
17 traditional and proper concern, and to do that by saying,
18 it's a network, is unjustified.

19 To circle back to the point with which I began, if
20 you start with the presumption that because something's a
21 network, network economies are important; because network
22 economies are important, you're in a natural monopoly,
23 essential facilities situation. If you begin with that,
24 then, of course, there's no lost to admission because you're
25 dealing with essential facilities by assumption; and why

1 would you ever want the owners of an essential facilities to
2 be permitted to exclude?

3 But it doesn't follow that anything that is
4 properly labeled a network is a natural monopoly without
5 proof.

6 If there is proof, then admission should be
7 required and the difficult task of what is the price should

1 interesting and difficult things that can happen in
2 networks. That, I submit, does not really provide new
3 analytical tools to be used to deal with these old issues in
4 a network context. So I am forced to conservative
5 conclusions.

6 Thank you.

7 CHAIRMAN PITOFISKY: Well, thank you for an
8 exceptionally clear presentation on this.

9 What we have been doing the last couple of days is
10 maybe ask a clarifying or two but save discussion, including
11 discussion among the panelists, for a little later in the
12 morning or the afternoon.

13 Dick, let me make sure -- I believe I understand
14 that you're drawing a distinction between an essential
15 facility that's essential to the competitor. That's not
16 enough. It's got to be essential to competition. If it's
17 only essential to the competitor, that's your notion of a
18 harmless error.

19 But let's assume it's essential to competition,

1 but that's not a clear statement.

2 In principle, there's a balance called for, of
3 course. In practice, I think that's not likely to be
4 feasible unless it can be shown that competition is simply
5 not feasible.

6 Then it seems to me -- and that's a difficult
7 showing in this day and age, and I think it's very difficult
8 in these industries. I think to the extent there is a
9 traditional essential facilities doctrine that says, if
10 competition is feasible, if access to this facility is
11 essential for competition to occur, then, reluctantly,
12 painful, awkwardly, we must compel access.

13 So I would go that far. I think essential for a
14 competitor is not far enough.

15 CHAIRMAN PITOFSKY: Right.

16 Thank you.

17 Other questions?

18 Our next speaker is Roel Pieper, President and
19 Chief Executive Officer of UB Networks and a Senior Vice
20 President of UB Networks' parent company Tandem Computers.

21 UB Networks is one of the largest network
22 communications vendors worldwide and provides enterprise
23 organizations with ATM, Ethernet, and others.

24 Prior to joining UB, Mr. Pieper served as
25 President and CEO of UNIX Systems Laboratories. Before that

1 he spent 10 years at Software AG, both in Germany and the
2 U.S. There he served as Chief Technical Officer and Senior
3 Vice President of the Technology Division.

4 Mr. Pieper.

5 MR. PIEPER: I would like to make an attempt to
6 comment on the subject of networks probably more in a, what
7 have been called a "real network sense."

8 Having had the experience of the leadership of the
9 UNIX community, or the UNIX Operating System environment for
10 a number of years 1990 to 1993, I would say I have been
11 whipped into shape as to what real standards were and what
12 real standards weren't and, even more importantly, what real
13 processes were and what real processes weren't.

14 In that experience I detected that standards is
15 not about technology. It's actually about attitude, and I
16 want to explain that in the following way:

17 The opposite of "open" -- a lot of people make the
18 mistake that when you talk about open standards, a lot of
19 people make the mistake that think that the opposite of
20 "open" is "proprietary"; and actually the opposite of "open"
21 is "closed."

22 Whereas the opposite of "proprietary" is "public."
23 So if you would draw a quadrant between the opposites of
24 those determinations -- i.e., "open" and "closed" and
25 "public" and "private" -- you come to the conclusion that

1 the winning quadrant is "open" and "proprietary."

2 Now what does that mean?

3 That means that there must be some process by
4 which standards evolve and proprietary value continues to be
5 added. It must be a coexistence of proprietary evolution,
6 you know, fostered by competition or fostered by invention,
7 whatever that may be, off of the basis and process of at
8 least a base of common, open standards that are moving
9 ahead.

10 I concluded after those years leading the UNIX
11 community that to be successful creating a valid standard,
12 at the heart of the success lies the attitude of the
13 providers, not the technology itself.

14 Now I'll come back to that particular point with
15 regard to a number of activities that I'm currently trying
16 to sponsor outside of my business activities in Silicon
17 Valley and other places, partially also for the Dutch
18 Government. I'm a Dutch citizen, and I'm advising to a
19 certain extent on somewhat sort of similar issues.

1 and, obviously, effective products, effective in the sense
2 of functionality, price, et cetera.

3 We can debate if that process is going to be
4 successful or not, giving the experience that we have had,
5 in the operating system wars that have mostly, you know,
6 subsided.

7 I believe that the risk of convergence, again
8 around monopolistic standards that are driven through
9 economies of scale, vendor dominance, in the sense of
10 network functionalities, network capabilities, will, again,
11 be derived off of what I would say "undocumented features"
12 and "capabilities" similar as that has happened in the
13 operating system types of environment.

14 Again, there is no real difference -- and I agree

1 is composite of academia, business, and administration-type
2 of, let me say, managers, leaders, and executives.

3 And this group has made a statement towards each
4 other and to the Valley that their mission is going to be to
5 try to foster sharing of technologies, sharing of ideas, but
6 way ahead of actual product delivery to the market.

7 And around that concept, which I have been part of
8 the founding of, the very specific new project has been
9 founded; and I would like to maybe start with some foils to
10 try to come to that conclusion and then fold in some other
11 points that I believe are very relevant to how an
12 administration in general -- this is my personal opinion --
13 should behave with regard to the participation in this whole
14 standards process.

15 It might be a little controversial, and that's
16 okay.

1 effects and how one could address some of these issues,
2 again, just bringing forward some suggestions.

3 Let me first try to put into perspective some of
4 the things that have happened in the industry and that
5 continue to happen in the industry.

6 The conclusion that I make is that paper standards
7 will continue to fail if they are not tied to real-world
8 evolution and are not in sync largely because of the lack of
9 timing.

10 We've seen that with OSI. We have probably seen
11 that with things around the UNIX Operating System. And we
12 run the risk, again, of seeing that around the ATM
13 standards.

14 There is a continuous risk that the more formal
15 processes will be run over by the, let's say, exclusion of
16 other technologies in that environment and, you know,
17 typically short cuts by vendors of a particular nature could
18 be made.

19 There are clearly de facto standards that are
20 very, very important. I mentioned here in the network sense
21 TCP/IP. I mean if TCP/IP is not a pure example of how an
22 unnoticed technology can suddenly appear as a real market
23 standard and actually work and actually be a real
24 collaborative-type of technology, interesting risks though
25 that these kinds of standards might actually be subsumed by

1 economic volume leaders as their ownership going forward.
2 That's actually another risk that could happen, even after a
3 certain technology standard has been established.

4 There have been attempts of what I would call
5 blended standards, blended standards where there is both a
6 reality test as well as a paper compatibility test. And I
7 mentioned just a few, X/Open, in the early 80's. And OSF in
8 the mid 80's, and today, things like the ATM forum that you
9 might be familiar with.

10 I absolutely am convinced that the early movers
11 must be identified more by an organization like this Smart
12 Valley that I mentioned or others around the world or in the
13 U.S. By trying to bring these early movers, these early
14 innovators to an environment that you could call a
15 "collaboratory," a "reference lab," environments in which
16 these early moving parts are identified and exposed to the
17 fundamental question: Would sharing be better or not?

18 Sometimes sharing is not necessarily good for that
19 single vendor; but after some, let's say, social pressure,
20 public pressure there is the possibility -- and I've seen
21 that work -- that some of these moving technologies could
22 actually reach a much broader market with much more
23 capabilities for a number of companies to be, you know,
24 competitively and economically able to take advantage of a
25 broader set of standards that have been made available

1 through sharing of technology.

2 I think users, in general, have become much
3 smarter and much more active in qualifying and disqualifying
4 vendors through their behavior, not through their ability or
5 willingness to apply standards in their products that they
6 deliver but actually by their attitude. You see much more
7 vendors making buying decisions blended by both their
8 opinion of the attitude of the vendor as well as the, of
9 course, technical and pricing proficiency of the products
10 that are being offered.

11 At the same time, vendors have become much smarter
12 as well. The way that proprietary values and undocumented
13 capabilities are being hidden are getting substantially more
14 sophisticated.

15 So there is a real question as to who is moving
16 faster and smarter in the right direction.

17 I believe we can talk a lot about these standards
18 in trying to come up with the right processes to write these
19 things down to share them on paper, but my conclusion has
20 been that the only way to really expose the issues of real
21 working and collaboratory-type technologies, if it's a
22 database application, a multi-media application, a
23 telephony-based application, a set-top application, it is
24 through exposure in live collaboratory.

25 So my conclusion in the sense of standard

1 definition and evolution is that the only place where
2 standards and evolution can happen is in the real world, but
3 we must find a way that this collaborative-type of
4 environment is fostered by a number of different
5 organizations. And one I believe clearly has to be the
6 administration or government. So let me switch to that
7 point.

8 As I have done for the Dutch Government, maybe
9 contrary to some belief in the U.S., I believe that there is
10 almost a black and white decision only for an administration
11 to decide to engage or not.

12 When you engage -- and what I mean by that I'll
13 explain a little bit later -- but when you engage as an
14 administration to participate in the evolution of the market
15 process, you have no choice but to go all the way. There is
16 no middle ground. You must try to be on top of the issues.
17 You try to have the best technical people, the best business
18 people, the best economic people on board to try to
19 understand what's going on in the industry.

20 The other side, which you could call black or
21 white, is to not do anything at all; and you basically let
22 it go the way it goes, a market free for all.

23 A governing body -- and I'm just mentioning a few
24 of them. Obviously in the U.S., NIST, in Germany, Deutsche
25 Industry Norm, you know, there are different types of

1 examples of norming bodies and norming organizations that
2 could exist if they are powerful and knowledgeable and
3 active in the sense of participation, not controlling.

4 I believe that there is a possibility -- and we
5 are experimenting in Holland with that -- that there is a
6 possibility by having both government guidelines, academic
7 guidelines, and business guidelines to create an environment
8 in which sponsoring tax incentives, public academic and
9 business frameworks are created that are, in a way,
10 coexisting with the real-world market dynamics but within
which these newer technologies, the early mover

1 in the network sense that would allow better economies of
2 scale between different companies. I suggest, for example,
3 that the early notions of EDI, "electronic data
4 interchange," could evolve much more broadly and much more
5 efficiently if the business-to-business communication
6 procedures and processes could be done on the basis of much
7 more capability technologies that would be derived off of
8 network functionality, inventory matching, order processing,
9 customer administration -- I could go on and on and on -- a
10 lot of very valuable applications that can become very
11 effective through the usage of a network, let alone the
12 distribution of goods in general as another discussion of
13 value that a network could bring.

14 Let me talk about first mover and second mover
15 subjects for just a little bit. Again, I'm identifying here
16 some organizations. I'm labelling it NIST, but for me that
17 is not so relevant. It has to be some kind of organization
18 or some group of organizations that I believe need to be put
19 into light that really drives the definition, behavior of

1 pressure, whatever might apply.

2 The example that I would like to point to of some
3 of these concepts that is happening in the U.S. -- a similar
4 project is happening in Holland -- is called BAMTA. BAMTA
5 is the "Bay Area Multi-media Technology Alliance." It was
6 started by Smart Valley. There is about 50 organizations
7 that are participating in that, both from academic,
8 administrative, as well as from business entities.

9 It is also sponsored, to a large degree by NASA,
10 AMES, in which the role of NASA, in this particular case, is
11 both the, let's say, monitoring of attitude as well as the
12 pursuing of certain objectives with regard to standards and
13 evolution in the network sense, in this particular case for
14 the health care education subject.

15 This organization has been surprisingly successful
16 in trying to bring together technologies and ideas that I
17 had originally thought would be really kept close to the
18 vest by a whole bunch of different companies. And I'm

1 environment, these things did happen; and there was no
2 formal process for it other than this type of a, I would
3 call it, somewhat of a social economic pressure model.

4 Obviously these kinds of organizations cannot be a
5 singular one. There must be a whole number of these, and it
6 cannot clearly happen just from a nation point of view.
7 There must be very strong international coordination and
8 verification.

9 I believe that these things will happen within the
10 European Community. I believe the European Community has
11 another, let's say, organization forum that will try to
12 drive and foster examples of these kinds of collaboratory or
13 projects that would have that common theme of sharing or
14 collaborative technology of the early mover category.

15 Now, obviously, for second mover technologies, the
16 situation is a little different. Let me use the example of
17 TCP/IP. There is a substantial risk that TCP/IP will be
18 taken over by some organization that simply subsumes it and
19 makes it economically inclusive in other capabilities. And
20 so that's just one example. There are probably other
21 technologies that could be subsumed by economic leaders.

22 There must be, again, an environment in which some
23 of these evolutionary steps of new technologies that have to
24 be added to an existing environment, similar to some of the
25 joint venture ideas, that when a new party with some

1 value-added ideas is coming to the same place, the real
2 market, the real application, or the role
3 business-to-business communication environments, then we
4 should find a process by which these technologies can be
5 added. If that is not possible by normal collaboration
6 between the business entities, there should be adjacent
7 procedures in place, such as these collaboratories that I
talked about, where that kind of a problem or oicbus

1 The smartness, if you want to call it that, by
2 hiding proprietary capabilities and closing them is getting
3 pretty special.

4 I think by engaged behavior, not controlled
5 behavior, by engaged behavior, one could sponsor, through
6 tax incentives, project incentives, according to specific
7 guidelines. I want to mention here some ideas that I have
8 derived from having been both in Finland and Singapore. I
9 mention Finland and Singapore as some countries that have
10 taken a very rigorous step along these lines of what I would
11 call engaged behavior.

12 Let me take Singapore as one example. In
13 Singapore there are a whole range of tax incentives, of
14 model suggestions that are being put forward by the
15 administration of Singapore but are derived of a very clear
16 project and model that they call "IT 2000," which is their
17 model to create an infrastructure, a society infrastructure,
18 a business infrastructure in that, let's say, physical
19 territory called Singapore, where companies that follow
20 those guidelines, or at least stay within, you know, a
21 reasonable definition of those guidelines, are given
22 substantial incentives to stay within those rather than to
23 disregard them.

24 We can debate that that's good or bad behavior,
25 but it's at least a stab ahead by an administration to try

1 to create more commonality in the public services, in the
2 infrastructure services that are being offered indirectly or
3 directly through an administration in the country or region
4 that they are operating in.

5 I believe a norm, an effective norm -- maybe not a
6 standard -- can be set and can be evolved by this
7 collaborative process by academia, business, and
8 administration. And somebody will have to step up to a
9 leadership role in the form of not controlling but actively
10 guiding that collaborative process forward.

11 And, you know, as a final statement, I know that
12 this is not the easiest solution, and maybe it is one of
13 very, very few.

14 CHAIRMAN PITOFSKY: Thank you very much for some
15 very provocative and interesting ideas.

16 Our next speaker is someone who --

1 But I believe, especially if we starting to think
2 about the usage of networks both by administration as well
3 as by public entities, you know, going forward, there is
4 going to be more and more interaction, I believe, through
5 networks either for, you know, personal, citizen-type of
6 administration activities or business-to-business or
7 business-to-government communication activities through
8 networks. There would be a lot of advantages and economies
9 of scales if government would evolve as an organization
10 themselves the same way.

11 COMMISSIONER VARNEY: I'll hold my others
12 questions for later.

13 CHAIRMAN PITOFSKY: I'm sorry to say our next
14 speaker has lived in the real world in this question of
15 access, joint ventures, and so forth.

16 Christine Edwards is Executive Vice President,
17 General Counsel and Secretary of Dean Witter, Discover, the
18 parent company of Dean Witter Reynolds and NOVUS Credit
19 Services, Inc.

20 As General Counsel at Dean Witter Reynolds,
21 Ms. Edwards has responsibility for the legal and compliance
22 functions of the broker/dealer, mutual fund, and investment
23 banking businesses.

24 As general counsel for NOVUS, she has
25 responsibility for the legal function of the three NOVUS

1 businesses: Discover Card, Lending Services Division, and
2 SPS Transactions.

3 Welcome to the FTC.

4 Am I right in assuming that you have paid some
5 attention to the Discover/VISA-MasterCard controversy?

6 MS. EDWARDS: I have paid a little attention to
7 it, yes, Mr. Chairman.

8 Thank you and good morning.

9 First of all, I would like to start out by taking
10 note of the tremendous antitrust expertise resident on this
11 panel this morning and promptly exclude myself from that
12 description. Instead, I'm going to testify today from the
13 perspective of having been involved in the credit and charge
14 card industry for about 25 years now, which, of course,

1 position of dominance and collective market power.

2 The policy issues I'm going to pose this morning
3 arise from the fact that changes in marketing and processing
4 technology have created, for the first time, the opportunity
5 for non-association proprietary networks to provide the same
6 kinds of services as the two associations and to do so
7 equally, if not more, efficiently than the bankcard
8 associations.

9 But at a time when there is a real opportunity to
10 encourage efficiency proprietary networks, at a time when
11 there's a real question whether there is a need any longer
12 for the associations, the associations are aggressively
13 using their substantial incumbency advantages to impede
14 competition from proprietary networks. They are also
15 working to extend those advantages into new financial
16 products and services like the electronic delivery of home
17 banking services.

18 These developments, I believe, raise important
19 policy issues which I think can be summarized in a question:
20 How should antitrust enforcement respond when two
21 industry-wide charge card networks use their market power to
22 impede the entry and the growth of efficient, competing
23 proprietary networks?

24 How these issues are resolved will determine
25 structure and competitiveness of the charge card industry;

1 but perhaps more important is whether the bankcard
2 associations are going to be allowed to use their market
3 power to impede competitors in other emerging payment system
4 markets, affecting other areas of electronic commerce.

5 Similar issues will, no doubt, come up in other
6 industries. We've heard about them this morning. The
7 policy decisions you make regarding these issues, whether by
8 affirmative decisions or by inaction, will have a
9 significant impact elsewhere in the economy.

10 For these reason, I applaud the Commission, and
11 you, Mr. Chairman, for holding these far-ranging hearings
12 and taking seriously the observations of business people and
13 their counsel, along with academicians and other antitrust
14 professionals.

15 In the United States today, there are only two
16 models for charge card networks. One is represented by the
17 networks operated by the VISA and MasterCard. They were
18 formed about 25 years ago. Both are extremely broad joint
19 ventures with virtually identical memberships that include
20 almost every issuer of general purpose charge cards in the
21 United States.

22 And I use the term "bankcard" to refer to the
23 charge cards that are supported by the two association
24 networks.

25 Now the competitive dynamics between the two

1 associations are curious. Since almost all card issuers
2 belong to both associations, their members gain no
3 competitive advantages against other charge card issuers if

1 purpose credit card market. Our strategy was to pursue a
2 model like Citicorp, which at the time participated not only
3 in the VISA and MasterCard networks but also operated
4 several proprietary networks of its own, including Diners
5 Club and Carte Blanche.

6 We decided to enter the charge card market by
7 first launching a proprietary charge, which we did by
8 rolling out the Discover Card in late 1985. We faced
9 enormous barriers to entry of our new network.

10 We had to deal with the classic chicken-and-egg
11 problem. We sent eager, young salespeople, who probably
12 didn't know any better, out with the assignment of
13 persuading hundreds of thousands of merchants to accept a
14 card that not one cardholder held.

15 At the same time, we had to persuade millions of
16 consumers to accept a card that they didn't know whether
17 they could use it in with any merchant.

18 It was a high-risk strategy. And it is very
19 likely that without the substantial business credibility
20 that Sears and Dean Witter had built over the years, that
21 both merchants and consumes would not have accepted the
22 card.

23 But we were successful. But to achieve our
24 success, we had to overcome not only fair competitive
25 responses from existing competitors but also a variety of

1 efforts by the bankcard associations to prevent Discover
2 Card from having a chance to compete in the market at all.

For example, VISA orchestrated an elaborate

1 are we were building also has the capacity of supporting
2 NOVUS-marked cards that are issued by other firms.

3 But there are some very significant differences
4 between the association networks and proprietary networks.

5 First, the association networks enjoy huge
6 incumbency advantages. Thousands of banks promote VISA and
7 MasterCard brands. And most merchants feel that they must,
8 as a practical matter, accept those cards.

9 Second, proprietary networks are simpler to
10 operate. And changes in marketing and processing technology
11 are making it possible for proprietary networks to compete
12 with increasing efficiency against the association networks.
13 Now that wasn't always true.

14 The industry has dramatically changed since when
15 the associations were formed. Banks have been permitted to
16 expand geographically. They have become more willing to
17 compete nationally. Credit cards are marketed across the
18 country by banks with no local presents. Transaction
19 processing is almost entirely electronic with no local
20 presence required. And firms with enormous resources, such
21 as General Motors and AT&T have entered the charge card
22 market either individually or in combination with other
23 firms.

24 If the industry were first coming into existence
25 today, there would probably be no need for networks operated

1 by giant industry-wide ventures like VISA and MasterCard. A
2 series of interlinked proprietary networks and processors
3 could perform the same services equally, if not more
4 efficiently.

5 You don't have to look farther than the Internet
6 for an example of how unnecessary a huge central clearing
7 house is today for the operation of an efficient,
8 electronically based network.

9 Third, in studying these industry changes, you

1 proprietary networks like ours.

2 At the beginning of the tape, she refers to a tape
3 which was just shown to all of their bank members featuring
4 Claude Aikens who was an actor. He is now deceased.

5 The video was shown to all association members
6 during the course of that year and was basically indicating
7 to banks that they should go to their merchants and tell
8 them not to accept Discover Card.

9 Let me show you the video.

10 (Whereupon a videotape provided by Ms. Edwards was
11 played.)

12 "Meeting the challenge of Discover"

13 "Copyright, August 1982"

14 "Presented by VISA S.A., Inc."

15 "John Bennett, Senior Vice President, Consumer
16 Products"

1 been made over the years in the VISA program.

2 "It's important for all of us to keep in mind that
3 Discover has not succeeded to date and that we're in the
4 position of strength. We have 150 million cardholders
5 worldwide; we have five million merchants on a worldwide
6 basis.

7 "And by working together and by being proactive,
8 rather than reactive, I think we can thwart the efforts not
9 only of Sears but of other outside competitors. And we can
10 develop a very effective means to compete.

11 "It's important that we not do anything in the
12 process to give away or dilute our market advantage.

13 "If we're successful in responding to Sears, than
14 other non-bank competitors, who are likely sitting on the
15 sidelines, will think again when they try to follow Sears'
16 lead.

17 "If we aren't successful, then there are going to
18 be many more "Discovers" that we're going to be hearing
19 about in coming years. And all of them are going to be
20 looking for a share of your business and your profits.

21 "Remember, it's not likely that Discover is going
22 to create new business. They're out to take away your

1 that proprietary alternatives like the NOVUS Network are a
2 potential competitive threat to their dominance that must be
3 suppressed.

4 And they have a variety of actions, first, to
5 impede the growth and development of networks that already
6 exist and, second, to deter the formation of new ones.

7 Let me give you a few examples.

8 VISA bylaw 2.10(e), which is not the bylaw that we
9 challenged several years ago, automatically terminates the
10 membership of any VISA issuer that begins to issue a card,
11 quote, "deemed to be competitive" with VISA cards.

12 VISA applies this rule only to Dean Witter and
13 American Express networks and not to VISA membership
14 participation in MasterCard or to Citicorp's Diner Club and
15 Carte Blanche program.

16 The punitive effect of this rule is clear: No
17 VISA member is likely to even consider signing onto a
18 proprietary network at the cost of automatic loss of its
19 ability to issue VISA cards.

20 The impact was very deliberate. When VISA's board
21 adopted the first version of this rule, the board asked
22 VISA's management to draw up a list of all of the non-bank
23 firms that had the capacity to introduce a competing
24 network.

25 The resulting list named more than 100 non-bank

1 firms, including General Motors, Ford, Chrysler, Shell Oil,
2 Amoco, and AT&T. The VISA board then instructed VISA's
3 management to monitor all of these firms, many of which were
4 then VISA members, and to expel or exclude them from VISA if
5 they actually began issuing proprietary cards.

6 Many of those firms were not, then, issuing cards;
7 but they have since entered the market. And not
8 unsurprising, in light of VISA's bylaw, a single one of them
9 have come forward which a proprietary card program.

10 Another example relates to processing charge card
11 transactions for merchants. In order to build a merchant
12 base for the NOVUS Network, it's been extremely important
13 that we offer merchants, particularly smaller ones,
14 cost-effective processing for their charge card
15 transactions. But merchants have no interest in a processor
16 who can't also process their VISA and MasterCard
17 transactions.

18 VISA has adopted rules that are designed to
19 prevent Dean Witter and American Express from efficiently
20 offering bankcard transaction processing. This has limited
21 our ability to achieve maximum efficiency and limited the
22 growth of our network.

23 Bankcard associations which account for 76 percent
24 of all transaction volume engage in standard setting.
25 Because of the associations' overwhelming market dominance,

1 these standards drive the market.

2 Our technology and our ability to change must be
3 nimble enough to comply with the standards that they have
4 set. We don't even have a seat at the table on the
5 discussions on standards. The recent VISA-Microsoft
6 discussions about setting security standards for
7 transactions over the Internet are a good example of that.

8 A final example is one that I find particularly
9 troubling. I start from the perspective that VISA has been
10 quite careful over the years to describe itself as a joint
11 venture association, only engaging in activities on behalf
12 and for the direct benefit of its members.

13 But VISA recently announced a for-profit merchant
14 processing joint venture with Total Systems Services Inc.

15 The significance of that announcement is that VISA
16 will be directly competing in a for-profit corporation with
17 its members in the marketplace at the same level as others
18 who do business with its network.

19 Now, with VISA's simultaneous role in setting
20 industry rules and standards, this is a development I think
21 that deserves careful attention in a part of this market
22 that Commissioner Varney recently described as "increasingly
23 concentrated."

24 Bankcard associations are also working to capture
25 other payment system markets, including on- and off-line

1 debit cards, stored value cards, Internet commerce, and the
2 new and potentially huge market for electronic delivery of
3 retail banking services to the home.

4 In some cases they are clearly leveraging their
5 market power with respect to charge cards in these new
6 markets.

7 Now, the facts that I have described this morning
8 raise several important antitrust enforcement policy issues,
9 I believe.

10 The goal of antitrust enforcement, I think, should
11 be to foster increased efficiency and innovation through
12 unfettered competition.

13 This kind of competition will occur only if the
14 activities of the two bankcard joint ventures that dominate
15 the industry are actively monitored.

16 This is the opposite, I think, of the hands-off
17 antitrust treatment that VISA advocates, but I believe it's
18 justified by the competitive landscape of this industry.

19 Antitrust enforcement should monitor association
20 practices like those that I have described this morning that
21 are designed to disadvantage proprietary network
22 competitors.

23 Antitrust enforcement should also be prepared to
24 challenge each new area of association activity. The
25 bankcard associations are antitrust anomalies. They are

1 extraordinarily large joint ventures of competitors, cutting
2 across virtually an entire industry.

3 Antitrust policy, I thought has always strongly
4 disfavored collective competitor activity of this magnitude
5 unless it can be justified by compelling efficiencies. At
6 the dawn of the general purpose charge card industry,
7 legitimate efficiency justifications probably existed for
8 the scale and scope of the bankcard associations. But
9 should historical fact also dictate the appropriateness of
10 the associations moving into new activities today?

11 We believe expansion of the activities of these
12 joint ventures should receive precisely the same searching
13 scrutiny as would the formation of a new joint venture to
14 engage in the same activities.

15 I believe it would be prudent antitrust policy for
16 the enforcement agencies to actively discourage the VISA and
17 MasterCard associations from engaging in any new activities.

18 If there are efficiencies that necessitate joint
19 activity in order, for example, for the debit card market to
20 develop or for home banking to take off or for health care
21 provider reimbursement processings to succeed, let
22 appropriately scaled new joint ventures to be formed. If
23 not and if individual companies can be compete efficiently,
24 then let they do to. But bankcard association joint
25 ventures should not be permitted to quietly take the market

1 power that they have achieved in the charge card industry
2 and parlay it into similar power in entirely new areas.

3 Only one significant, proprietary network has
4 entered the charge card market in over 35 thanks largely to
5 the bankcard associations. Antitrust review should not
6 permit them to have the same stifling effect in other
7 markets.

8 I also think that bankcard associations should be
9 prohibited from engaging directly in for-profit activities.
10 Their central rulemaking and standard setting role, coupled
11 with their market power, creates far too much risk of the
12 associations' leveraging their not-for-profit activities
13 into an unfair competitive advantage in their related
14 for-profit businesses.

15 At approach that antitrust takes to the bankcard
16 associations and their networks will have a critical impact
17 on the industry's competitive landscape.

18 The business people who I advise will make
19 decisions about where they take the NOVUS Network based on
20 their assessment of the legal ground rules under which they
21 and the bankcard networks will be operating.

22 But the same will be true for anyone else who
23 considers a business challenge to the bankcard networks.
24 This is an industry in which antitrust policy will influence
25 real investment decisions, decisions that will determine the

1 intensity and the innovation of the competition in the
2 future competitive structure of the charge card market.

3 A structure today is clearly far from optimal. We
4 do not ask you to prejudge the outcome of free competition
5 between bankcard associations and their competitors. We
6 only ask for the opportunity to have the market, not the
7 associations, decide that outcome.

8 Let me close by relating what I have said this
9 morning to the specific questions that you posed on the
10 agenda for this morning's session.

11 Networks, particularly ones operated by joint
12 venture that encompass virtually an entire industry, as the
13 bankcard associations do, very definitely can give rise to
14 opportunity for strategic anti-competitive conduct.

15 Jointly owned networks can amass a substantial
16 market power and can use it to prevent the entry and growth
17 of new competitors who want to offer more efficient network
18 processing by taking advantage of technological innovation.

19 As for the criterion assessing whether strategic
20 conduct and industry standard setting are pro-competitive or
21 anti-competitive, I believe it continues to be traditional
22 fact-specific inquiry: Does the conduct in question
23 increase the efficiency of the parties that engage in it?
24 Or is its primary purpose and effect to reduce the intensity
25 of competition among themselves and from others?

1 The bankcard association conduct that I've
2 described this morning I think clearly fails that test.
3 That's why I think it deserves your attention.

4 I thank you for the opportunity to testify this
5 morning, and I appreciate the efforts of the Commission to
6 examine these issues.

7 CHAIRMAN PITOFSKY: Well, thank you very much for
8 directing our attention so forcefully to a real-world
9 controversy that relates to these theoretical issues.

10 Let me just ask one question to make sure we set
11 the stage for our later discussion and to make sure we
12 understand that there is a real difference view here.

13 Let me recall Professor Schmalensee's earlier
14 comments. His thought was that where there is a successful
15 joint venture, access is only mandated where it's essential
16 for competition.

17 Discover was already in the market and competing
18 rather successfully in that market. So without trying to
19 decide which is right or wrong or what the policy issues
20 are, you would be urging a broader view of mandatory access
21 than one that says it only is required where essential to
22 competition?

23 MS. EDWARDS: Actually, first of all let me start
24 out by answering that question by observing that, to begin
25 with, we did not use an essential facility argument in our

1 case against VISA.

2 Second, I think that although the bankcard
3 associations do exhibit many of the qualities of an
4 essential facility, we were very careful this morning in
5 putting together our testimony in not dealing with issues of
6 membership.

7 Instead, I think what we attempted to do is look
8 at competition from the network's perspective and look at
9 future issues that we think the enforcement agencies should
10 be focusing on there in terms of competition between
11 networks of the bankcards versus proprietary networks.

12 If what you're addressing by the essential
13 facilities doctrine is actual membership, those are issues I
14 think we tried to effectively battle before and have lost;
15 and those are previous battles.

16 CHAIRMAN PITOFSKY: I see. All right. Good.
17 Good.

18 Any other comments or questions?

19 All right. Let's have one more presentation, and
20 then we can take a break and open it up for a broader
21 discussion.

22 Amy Marasco is Vice President and General Counsel
23 of American National Standards Institute, ANSI. She is
24 primarily responsible for overseeing ANSI's Procedures and
25 Standards Administration Department which provides support

1 to the Board of Standards Review, the Executive Standards
2 Council, and the Appeals Board.

3 Ms. Marasco also assists those bodies in
4 formulating and implementing policies and procedures
5 regarding the accreditation of standards developers and
6 standards development process.

7 Before joining ANSI in July 1994, Ms. Marasco was
8 an attorney with a law firm in New York for 11 years.

9 Ms. Marasco.

10 MS. MARASCO: Thank you, Mr. Chairman. Good
11 morning.

12 My name is Amy Marasco, and I am the Vice
13 President and General Counsel of the American National
14 Standards Institute, which is usually referred to by its
15 acronym ANSI.

16 ANSI is a federation of industry, professional,
17 technical, trade, labor, consumer, and academic
18 organizations and some 40 government agencies.

19 I will focus my comments today on two more general
20 issues than those relating to networks.

21 The first being: How should enforcement agencies
22 and the courts approach the voluntary consensus standards
23 development process to determine whether impermissible
24 anti-competitive conduct is present?

25 And, second: What is or should be the process by

1 which patented technology is incorporate into standards?

2 And this will lead me to some brief comments on
3 the proposed consent decree in FTC v. Dell Computer
4 Corporation.

5 The benefits and pro-competitive effects of
6 voluntary standards are not in dispute. Standards do
7 everything from solving issues of product compatibility to
8 addressing consumer safety and health concerns.

9 The standards also allow for the systemic
10 elimination of non-value added product differences, reduce
11 costs, and often simplify product development. They also
12 are a fundamental building block in international trade.

13 That is why the rule of reason, typically, is
14 applied to standards activities. Weighing positive effects
15 against anti-competitive ones, however, is not always easy
16 to do.

17 One of the principle difficulties confronted by
18 enforcement agencies and the courts when applying the rule
19 of reason to standardization activities is that any cost
20 benefit analysis or consideration of possible alternative
21 standards often requires a technical expertise that these
22 bodies normally admittedly lack.

23 ANSI's view is that the best alternative is to
24 leave the resolution of technical issues to the experts who
25 participate in the standards development process and focus,

1 instead, on the process itself.

2 Focusing on the process also has the benefit of
3 being easier for courts and enforcement agencies to analyze;
4 providing clearer guidance to the business community; and
5 the process can be designed and, if necessary, to modify, if
6 not eliminate, the possibility of anti-competitive activity.

7 This has been ANSI's approach, and we believe it
8 has been effective. In its role as the accreditor of U.S.
9 standards developing organizations, ANSI seeks to further
10 the integrity of the standards development process and to
11 determine whether candidate standards meet the necessary
12 criteria to become American National Standards.

13 ANSI approval of these standards is intended to
14 verify that the principles of openness and due process have
15 been followed and that a consensus of all interested parties
16 has been reached. These requirements ensure that the
17 playing field for standards development is a level one.

18 Standards are market driven. If a standard is
19 developed according to ANSI requirements, there should be
20 sufficient evidence that the standard has the substantive
21 reasonable basis for its existence and that it meets the
22 needs of producers, users, and other interest groups.

23 Is the ANSI system absolutely foolproof? The
24 answer is no. But it offers several advantages to other
25 methods when evaluating whether anti-competitive activity is

1 present in the standards development process.

2 First, it only requires a procedural and
3 process-based review and not a dissection of the technical
4 merits of the standard. We agree that due process in and of
5 itself is and never can be a complete defense to an
6 antitrust claim. However, the value of an open system and

1 incorporated into a standard?

2 The issue is this seemingly incongruous marriage
3 between what is essentially a government-granted monopoly
4 and a standard which is often viewed as a public good.

5 In place of wedding vows, ANSI has developed and
6 implemented a patent policy. The ANSI patent policy
7 encourages early disclosure of patent rights that may be
8 implicated by a proposed standard. And it requires that the
9 patent holder supply to ANSI a written assurance that either
10 it will license the technology to would-be users for free or
11 that it would license the technology on reasonable and
12 non-discriminatory terms.

13 Very often this occurs before the standard is
14 completed. Otherwise, it is requested as soon as the patent
15 right at issue is discovered.

16 ISO and IEC, the two principal, non-treaty
17 international standards organizations, of which ANSI is the
18 U.S. member body, have a similar patent policy that applies
19 to international standards.

20 This brings me to the FTC's proposed consent order
21 with Dell Computer Corporation. By way of the background,
22 for those not familiar with this matter, the FTC filed a
23 complaint against Dell because a Dell engineer participated
24 on a VESA, which stands for Video Electronics Standards
25 Association, Standards Development Committee, which, by the

1 way, is not ANSI accredited.

2 When asked, the engineer stated that he had no
3 knowledge of any Dell patents that would be implicated by
4 the standard under development. After the standard was
5 finalized and in widespread use, Dell began asserting patent
6 rights against users of the standard.

7 In paragraph 4 of the proposed consent order
8 between the FTC and Dell, Dell would have to license its
9 technology for free if it, quote: "Intentionally failed to
10 disclose," its patent rights in response to an inquiry from
11 a standards setting body.

12 I would like to emphasis the word "intentionally."
13 ANSI absolutely agrees with the Dell consent agreement to
14 the extent it applies to situations when a participant in
15 the standards development process intentionally and
16 deliberately fails to disclose that his or her organization
17 holds a patent relating to the standard in question in an
18 attempt to gain an unfair competitive advantage. This would
19 violate ANSI's and ISO's and IEC 's patent policies as well.

20 What is possibly of more concern to us is
21 paragraph 5 of the consent order. That paragraph appears to
22 impose some sort of duty on Dell to set up a mechanism to
23 check whether or not it has any patents implicated by a
24 standard under development in order to disclose those
25 interests prior to the standard's completion.

1 In essence, the consent agreement could set a
2 precedent to the effect that the corporate representatives
3 participating in the development of a standard are under an
4 affirmative duty to exhaustively review their patent
5 portfolio and disclose their company's patent rights before
6 the standard is finalized or be required to license their
7 technology for free.

8 Unintentional failure to disclose a patent right
9 would be treated the same as an intentional one.

10 First, as a practical, matter, some companies
11 would find this affirmative duty to identify all possibly
12 applicable patents virtually impossible to fulfill. Many
13 U.S. participants, at any given moment, of literally
14 hundreds of employees, participating in as many standards
15 development activities and in excess of 10,000 in their
16 intellectual property portfolio. Often the implication of a
17 specific patent in connection with the portion of a very
18 complicated standard is not easy to determine or to
19 evaluate.

20 These companies often have invested billions of
21 dollars in research and development in order to develop this
22 portfolio. By requiring them to assume an enormous research
23 burden each time they participate in a standards development
24 process, these companies may effectively be denied the
25 opportunity to participate in that process for fear of

1 making their intellectual property a public good.

2 This would be unfortunate in that we all benefit
3 when what the experts decide is the best technology is
4 incorporated into standards and what was once available

1 pursued and which have been repeatedly and successfully
2 prevented from becoming a requirement in the international
3 standards arena.

4 For example, a few years ago, the European
5 Telecommunications Standards Institute, or ETSI, proposed an
6 intellectual property policy that many U.S. businesses
7 believed to be coercive; and it became the subject of a
8 trade dispute between the European Community and the United
9 States.

10 The plan was that ETSI would announce a one-page
11 work program when it undertook a new standards development
12 project; and if a member did not quickly disclose any
13 possible patent rights, then the patent would be deemed
14 automatically licensed on terms that were, in effect,
15 acceptable to ETSI.

16 The U.S. Government, working with ANSI and the
17 U.S. industry, was successful in preventing the ETSI policy
18 from becoming a reality.

19 In the global marketplace, there have been and
20 continue to be efforts such as ETSI's to establish a process
21 to facilitate what some would call a technology grab of U.S.
22 intellectual property in an effort to reduce or eliminate
23 any competitive advantage the U.S. enjoys as a result of its
24 collective intellectual property portfolio.

25 ANSI would caution the FTC from enunciating any

1 "disclose it or loose it" policy that competitors in other
2 nations could then point to as a reason why the U.S. should
3 accept a similar condition for participating in the global
4 marketplace.

5 Thank you very much. I appreciate this
6 opportunity to comment on these issues, and I am very
7 willing to provide additional information upon request
8 and/or receive any input from the FTC on what we at ANSI can
9 do to address anti-competitive concerns or issues as they
10 relate to the voluntary consensus standards development
11 process.

12 CHAIRMAN PITOFSKY: Thank you very much for
13 participating here.

14 Let's take about a 10-minutes break; and then we
15 can begin by opening things up to questions, comments,
16 exchanges among panelists. And then we will go on with
17 other presentations.

18 (Whereupon, a brief recess was taken.)

19 COMMISSIONER VARNEY: Why don't we take a little
20 bit of time just to talk about what we've heard this morning
21 before we do some further presentations.

22 I would like to start by asking Professor
23 Schmalensee what you thought of a couple of the
24 presentations, particularly what we heard from Merrill Lynch
25 and from Roel Pieper.

1 MS. EDWARDS: Dean Witter.

2 COMMISSIONER VARNEY: Dean Witter. I'm sorry.
3 I'm not feeling too well today, Christine. I really
4 apologize.

5 MS. EDWARDS: It happens all the time.

6 COMMISSIONER VARNEY: Dean Witter.

7 MR. SCHMALENSEE: Mr. Pieper raised a number of
8 issues that I confess I haven't thought a lot about. I
9 understand both the utility and the frequency of relatively
10 informal discussions among actual or potential competitors
11 about evolving standards in high-tech industries. It
12 happens in a variety of settings. It clearly has values.
13 There are clearly risks posed by it. And I don't have any
14 particular constructive thoughts to add.

15 MS. VALENTINE: Actually, maybe to focus that a
16 little more, one thing we did here yesterday in a telecom
17 and computer context was that, if a firm or a competitor is
18 required to disclose relatively early on in the process
19 standards or technology or interfaces -- they're not
20 standards yet, technology or interfaces -- that this leads
21 to a real dully of incentives for innovation --

22 MR. SCHMALENSEE: Well, I think that's right.

23 MS. VALENTINE: -- and that's, I suppose, one
24 issue.

25 MR. SCHMALENSEE: It's the question of what does

1 "require" mean?

2 And if I understood Mr. Pieper correctly, he's
3 dealing with a situation in part in which you have standards
4 and technologies that need to interoperate; and so I have a
5 reason to disclose the way I'm thinking because I'd like you
6 to be thinking in a way that will work with what I'm
7 thinking.

8 That's a little different from a situation in
9 which you have a set of competitors that are all, as it
10 were, head to head and you're requiring early disclosure.

11 I don't have any particular informed thoughts to
12 offer. But I do think that distinction is worth keeping in
13 mind. If I have to interoperate, then preventing people
14 from talking has high costs.

15 I mean, despite the fact that there are
16 difficulties between them from time to time, Microsoft and
17 Novell have a variety of technical communications and have
18 had over the years and has noted this publicly and
19 privately, because their systems need to operate. And to
20 prohibit that has high cost. To have too much of it also
21 has potential risks.

22 I disagree with less of Ms. Edwards' than one
23 might think. She said relatively little about membership,
24 and I don't have a whole lot to say, except I would remind
25 us all that the lack of competition between VISA and

1 MasterCard, to which she point, is a result of an
2 antitrust-induced shotgun wedding between the members of the
3 two associations.

4 And it, I think, illustrates perfectly the notion
5 that exclusion isn't always anti-competitive. If VISA had
6 been able to exclude MasterCard issuers, arguably, we would
7 have today two competing bankcard associations instead of
8 two associations that do compete to some extent but are
9 surely not independent competitive entities.

10 On the hole question on the kinds of conduct that
11 she described, I don't have any particular to say about the
12 joint marketing. There are issues involved in, is it
13 appropriate to market collective since they have marketed --
14 done marketing collectively, the notion that you would have
15 a meeting of members of an association faced with an entrant
16 that wouldn't discuss the entrant and competing against it I
17 find a little far-fetched.

18 But I think the issue of principal on which she
19 and I do agree and that potentially looks at the new
20 activities, there are two.

21 First is that a joint venture, association,
22 whatever, that has such wide coverage in an industry that
23 its operations are properly subject to closely antitrust
24 scrutiny. I don't think there's any plausible grounds for a
25 claim of immunity. It's collective action by a large

1 fraction of an industry that is properly a subject of
2 concern.

3 And the second is -- and I hadn't thought of it
4 until she mentioned it, but on first blush it strikes me as
5 an appropriate notion -- that a significant change in the
6 scope of a joint venture ought to be thought of like a new
7 joint venture.

8 As to the particular incidents involving terminals
9 and standards and new enterprises, I'm simply don't -- I'm
10 not familiar with them. I'm not here to defend VISA. And I
11 don't have any thoughts on those factual matters. But on
12 the principles, I don't think we -- at least as to
13 operations, we don't differ dramatically.

 COMMISSIONER VARNEY: Okay. Before I turn to my

1 East Asian models that seem to have extensive government
2 involvement, and I find that troubling partly because I have
3 yet to see any effective software or advancements coming out
4 of these models and, therefore, to use them as guides for
5 what we should be doing in the United States is somewhat
6 nerve-racking to me.

7 I think that obviously there are circumstances in
8 which government participation is desirable when we are
9 talking about substantial market failure. But even there,
10 after the initial seeding of the ground, it strikes me,
11 again, that it's much more desirable to rely on private
12 incentives, whether cooperatively or individually, to
13 promote future development.

14 I think that there are dangers through government
15 participation leading to uniformity, leading to the use of
16 federal government funds for projects that may or may not be
17 wise; and, in the end, I think we would end up with less
18 competition, less progress, and less development than we
19 would if we had simply relied, to the maximum extent
20 possible, on private incentives.

21 I must say that I found his four-part model of the
22 standards to be extremely useful in thinking about
23 developments. And there are very few boxes that I would
24 think that "public" and "open" is the right box. I think
25 most of the right boxes that contain anything that is really

1 on people's agendas are probably in the three other ones.

2 So the dangers that I think arise is when there is
3 a decision to move either horizontally or vertically amongst
4 these boxes because that changes the playing field and
5 creates the kind of competitive concerns that we have heard
6 expressed in many other forums. I will probably talk about
7 it a little bit more later on.

8 But the idea of box is really superb and I think
9 that it will help a lot of people organize their thinking
10 about the standard-setting processes and how to structure
11 antitrust and public policy around them.

12 COMMISSIONER VARNEY: Yes.

13 MR. PIEPER: Maybe I could just quickly answer
14 that. Obviously, my statement with regard to how much and
15 how government interaction and participation should happen
16 is not an easy subject, and I'm fully aware of that.

17 I believe that by participation and engagement, as
18 I described it, of both business, academia, and government
19 administrative, local, federal or state, I believe one will
20 arrive at capabilities both within the business environment
21 as well as in the administration environment, because in the
22 end administrative functions and organizations are as much a
23 company in the sense of procedures and activities as a
24 normal company in its administrative processes.

25 So I believe there is a lot of value if there is

1 active participation as to how much the government should be
2 engaged in setting more harness-like or dulling effect-like
3 guidelines. I mean obviously that should work its way out
4 by having enough of a balance between both academia and
5 business participation in this collaborative-type of
6 environment that I described.

7 The examples that I used the -- and I can make
8 them a little bit more specific. For example the
9 administration in Finland made a very strong suggestion both
10 to business and academia that they wanted to be the leading
11 country by providing the best ATM network infrastructure to
12 business in general. And they provided tax incentives.
13 They provided funding projects, examples, et cetera, et
14 cetera. They did not necessarily influence the standard.
15 They did not necessarily influence what was being built.

16 But they did force a particular, let's say,
17 momentum that I think is going to be -- in that particular
18 case is going to be very beneficial for that country. And
19 I'm just using it as one example where active government
20 engagement -- maybe not control and maybe not direction --
21 did create a much higher momentum in that particular example
22 of ATM connectivity for businesses that is not found
23 anywhere in the world.

24 COMMISSIONER VARNEY: Okay. Let me start down on
25 this end of the table, and we'll work our way up

1 Becky.

2 MS. BURR: Mr. Pieper, one of the things that we
3 heard in a slightly different context over the last few
4 weeks is that the capital formation industry is increasingly
5 requiring a strong, well-protected, proprietary system. And
6 one of the questions I had for you is: How is the capital
7 formation industry responding to the kind of collaboration,
8 early collaboration that you're talking about?

9 Is there participation from the venture
10 capitalists, for example? And is the desire to have a
11 locked-out, protected technology interfering with the
12 collaboration process?

13 MR. PIEPER: Well, being in Silicon Valley, I
14 would say that almost anything that you do, either overtly
15 or not, will be shared by venture capitalist in some form
16 anyway. There is not a lot you can hide in Silicon Valley.

17 But I would say that, given the role of the size
18 and dominance of the companies like Microsoft and Intel,
19 that most of the activities today, both with regard to
20 computing and networking, get a lot of support of the those
21 organizations in the sense that people are trying to, one,
22 find new ways to create a more level playing field. The
23 Internet clearly is a space where there is a wide open door
24 at the moment to escape some of the current monopolies in
25 place of Microsoft and Intel. And there's an enormous

1 amount of money rushing into that space.

2 At the same time, there's a big concern that
3 effective applications, networked applications, multi-media
4 applications -- and what I mean by "effective" actually
5 working together, actually, you know, usefully communicating
6 and transmitting data, images, voice and text -- if they are
7 not created, that will also die. You know, it will peak up
8 and then it will come down again because it simply will not
9 work together.

10 So that's why this collaborative perspective is
11 really focused on making that networked application
12 environment, for whatever business, work. And there's a lot
13 of investment going into that space by private and public
14 financial institutions.

15 MR. COHEN: I have a question for Professor
16 Schmalensee and perhaps anybody else on the panel who would
17 like to join in.

18 I understand you made the point that existing
19 economic theory of narrowsense networks doesn't provide much
20 in the way of general rules for antitrust policy.

21 But at the same time, I would ask you to try to
22 shift your point of view a little bit and suppose that you
23 are controlling or allocating antitrust enforcement
24 resources and you do find an industry in which there's a
25 presence of very strong network effects, does that suggest

1 to you any particular practices at which you would want to
2 take a particularly close look?

3 MR. SCHMALENSEE: One of the ways you might come
4 to the conclusion that there were such strong effects would
5 be the emergence of a highly concentrated structure,
6 particularly the emergence of what might be characterized as
7 a dominant seller.

8 It seems to me -- if one has an industry that has
9 a fragmented structure, then one is reaching to conclude
10 that there are strong -- one is reaching to conclude that
11 there are strong network effects.

12 So if you have an industry with a dominant firm,
13 let us say, that can be properly characterized, worry about
14 the usual things you worry about in a dominant firm
15 industry. You worry about exclusionary strategies. Now, it
16 may be that because the network -- because the industry has
17 network characteristics that there are particular strategies
18 that are attractive because of the nature of the business.

19 But it seems to me the basic question, what do I
20 worry about when I see a dominant firm, doesn't depend on
21 there being a network. You can worry about a dominant
22 vendor of sand, or you can worry about dominant vendor of
23 operating systems. In both cases, your initial worry is
24 exclusion. The strategies you look at depend on the nature
25 of the network, what's available. They may have to do with

1 standards. They have to do with pricing. They may have to
2 do with whatever.

3 And I don't think there is an answer that goes
4 across all networks. I think it depends on the fact of the
5 business. When somebody charges that Strategy X is

1 is an important way in which markets differ. It is an
2 important way in which some network industries differ from
3 some non-network industries. And you have to think about
4 it.

5 But, again, I don't think that -- some industries
6 that have a high degree of innovation also are marked by the
7 importance of patents. Some industries that have a high
8 degree of innovation, patents don't play an important role.
9 How you think about those two industries and a variety of
10 issues would be different.

11 So, again, I don't think there is a simple, single
12 answer that covers innovation. But where it's there, its
13 implications have to be addressed.

14 COMMISSIONER VARNEY: Professor Teece, do you have
15 a comment on that, or do you want to wait for your
16 presentation?

17 MR. TEECE: I'll wait.

18 COMMISSIONER VARNEY: Okay.

19 You had a question, didn't you?

20 MR. ANTALICS: Yeah. I had a question for Amy
21 Marasco.

22 COMMISSIONER VARNEY: Okay. Go ahead.

23 MR. ANTALICS: Relating to the negligence aspects
24 of your comments with respect to standard setting, would
25 your opinion on the burden change if the company simply had

1 the option of not making the certification on behalf of the
2 corporation as to a patent right?

3 And also, I guess, would your opinion change if
4 that standard ultimately became the dominant standard in the
5 industry so that the choice, then, is between the company
6 that made the mistake and consumers that are ultimately
7 going to have to pay the price?

8 MS. MARASCO: Well, I do believe that most
9 companies want to disclose their patent rights. There's a

1 self-policing that you'd find out about it because some
2 competitors would say, this is unfair, for these various
3 reasons, or there is some severe anti-competitive effect.

4 So I would agree with that.

5 COMMISSIONER VARNEY: Okay. Jonathan.

6 MR. BAKER: My question is for Professor
7 Schmalensee and anyone else who might be interested in it.

8 Suppose we went down the road of identifying, in
9 an industry with big network externalities and sort of
10 national monopoly properties, a problem that, where access
11 to the natural monopoly facility somehow seemed essential
12 for competition and we decided that we decided that we would
13 seek mandatory access or interconnection of some sort.

14 Should we worry, in that sort of case, that the --
15 about the possibility that the market which had chosen the
16 standard or whatever, which had given them the natural
monopoly in the first place, that the market had tipped to

1 enforcement agencies should be constantly worried about a
2 range of things.

3 But I guess that one strikes me, in the situation
4 you described, as not something at least that it's
5 productive to lose sleep over. You hypothesized a situation
6 in which access in one form or another to the network is
7 important for there to be effective competition.

8 And the situation -- that is one in which you want
9 to compel access perhaps by standards and open architecture
10 or something like that or perhaps by forced membership or
11 depending on what's happening.

12 There will still be an incentive for someone to
13 supplant the network. We always tend to think of natural
14 monopoly or network-based monopolies or near monopolies as
15 things that endure. Henry Ford's Model T lasted a lot
16 longer than Word Star.

17 Should the antitrust agencies had been worried
18 that the economy had tipped to the wrong cheap black car?
19 Well, I suppose; but what are you going to do about it,
20 productively?

21 The last thing, it seems to me, you want to do is
22 say, well, we have an apparent winner; it could be the wrong
23 winner, so we'll handicap it. It seems to me that's the
24 only option you've got is to say: We want to handicap this
25 to make, possibly, emergence of something else. Well, there

1 may not be anything else. There will be no shortage of
2 people who will come forward and say: We are actually
3 better if only you would handicap these guys. That's
4 certainly true.

5 But it seems to me, as an enforcement matter, you

1 So, I mean, I think in principle there is a
2 diminution of incentive. It operates most strongly against
3 those who are most vested, the big players in the old
4 design.

5 But if it's a situation in which tipping is
6 possible, the rewards to being the tipper are sufficiently
7 large, again, that if you have more than a couple of
8 players, I don't think you need to worry about the
9 diminution of incentives.

10 And, in any case, as in all membership issues,
11 there is a problem, of course; but I guess my inclination
12 would be to choose competition in the present, if you really
13 think it's an essential facility, over the possible slight
14 increase in the incentives for the emergence for the next
15 design.

16 MR. BAKER: Thank you.

17 MR. ORDOVER: Let me just make one point. I think
18 that there was an incomplete hypothetical from Baker. And
19 that is that, he did not specify the terms of access.

20 I always get nervous when people talk about
21 "access" as if it were enough to say that. I guess it's
22 important to specify all the dimensions which access can
23 take place, the price, the terms. Other than the price, the
24 obligations and the duties that come along with having
25 access. For example, to the Ford Model T design, I might

1 also compel to therefore defray the additional R&D cost that
2 Ford may decide to embark upon to modify the design; or I'm
3 just going to be allowed to take part of the old version of
4 it.

5 So if I have to anything to say -- which is not
6 much today, somehow -- I have never done that; I always say
7 something -- and that is when we talk about access and
8 access rules and we don't talk about it in the abstract, but
9 really we are talking about it in a very concrete sense,
10 specifying all the key dimensions and all the rules that
11 would govern access along these key dimensions, such as
12 price and contribution to costs, all those things will
13 matter to incentives, goes to stimulate current competition
14 but also to overcome at preexisting standard or to supplant
15 Model T because these things will interplay in firm's
16 decisionmaking processes.

17 And the big gap that we have I think now in our
18 learning so far, still is in my perspective, is that we
19 don't know how to specify these rules of access. We can
20 only talking about granting access but not specifying the
21 rule. And that's the a big danger, relying on access while
22 not really being clear on the next step.

23 COMMISSIONER VARNEY: Before we continue this
24 discussion further, let's turn to Professor Teece for your
25 presentation, and then I think part of that will fold into

1 this; and we will continue with the questions.

2 Please go ahead.

3 MR. TEECE: My presentation will rather short and
4 crisp, in part because my colleagues have already helped me
5 out by covering important issues about standards and
6 antitrust policy.

7 What I thought I would do is focus somewhat more
8 narrowly on the question of standard setting and
9 intellectual property, because, increasingly, as
10 intellectual property gets more value and as standards
11 become more important, there are an increasing number of
12 circumstances -- and Amy has already reminded us of one --
13 where these two issues become joined.

14 Now, as an opening statement, I think it's
15 important to recognize that standards are important for
16 markets to form. So in some sense, standards and getting
17 standards set are really almost a precondition for
18 competition in many circumstances. I think about
19 multi-media, for instance, and why isn't much going on
20 there?

21 Well, in part it's because of the absence of
22 standards and there isn't this sort of coalescence around a
23 major standard. And on a general philosophical level, that
24 should lead us to want to see efforts, including cooperative
25 efforts, to get standards formed. Because in some sense,

1 that is an enabling factor for competition.

2 So in a Schumpeterian sense where really what's
3 important to competition is new products and new
4 innovations, standard setting is an early, upfront step
5 that's necessary to kick off a new round of competition.

6 Having said that, I also recognize that there is,
7 in sort of antitrust, almost an implicit bias that sort of
8 open standards are better than closed and public is better
9 than proprietary. But having said all of that, I think we
10 have to recognize that very often standards increasingly
11 involve proprietary elements; and that, indeed, one has to
12 recognize that if, in fact, technology that's proprietary

1 And I guess I'm saying this because, in some part,
2 there's a lot of natural protection already out there in the
3 standard setting process for the kinds of concerns that the
4 Federal Trade Commission and other antitrust agencies might
5 have.

6 So let me turn and address specifically the very
7 narrow point about the Federal Trade Commission and what,
8 for want of a better term, I'll call the rule of Dell. This
9 is -- I think Dick Schmalensee started talking off by
10 saying, you know, in the area of standards at a conceptual
11 level, one of the properties is, you know, that there aren't
12 any clear rules so the government is trying to craft clear
13 rules in an environment where it's not clear from the
14 conceptual level what's right and what's wrong.

15 But also, here there are enormous practical
16 problem. And the practical problems are almost deeper than
17 the conceptual ones.

18 And remember here the circumstances was Dell had
19 some intellectual property that was wound up in a standard
20 for, I think it was called the VO Bus, and it didn't
21 disclose this ahead of time; and the Federal Trade
22 Commission, in a proposed settlement, has said, okay, you
23 must give this technology away, basically, to get out of our
24 hair.

25 And this, I think, is a very problematic rule.

1 Amy pointed to one aspect of it, namely -- and it was a very
2 obvious one -- large companies don't know what their
3 intellectual property is. And it's not just a question of
4 patents. One of the virtues of patents is at least, you
5 know, they get filed and you can look them up. There are
6 many other elements of intellectual property: copyright,
7 copyrightable material, maybe even trade secrets, where it's
8 not so apparent.

9 So the notion of a mechanical intellectual
10 property audit that will expose everything so whoever's
11 sitting there on the standard committee knows what the
12 company's portfolio of intellectual property is, I mean,
13 that's a myth. I then it's theoretically a valid concept,
14 but as a practical matter, it's a myth.

15 A second issue that you didn't point out but I
16 think is an even larger one is that -- and it's not really
17 revealed so much by the Dell facts -- but in the Dell case,
18 you know, there was a patent that read on a standard and
19 vice versa. But there may be other circumstances where
20 someone has a very broad-based patent that may be implicated
21 in a standard.

22 So quite unknowingly, a standard may touch on some
23 broad-based patent of enormous scope. So what you could
24 find under this sort of rule is that a firm that had a very
25 valuable patent that wasn't sort of directly implicated in a

1 standard but indirectly was implicated because a standard
2 may, in fact -- or conceivably could read on many different
3 patents and many different pieces of intellectual property
4 that the Dell-type rule could end up torpedoing the value of
5 a broad-based patent.

6 And if that is the case or if there's any
7 significant danger of that, I think what most prudent firms
8 should do, given that they can't accurately audit their
9 intellectual property is stay out of the standard-setting
10 process. And that's the fundamental problem with the sort
11 of the Dell-type rule is that, given the uncertainties that
12 occur because of the difficulty of auditing intellectual
13 property, the prudent thing to do, in many cases, may be to
14 stay out of the process. And that, in turn, slows down
15 standard setting and slows down competition. So what on its
16 face may look like a pro-competitive rule could, in some
17 more fundamental sense, be anti-competitive.

18 And, likewise, the notion of compulsory licensing
19 takes away the value or the possibility of an injunction.
20 And this is something that goes to other aspects of your
21 charter and other people's charter that's I suppose already
22 there; and I wouldn't argue with it too much, but only
23 simply to point out that if there is a compulsory licensing
24 requirement, you know, any potential infringer might just as
25 well say: Well, look let me risk infringement and we'll pay

1 up in the courts because we won't pay more than a reasonable
2 royalty there. In other words, taking away the power to
3 bring about an injunction grossly diminishes the value of
4 much intellectual property and orders the Dell rule deal,
5 with the whole question of what do you do with pending
6 patents and intellectual property that's incipient. The
7 deeper you look into these questions, the messier they get,
8 I suppose, is a basic message.

9 And I think Commissioner Azcuenaga's instinct that
10 there wasn't something quite right here -- at least she
11 didn't see a section 5 issue, that may be true; I'm not a
12 lawyer -- but I certainly see the creation of a tremendous
13 amount of uncertainty. And uncertainty is the bane of new
14 investment.

15 So all of this simply comes down to the fact that,
16 indeed, I don't think networks justify new rules, to echo
17 another speaker; and that, if this be the type of rule that
18 we are creating to deal with these problems, I think it has
19 strong practical problems as well as fundamental conceptual
20 weaknesses as well.

21 So that's enough for an opening statement about
22 some of the new emerging issues in standard setting.

23 COMMISSIONER VARNEY: Well, Professor Teece, let's
24 postulate the Dell rule slightly differently and get your
25 reaction to it.

1 MR. TEECE: All right.

2 COMMISSIONER VARNEY: Suppose the Dell rule says,
3 only when the official that's participating in the standard
4 setting has knowledge of an existing patent that could be
5 exerted against those who eventually adopt the standard
6 should the company be held liable, is that reasonable?

7 MR. TEECE: Yeah. I think, you know, there's sort
8 of a deliberate sort of opportunism here. But my
9 understanding is that's already -- isn't there strong case
10 law that already provides support for that? In which case,
11 you know, it's not clear the FTC has a role.

12 But, yeah, I mean, clearly one doesn't want to
13 support deliberate opportunism in the standard setting
14 processes. But sorting out deliberate opportunism and
15 strategic opportunism from the absence of omniscience is the
16 task at hand.

17 And I would be much more comfortable with
18 something along those lines.

19 COMMISSIONER VARNEY: Other comments.

20 MR. ANTALICS: Yeah, I have a question. This was
21 actually raised by somebody in the audience.

22 Isn't the patent holder the person who has the
23 best -- the most efficient person to do the search and the
24 person put in the best position to identify whether or not
25 they have a conflict in the technology with what's going to

1 be incorporated in the standard and together they have the
2 option of either certifying or not certifying? Shouldn't
3 they be the ones who make the decision of, if they are going
4 to certify, they do the search?

5 MR. TEECE: Well, that presumes that a search
6 ought to be the done and a search, when completed, will, in
fact, display whether no

1 And the point being that at a time that a
2 particular standards being developed, there are many
3 difference routes along which one can proceed. And,
4 therefore, the outcome of the standard setting process maybe
5 to -- I guess the right word from the Silicon Valley is
6 evangelize a particular standard and, therefore, to create
7 value where, potentially, initially was very little value to
8 begin with. It was one of many particular ways to proceed;
9 and once the road is chosen, the value is created.

10 And the question to my mind is: While having been
11 a part of the that process, who should be allowed to extract
12 the additional value that was created as a result of the
13 standard setting procedure?

14 And I think that if that value is fully allocated
15 to the one whose particular patent or piece of intellectual
16 property right was actually evangelized through the process
17 is allowed to capture all of it without disclosing the
18 initial interest, I think that the wrong incentive is
19 potentially being created. And also it creates a
20 disincentive, potentially, for other players to engage in
21 the standard setting process that creates values for others.

22 So the rule, perhaps, may be too strong. I have
23 not studied the rule at any great length. But I would
24 suggest that if there is a problem of resolving the
25 conflict, that the way to approach it would be to grant --

1 not to expropriate the intellectual property right. But,
2 again, to come back to what I have been harping upon, which
3 is to say that the benefits of the standard setting value
4 creation should be somehow divided amongst the owner as well
5 as those who participate in the process of enhancing the
6 value.

7 In other words, the value should not all rest with
8 the original owner who, at some point, realizes whether by
9 mistake that he or she failed to inform or obviously if it
10 was a strategic withholding that the matter is quite
11 different.

12 But I believe that there are trade-offs going both
13 ways; and, therefore, to take only the viewpoint of the
14 owner distracts from the fact that the other players have a
15 stake in resolution of the conflict in a way that does not
16 expropriate all the value from them and does not transfer
17 all of it onto the owner of the intellectual property right.

18 And that viewpoint also has to be respected in
19 some way. I don't have the solution to it, but I would not
20 want it to become completely disregarded.

21 MR. TEECE: No. Let me just say, nor would I.
22 But the Dell rule, is you'll give it up for zero royalty, if
23 I understand it correctly. Right? The Dell settlement did
24 not allow Dell to take a reasonable royalty.

25 Am I right about that?

1 MR. ANTALICS: The Dell settlement would say, with
2 respect to the standard, you know.

3 MR. TEECE: Okay. So zero royalty, which presumes
4 -- so you and I agree

5 MR. ANTALICS: It would also presume you have to
6 look at other facts as to whether or not the patent itself
7 had any value apart from --

8 MR. TEECE: As a standard, right

9 MR. ANTALICS: Right. And certainly that's part
10 of the analysis.

11 MR. TEECE: Well, the standard setting bodies,
12 basically, are consistent in their approach to what Janusz
13 just advanced.

14 Because if there isn't -- you know, the usual
15 approach is we prefer not to have a standard that's
16 proprietary; if there's a close substitute, we'll move to
17 that; and if there's not a closed substitute, than a
18 reasonable royalty over the intellectual property that's
19 involved is acceptable.

20 And in this case, the thing that I think both of
21 us would find troubling is the zero royalty.

22 CHAIRMAN PITOFSKY: All right.

23 It's a pleasure to welcome back Professor Janusz
Ordover, who has participated in these hearings before and

1 organizing these hearings from their very beginning.

2 He's a Professor of Economics at New York

1 In other words, the networks effects can, indeed,
2 cause dominant firms to unravel very quickly, maybe perhaps
3 more quickly than a sand or gravel monopoly would unravel.
4 On the other hand, the time that it takes to cause the
5 tipping may be much longer than we would find desirable or
6 socially desirable.

7 Now, nevertheless, I would agree with Dick to the
8 extent that one should be very careful in crafting rules
9 designed to supplant the network dominant firm before its
10 time.

11 Who said they will not serve Gallo before it's
12 ready, I don't think Gallo is ever ready to be drunk.

13 Sorry about that. I just like wine.

14 It seems to me there are great dangers to coming
15 to a viewpoint that somehow the particular technology has
16 run its course and it should be supplanted by a newer and
17 better technology with the assistance, especially of those
18 who have a vested interest in supplanted the preexisting
19 one, which is the brand of competitors.

20 I believe strongly that network industries require
21 very careful application of economic theory, which,
22 unfortunately, has not developed to the point to offering
23 clear enough guidance what to do.

24 So we are now in a very difficult position, I
25 think, because we need to address these issues; they come up

1 in front of the Commission on a daily basis and in front of
2 the courts. Yet very little guidance can be gleaned from
3 the literature that has emerged thus far. I think the
4 literature is superbly summarized in Bill Cohen's background
5 paper. And I think we all should be grateful, yet again,
6 for his efforts.

7 The fact of the matter is that the results that we
8 have on these theoretical results are very specific to the
9 assumptions that people have made about the nature of the
10 problem they are modeling. And, as such, they are not
11 robust, the change in these assumptions.

12 Nevertheless, I think that there are some things
13 perhaps we can learn. And I tried to summarize a few of
14 them that, at least I have learned over the years. Let me
15 just share those with you very quickly because I would like
16 to move on to questions and answers as opposed to
17 presentation.

18 First of all, I would say, agreeing again with
19 Dick, I think that the anti-competitive dangers of these
20 network of industries, network markets, are much less
21 pronounced; but there is at least some scope for
22 internetwork competition, or what I used to call
23 "intersystem competition." But now we have to advance to
24 bigger and better ways of thinking about it.

25 So thinking about internetwork competition, I

1 think, as a starting point: Is there a scope for such
2 competition? What other forces are preventing it? And if
3 internetwork or intersystem competition is adequately,
4 sufficiently potent, then I believe that we are safely in
5 the world in which antitrust can fall back on some of the
6 principles that we had learned before.

7 Coming to the discussion as to the VISA/MasterCard
8 problem -- again, I'm not aware of the history leading up to
9 this particular unity of VISA and MasterCard membership, but
10 it would strike me that many of the problems that we have
11 encountered in that area would have completely disappeared
12 had there been two competing interbank consortia. Because
13 in such a world, if Dean Witter, for example, were to be a
14 valuable entrant into any one of these consortia, if
15 anything, you would expect both of them to vie for such a
16 new participant to participate and to extend the scope of
17 the bankcard business within a particular joint venture or
18 association, whatever you want to call it.

19 So the presence of some competition among systems
20 or networks, I think, is a strong guarantor that a market is
21 likely to work reasonably well and, therefore, to minimize
22 significantly the need for any sort of intervention, as to
23 the rules of access, as to the membership rules, as to the
24 kind of activities that the joint venture can venture out of
25 and enhance its market presence in the new and exciting

1 possibilities that open up.

2 Now, that is, I think fairly uncontroversial
3 because I think that competition works much better than any
4 regulator can.

5 However, when exclusion -- and this is sort of a
6 second point, when exclusion from a network is potential
7 substantially detrimental to the excluded firm or firms and
8 when the excluded firms cannot reasonably overcome the
9 impediment, there is a need, perhaps, for some antitrust
10 scrutiny.

11 And the antitrust scrutiny, to my mind, should be
12 governed by a fairly simple question or simple principle
13 which, as I admitted over the years, is not easy to apply.
14 And the principle ought to be -- at least the way I have it
15 in my mind -- is whether or not the conduct of the excluding
16 network of the excluding association that has these network
17 features is best explained by reasonably direct efficiency
18 rationale or can best be rationalized as a desire to exclude
19 an equally or more efficient competitor.

20 In other words, I would like to see an exploration
21 that proceeds along three steps.

22 In step one there are various structural indicia
23 that one may want to look at that will shed light on whether
24 that particular network that isn't dominant at the moment is
25 likely to maintain its dominance over a medium hall. I am

1 not talking about being displaced next week but over the
2 hall that we would view as reasonably short so as to not to
3 be concerned about potential anti-competitive effects.

4 These structure indicia relate to the question of
5 how easy it is to tip one network's dominance into a losing
6 proposition, Visicalc and whatever other things that we have
7 heard from the software world, of course, that are examples
8 of networks that were falling by the wayside.

9 So a structural evidence suggests that the
10 persistence of a network is not likely to be prolonged, I
11 would say, forget about worrying individual conduct and
12 let's just dissipate market power.

13 Step two, I would look at the reasons why these
14 exclusion takes place. We know from the old fashion
15 literature -- and I guess we will come back to it this
16 afternoon -- that generally there's only one monopoly profit
17 to be had. So if there is one monopoly profit to be had and
18 you have some scarce assets, maybe membership in the VISA,
19 why can't you get all your profits by charging the
20 appropriate amount for a VISA membership?

21 Well, the problem, of course, here would be that
22 the membership rules are anonymous and you cannot charge
23 different people different access fees. You cannot charge
24 Dean Witter a different amount for playing with VISA than
25 you can charge Ordover Bank. I don't have a bank, but I

1 could start one up to issue VISA cards, for example.

2 So that is a problem, that the owner of a scarce
3 asset, be it the network or be it anybody, cannot always
4 extract that maximum amount of monopoly that is, perhaps,
5 available from the assets. And that may be a good
6 explanation why exclusion takes place.

7 Some reasons for exclusion I think are more
8 pernicious than others. I believe that the reason for
9 exclusion driven by the desire to enhance one's ability to
10 price discriminate is substantially less pernicious than the
11 one designed to stymie competition in the next rounds of
12 technological developments. I think that's the most
13 pernicious reason I can imagine to stifle dynamics as
14 opposed to worry about current reshuffling of consumer

1 substantially less capable of providing its proprietary card
2 if it's excluded from VISA and MasterCard as opposed to
3 whether it's merely an inconvenience and of marginal benefit
4 that perhaps does not substantially effect the competitive
5 balance.

6 And I think that this sort of three-step inquiry
7 can help along in trying to sort out the pro- from
8 anti-competitive types of exclusionary conduct.

9 I would also want to make a point, going back to
10 the standard setting issue a little bit and this unilateral
11 networks or private network, that when firms individually
12 race to establish a dominant network, I think that it should
13 be, in my opinion, reasonably -- that kind of race should be
14 reasonably free of antitrust scrutiny. I think that races
15 leads to winners, and it's very dangerous to handicap the
16 race on a continuous basis though antitrust scrutiny along
17 the path of competition.

18 I believe, with Dick Schmalensee and Liebowitz and
19 Margolis, that it's only rare, if ever, that the wrong
20 winner actually wins. I believe that it's very unlikely
21 that the winner will be, in fact, able to extract surplus
22 and behave anti-competitively once victory has taken place.
23 There are some situations, but they are very limited in
24 scope; and, therefore, I believe that such competitive races
25 should be left to the market with most minimal amount of

1 supervision.

2 I think that the most dangerous problem that can
3 come up is when the nature of the race is sort of changed or
4 the nature of competition is changed ex post with what we
5 have come about to call the installed base opportunism, I
6 guess, thanks to Steve Salop, who's in the audience and
7 who's such a marvelous crafter of ideas and terms.

8 I believe that, as long as we can protect against
9 installed base opportunism through antitrust intervention,
10 then races towards patents, towards standards, towards
11 networks, are going to be pro-competitive on the whole. And

1 creates a presumption of a competitive problem from the
2 standpoint that, assuming that such action exclusion is
3 costly in some way. It might be costly for -- I'm just
4 using VISA generically. Please don't hold to any of it. I
5 don't know anything about VISA, other than my balances.

6 If it's costly for VISA to engage in rules which
7 are exclusionary, for example, withholding an entry to
8 someone who can benefit the VISA organization by expanding
9 the size of the VISA market, then I would be concerned why
10 such a beneficial entry is blockaded.

11 And perhaps the reason might be that such a
12 beneficial entry is mostly rational because it affects the
13 intensity of competition elsewhere.

14 CHAIRMAN PITOFSKY: Well, suppose that the joint
15 venture -- get away from VISA. Suppose the joint venture,
16 in a burst of candor, says: Look, they're not more
17 efficient than we are; but the fact of the matter is, we
18 make more money with them out than with them in. Is --

19 MR. ORDOVER: I don't see there is any problem
20 with that, as long as the excluded firm can fend for itself.

21 CHAIRMAN PITOFSKY: No, no. It can't. It's an
22 essential facility. It's a dominant player in the joint
23 venture or the monopoly. It's a decisive competitive
24 advantage to have the benefits of membership in the joint
25 venture, and the reason for excluding them is, we make more

1 money with them out, as the defendants said in Otter Tail in
2 a burst of candor, they gouge holes in our profits.

3 Is that a justifiable reason to keep them out?

4 MR. ORDOVER: Well, I think it's certainly a
5 justifiable reason to keep them out if the dissipation of
6 profit -- one would have to -- I think I would like to ask:
7 What's the reason for the dissipation of profit caused by
8 the new entry?

9 Is it because they're going to free ride? It's
10 because they are not going to contribute to the future
11 development of joint venture product? What is it that
12 dissipates this profit?

13 If you take a joint venture that has a large
14 number of firms and firms are already competing, then it
15 raises a question of what's different about this particular
16 entrant or potential entrant as opposed to the ones who are
17 already in. I mean all of those who went in dissipated
18 profits to some extent. Is the joint venture of just the
19 optimal size? Who knows.

20 But I think it's the absence of the ability to
21 negotiate entry terms on more individualistic bases that
22 creates, potentially these disincentives to admit.

23 And if you go back to Otter Tail, I think the
24 reason exclusion was to place there was not because of the
25 -- it was partly because of the regulator rate. It could

1 not negotiate rates; and, therefore, you had absolutely no
2 incentive, as we know, to enter the contract with somebody
3 who would purely divert profit from you and would not be
4 able to compensate you for any portion of that.

5 So I think that one answer to that kind of a
6 quandary would be to allow joint ventures or networks to
7 negotiate more personalized contracts with potential
8 entrants, especially those who appear late in the game as
9 opposed to require or mandate that so-called
10 non-discriminatory access out to be granted. I think that
11 would probably lead to fewer problems, more entry, less
12 tension than a very simple rule which says you have to grant
13 non-discriminatory access.

14 I think that entrants are different; therefore,
15 they should be potentially treated differently.

16 CHAIRMAN PITOFSKY: Dick, you were going to
17 comment?

18 MR. SCHMALENSEE: Yeah. That brings back a point
19 that Janusz raised earlier that I wanted to react to in the
20 context of Jon Bakers's hypothetical. Janusz, in his
21 response to that, reminded us that when you declare
22 something an essential facility, you are starting a
23 regulatory process.

24 And letting them negotiate doesn't necessarily do
25 it. It needs to be a supervised negotiation, which is why

1 it is not something you want to do lightly.

2 Particularly, Jon's hypothetical had to do with,
3 suppose you were worried about incentives for tipping and
4 you were worried about incentives for coming out with the
5 next standard, let us say, I guess that I would argue that
6 in a situation -- and Janusz also reminded us of the time
7 dimension of essentiality.

8 I guess I would argue that the shorter the likely
9 duration of an essential facility, the less likely you
10 really want to think of it as essential and go down that
11 regulatory road. That if historically things get overturned
12 every five or ten years, you might want to think twice about
13 creating a structure to supervise individualized access
14 fees.

15 I also think, just to react to some of what he
16 said, the question of whether you have to have an efficiency
17 rationale for exclusion, whether that's a necessary test, I
18 think raises some operational questions that are difficult.

19 Suppose, to get away from VISA, I decide to
20 operate Schmalensee's Raspberry yogurt stands. It's a great
21 name. And I'm going to run it as a joint venture because I
22 don't have a lot of money. So we have this group, and I
23 want to get nationwide coverage. So we set up these yogurt
24 stands and I get nationwide coverage. And I say, that's
25 terrific, we have what we want, we have nationwide coverage,

1 we're all very happy. Janusz, who has two or three yogurt
2 stands says, I want to join. We have a meeting. My
3 co-venturers says, no, why should we let a competitor in?

4 Now, can I do that? Well, I can't do it if
5 there's going to be a material adverse affect on
6 competition. It really is essential to use my terrific name
7 to sell raspberry yogurt, let us say, assuming that's a
8 market.

9 But suppose there isn't a huge material affect on
10 competition, then it seems to me requiring us to come up
11 with an efficiency rationale for not letting competitors in,
12 for not expanding the scope of the joint venture, for not
13 going down the road of having to explain why we don't want
14 to go through the hassle of negotiating access fees and set
15 up an apparatus to vet the special fees we want to charge
16 Janusz because he's a difficult person -- which, of course,
17 he isn't -- I think placing a high burden on that kind of
18 decision serves no useful purpose.

1 effectiveness of competition in the market.

2 MR. ORDOVER: Can I just say one thing?

3 That is, I never understood how can I have
4 competition without competitors? I always thought the
5 dictum about protecting competition of competitors is very
6 clever. That is slightly shaky in my own little head. But
7 I think that competition requires either actual firms
8 competing or at least potential competitors pressing on the
9 dominant firm.

10 CHAIRMAN PITOFSKY: Suppose there are enough
11 competitors to allow for a process, do you have to let the
12 other one in if there's going to be an effect on party --

13 MR. ORDOVER: Oh, no. Of course. The whole issue
14 arises only when there is a substantial potential problem.

15 If there are 55 different flavors of yogurt
16 competing, there's absolutely no problem. And if there is
17 even one, but I can reasonably well offer the "Ordover
18 Coffee Yogurt" in competition with Dick's, there's no
19 problem.

20 There's a question that arises whether or not I am
21 going to be vanquished. And even if I am vanquished, that's
22 still all right as long as I would have died because nobody
23 wants to have my yogurt in competition with yours. That's
24 still fine by me.

25 So I'm not that concerned that the rule will be

1 over-broad.

2 CHAIRMAN PITOFSKY: Let me interrupt the
3 discussion and make sure we hear from our speaker this
4 morning, and then we'll come back to an exchange.

5 Tom Rosch is managing partner of the San Francisco
6 office of Latham & Watkins, nationally regarded as one of
7 the preeminent practitioners in the areas of antitrust trade
8 regulation law. He has been lead counsel in more than 50
9 federal and state court antitrust cases.

10 Tom served as Chair of the ABA's Antitrust Section
11 in 1990. He currently serves as Vice Chair of the
12 California Bar Association's Antitrust Section.

13 And I remember him best as Director of the FTC's
14 Bureau of Consumer Protection from 1973 to 1995.

15 In 1989 he was a member of the special committee
16 to study the role of the Federal Trade Commission.

17 It's a great pleasure to welcome you back to the
18 FTC.

19 MR. ROSCH: Thank you, Mr. Chairman, and
20 Commissioner Varney, and members of the senior staff.

21 I do have a couple of things I would like to say
22 at the beginning. First, I must join Christine and the
23 numerous other witnesses before us who have expressed their
24 appreciation to the Commission for this process and for our
25 being able to participate in it.

1 Whatever comes of the process, it's, I think,
2 enormously valuable to the American people that the
 Commission ta

1 the Commission might exercise prosecutorial discretion in
2 determining whether to attack the formation or practices of
3 networks.

4 Let me say at the outset that I have defined
5 networks rather differently than Dick Schmalensee has or,
6 indeed, that many of the other folks who have spoken today
7 have.

8 They seem to have defined networks as essentially
9 being alliances of competitors of really more than two
10 competitors, multiple competitors but more than two. And I
11 would define networks more broadly than that, to include
12 simple joint ventures including two actual or potential
13 competitors. And I'm not at all clear that, as I have
14 listened, that what I have to say about that subject differs
15 because there's more than two.

16 I can't help but remark on the explosion of
17 networks that we are seeing today, and the different kinds
18 after networks. I mean, 10 years ago the Toyota/General
19 Motors production joint venture was a real novelty. Today,
20 at least in my practice, I encounter a variety of teaming
21 agreements by defense contractors; I see joint operating
22 agreements by hospitals; and all sorts of communications
23 providers; I see joint research and development; joint
24 ventures by biotech firms. I'm seeing an enormous number of
25 embryonic buying arrangements, group buying arrangements by

1 competitors.

2 It is true explosion. Now, one, under those
3 circumstances, might ask oneself, well, why? Why are we
4 witnessing this? I suppose a cynic might say that
5 competitors are looking for strategic sort of
6 anti-competitive behavior, and this is one form of it.

7 A more benign explanation, however -- let me stop
8 right there and say that I acknowledge that there are
9 several forms of strategic anti-competitive behavior that
10 can stem from joint venture activity. I guess I could just
11 lump them into three categories: price stabilization,
12 quality stabilization, and market exclusion. But they're

1 formation of joint -- I think that was a very astute
2 observation.

3 I think it behooves the Commission and the Justice
4 Department to take a very close look at whether or not the
5 venture is being formed or is engaging in practices for the
6 former reasons rather than the latter.

7 And, indeed, I would suggest that the courts and
8 the Congress have counseled that as well. For example, the
9 Supreme Court in Broadcast Music recognized that there were
10 substantial efficiencies that could flow from even a
11 marketing joint venture.

12 And the Congress, in enacting the Research and
13 Production Act in 1993, recognized that there were
14 substantial efficiencies that could flow from a production
15 joint venture as well as from a research and development
16 joint venture.

17 So to some extent what I'm about to say about
18 efficiencies is rooted in the law.

19 Let me just suggest, then, a multi-part test that
20 the agencies might wish to employ in determining whether and
21 in what circumstances they should exercise prosecutorial
22 discretion in addressing the formation or extension of joint
23 ventures -- horizontal, now I'm talking about -- and the
24 practices of joint ventures.

25 It is quite a different calculus, I might add,

1 than Janusz has proposed.

2 It starts with an assessment of whether or not
3 there are efficiencies involved. Now, why does it start
4 there? Two reasons.

5 First of all, because, I would suggest, most
6 respectfully, that it is easier to make that determination
7 than it is to predict the sorts of things that one is
8 required to predict under the Merger Guidelines, that is to
9 say, whether or not what will happen if there's a small but
10 significant non-transitory price increase, or whether entry
11 is likely to occur within two years.

12 Efficiency questions frequently turn on facts
13 which can be determined relatively easily. Over-capacity
14 either exists in an industry like a hospital market or it
15 doesn't. And one can make a fairly clean determination as
16 to whether or not a joint venture, under those
17 circumstances, is likely to lead to competitive equilibrium
18 and to a maximizing of resources.

19 The same thing is true of redundancies and
20 complementarities. In the context of biotech transactions,
21 for example, it's pretty easy to assess claims of
22 complementarities. And it's fairly easy to determine
23 whether or not redundancies exist whose elimination can
24 yield efficiencies.

25 Second, the second reason for focusing on

1 efficiencies first is that it is a decent filter through
2 which to eliminate those transactions which are nothing more
3 than a subterfuge for price fixing or other per se or near
4 per se type horizontal conduct.

5 If there is no efficiency at all involved, then
6 one must stop and ask oneself why the participants are doing
7 the deal. And if they don't have a pretty compelling
8 reason, then the inquiry should stop right there.

9 Now, I think that that only works with respect to
10 an assessment of the formation or extension of a joint
11 venture. I don't think it works as well with respect to
12 practices. And I'm talking now, also, with respect to
13 exclusionary practices, whether or not the joint venture is
14 excluding other folks from joining.

15 In those circumstances, I think the absence of
16 efficiencies is indicative but not Talismanic. But with
17 respect to the formation or extension of a joint venture, I
18 would suggest that if there are no efficiencies, a very
19 heavy burden then shifts to the venturers to justify the
20 existence of the venture.

21 Now, suppose that some efficiencies are
22 identifiable -- or, more specifically, suppose that the
23 agency concludes that there are substantial efficiencies and
24 those are relatively certain. Under those circumstances, I
25 would respectfully suggest that the presumption ought to be

1 in favor of legality and that that presumption ought to get
2 stronger the more substantial and certain the efficiencies
3 are.

4 Let me speak to the point that was just made. A
5 potentially efficiency-enhancing venture should not be
6 dismantled just because it may also potentially stabilize
7 the price or quality of the product sold by the venturers
8 themselves. That shouldn't matter if there's enough other
9 competition in the marketplace to discipline the venturers'
10 price and quality.

11 Similarly, a potentially efficiency enhancing
12 venturer should be challenged just because it may, by
13 membership restrictions or otherwise, prevent some firms
14 from competing. That shouldn't matter either, so long as
15 there's enough other competition in the marketplace to
16 discipline price and quality; and that's where the focus
17 should be.

18 Indeed, it's strongly arguable that structural
19 relief should not be sought whenever there is enough
20 competition in the market that it's likely that the
21 efficiencies will be shared in any respect with consumers.

22 Now, the trick there, of course, is to identify
23 how much competition is enough. The Merger Guidelines,
24 quite frankly, are not very helpful in that respect. As
25 both agencies have tacitly acknowledged in their treatment

1 of hospital joint ventures and even hospital mergers,
2 competition in markets with HHI's well in excess of 1800 may
3 be sufficient to discipline price and quality, especially if
4 the purchasers are powerful and sophisticated and/or the
5 purchases are made by a bidding process which prevents
6 collusion or if there are other forces at work which ensure
7 competition.

8 I can't help but comment on this notion, for
9 example, that by sharing information we are somehow stifling
10 competition. And I'm talking now about an innovation
11 markets like biotech or semi-conductor or other markets of
12 that kind. I think that badly underestimates the
13 non-economic rivalry that exists among scientists and
14 engineers today. It exists entirely independently of the
15 sorts of economic aspects that the economic models are
16 mostly concerned with. And those forces, I think, should be
17 taken into account in determining whether or not there's
18 likely to be enough continuing rivalry and competition and
19 even in a highly concentrated marketplace, to ensure that
20 some of the efficiencies yielded by a combination of
21 competitors will be passed on to consumers.

22 Frankly, I mean, Intel has been thrown up from
23 time to time as being a good example of -- or the
24 semi-conductor market is thrown up from time to time as being
25 a good example of a highly concentrated market where

1 competition has suffered.

2 I must say, from my observation, nothing could be
3 further from the truth. That firm behaves as though it is
4 under competitive siege, and it has been -- it's behaved
5 that way for the last 10 years. And I think it's because
6 the mentality down there is being driven, to be sure, to
7 some extent by economic considerations but also, to some
8 extent, by a fear that they are not going to be first in
9 science. And I don't think that that can be disregarded in
10 the calculus.

11 In short, particularly where you're talking about
12 transactions which are not as enduring as mergers, I don't
13 think that the agency should treat the Horizontal Merger
14 Guidelines as gospel in assessing the effects of these
15 arrangements.

16 Now, third, the presumptions against structural
17 relief, based on efficiencies, should not extend,
18 necessarily, to challenges to ancillary provisions which
19 aren't reasonably necessary to achieve the efficiencies
20 offered by the network and which may potentially stabilize
21 price or quality or exclude competitors from the market.

22 To the contrary, I think that proper antitrust
23 enforcement demands that, under those circumstances, that
24 kind of activity should be prohibited.

25 I have to comment in one respect here, though,

1 about an issue that has come up with respect to the external
2 conduct of network participants, raised by Christine's
3 testimony with respect to Discover and VISA.

4 The interesting question there, to me, is whether
5 or not the external conduct of that kind should be judged
6 under section 1 or section 2. And it makes a difference --
7 it may make a difference as a matter of law because
8 Copperweld suggests that the standards of performance
9 required by section 1 are more stringent than they are under
10 section two.

11 I have no doubt at all that the external activity
12 of a joint venture should be subject to a consent decree,
13 and one should not hesitate to impose a consent decree when
14 it is exclusionary in a sense that it injures competition.

15 But I also have no idea, at this point, as to what
16 the proper legal standard ought to be in evaluating that
17 kind of conduct.

18 Now, this three-step calculus obviously reflects a
19 bias against stifling the kind of developments of the kinds
20 of networks that we're witnessing; and it reflects a view
21 which may be naive, I will admit, but it is still my view,
22 that the purposes and potential effects of these networks
23 are generally efficiency enhancing and that the agencies
24 ought to be very, very careful about second guessing them.

25 The stakes here are enormous. There are genuine

1 efficiencies involved. If the agencies get in the way of
2 the achievement of those efficiencies, we are not going to
3 be doing anybody a favor. If, on the other hand, the
4 agencies get it right, we are going to see an explosion of
5 the development of consumer products, particularly in the
6 biotech area and the communications area, that are going to
7 drive this economy for the next half century, just as the
8 development of the electric light and the combustion engine
9 at the beginning of the century drove our economy for that
10 half century.

11 CHAIRMAN PITOFSKY: Well, thank you for yet
12 another provocative set of proposals.

13 Any questions? Comments? We have a few minutes.
14 I had a question. Hardly a word about market
15 power.

16 MS. VALENTINE: That's my question.

17 CHAIRMAN PITOFSKY: Let's assume it is a highly
18 efficient teaming arrangement, only two companies left,
19 making a certain kind of missile, they get together in a
20 joint venture and bid together to the Department of Defense,
21 highly efficient, is that presumptively -- could the
22 presumption be overcome because of the market power in that
23 situation?

24 MR. ROSCH: Yes. It is a presumption that is
25 rebuttable. But I'm suggesting that if the efficiencies are

1 clear and substantial, very substantial, one ought to be
2 very, very careful before proceeding if there is even
3 another competitor there. And the Defense Department
4 situation is a very good example of that where you have a
5 power buyer, essentially, there so that you have a good deal
6 of countervailing power at work.

7 MS. VALENTINE: Can you look at the other end?
8 Let's say there's no market power or let's say there are, I
9 don't know, five van lines that operate across a whole state
10 and two that operate only, one in the northern half and one
11 in the southern half and they want to get together and offer
12 statewide moving services as well.

13 And let's say there are no real integration
14 efficiencies, or very, very few, do you want us, before we
15 ask what market share that sixth entrant in the statewide
16 service would have -- you want us to ask what the
17 efficiencies are?

18 MR. ROSCH: Well, I think in your hypothetical, if
19 I understand it correctly, Debra, you have assumed that
20 there are no efficiencies from the transaction.

21 MS. VALENTINE: I'm trying to give you one where
22 there are very few, and I haven't thought about this long.

23 MR. ROSCH: Okay. And, frankly, the one that you
24 posit seems to me to be one in which there would be
25 substantial efficiencies.

1 MS. VALENTINE: There is certainly a new product
2 that they couldn't offer. Okay. In the BMI sense.

3 MR. ROSCH: Okay. And, again, the question is?

4 MS. VALENTINE: Do you want us to look at the
5 efficiencies first?

6 I think I understood from your example --

7 MR. ROSCH: I would always look at the
8 efficiencies first.

9 MS. VALENTINE: -- that you would approach this as
10 opposed to Janusz.

11 And then I guess, Janusz, what's your perspective
12 on this?

13 MR. ORDOVER: I would say stop looking right away.
14 There are five already. Sixth one, nothing can go wrong.
15 Nothing can go wrong.

16 MS. VALENTINE: I would hope not.

17 CHAIRMAN PITOFSKY: Dick.

18 MR. SCHMALENSEE: I think it's important to keep
19 in mind Tom's point. You do want to take a different
20 algorithm to the formation of a venture versus the question
21 of membership.

22 And I guess my view would be that there is some
23 question as to how serious an efficiency test you want,
24 whether it's a quick-look plausibility test, which your
25 hypothetical passed, for all us, I think in 30 seconds; or

1 whether it really is a "let me see what the investment
2 bankers told you" kind of efficiency test, let's walk
3 through the numbers.

4 And I guess I would opt for the first level on the
5 formation, then see if there is a potential structural
6 problem using, plainly, a test weaker than the Merger
7 Guidelines, because it's not complete integration and only
8 if you're in a trade-off situation, fall back to the
9 detailed analysis.

10 CHAIRMAN PITOFSKY: David?

11 MR. TEECE: I would like to make a few comments.

12 And, Tom, I'm basically very much in agreement
13 with what you had to say. But I thought there were a few
14 things you said that were worth highlighting.

15 One is an acceptance of the notion that
16 efficiencies are transparent. Historically, in antitrust,
17 that's been a controversial point. But I think you're close
18 to being right in a lot of the new industries that we're
19 talking about -- and you mentioned biotech, you talked about
20 telecommunications. I mean, if a new biotech firm has a
21 teaming arrangement with an established pharmaceutical firm,
22 you don't have to be a rocket scientist to see that there

1 that some of these efficiencies are a lot easier to
2 ascertain and identify than what we're looking at, say, 15
3 years ago when firms were talking about consolidating plants
4 and, you know, bringing about production efficiencies. You
5 ran into a different sort of managerial calculus about
6 efficiencies.

7 So I would certainly like to underscore what
8 you've just said that, namely, when it comes to
9 complementaries, over-capacities, redundancies in these
10 high-technology industries, it's actually easier once you
11 understand the technologies and once you understand the
12 commercialization process.

13 One thing which I would like to ask you -- I
14 presume it's embedded in your framework -- presumably you
15 would support a safe harbor-type exception. I mean the fact
16 that you're willing to give a presumption for efficiencies
17 is, in fact, perhaps even stronger than sort of giving a
18 safe harbor exemption for cooperative arrangements that are,
19 say, less than 25 percent of the market.

20 Am I right about that?

21 MR. ROSCH: In ordinary circumstances, I would
22 think so.

23 But that's not really a safe harbor. I guess I
24 would want to leave myself -- if I were on the staff, I
25 would want to leave myself an out, where 25 percent would

1 not be enough. But generally speaking, yes.

2 MR. TEECE: Okay.

3 CHAIRMAN PITOFSKY: Other questions or comments?

4 MS. VALENTINE: I had one question from the
5 audience earlier. And this one is really for Janusz and if
6 Dick Schmalensee comes back. I'm not sure if he's here any
7 more or not.

8 MR. ORDOVER: He's deregulating transport now.

9 MS. VALENTINE: Right.

10 I think -- and this isn't critical to the question
11 -- that duality or joint membership -- and we can try to
12 make it abstract -- two joint ventures came about because
13 earlier the Department of Justice declined to opine as to
14 whether one of those networks were to exclude someone who
15 was in the other network, would not be an antitrust problem.

16 But let's say now we do have joint membership in
17 two industry networks in which about 70 or 80 percent of the
18 participants of that industry are a member of each network.

19 Would you think there was a role for antitrust
20 scrutiny or enforcement in that situation?

21 MR. ORDOVER: I think that I can fall back on an
22 easy answer, which is, yes, to the extent that these firms
23 now under the joint grouping engage in new activities which
24 are not directly related to the original purposes of the
25 network.

1 For example, the original purpose was to offer
2 Product X, but now they are going to become involved, one
3 way or the other, through offering Product Y. And unless
4 there are any obvious reasons why the joint membership
5 should get engaged in such a project, then I would like to
6 see a new look. There is no justification any more,
7 perhaps, but may be.

8 But I think there isn't because the underlying
9 technologies have changed so that the -- again, generically
10 speaking, a merchant can get on some particular electronic
11 box and process any particular stream of digits. It doesn't
12 make any difference whether it's coming from American
13 Express, coming from Discover, or coming from VISA or
14 wherever. To the extent technology has progressed to that
15 level, there may be no rationale for joint activity on the
16 new front.

17 I would say it would be a mistake to now decide
18 that the old membership ought to be somehow sorted out as
19 between the two potentially competing joint ventures. I
20 think that would be a big mistake because that would create
21 fears for formation that at some point somebody says, well,
22 we've got to divide you up; you go to one side of the court,
23 you got to other side of the court. I would not advocate
24 that.

25 But I think that, as always, going forward at the

1 potentially appropriate time to review the new activities to
2 see how they are directly related to the activities that
3 were initially a rationale for the formation and to see
4 whether any efficiencies, as Tom would say, would be lost as
5 a result of limiting the activities to a subset.

6 I believe that there's always a great virtue in
7 competition. That's why I always was of the view that it's
8 goods to have more than one network if you can sustain it.
9 In some markets you can't with standards that are often
10 impossible. But to the extent that you can sustain more
11 than one network, I think you should move towards that goal,
12 but protecting the efficiencies that might be otherwise
13 lost. I don't see any reason why such efficiencies would
14 dissipate in the hypothetical that you gave.

15 CHAIRMAN PITOFSKY: Well, I want to thank the
16 members of this panel very particular for an extraordinary
17 session. I started the morning off by saying that I truly
18 believe this is among the most difficult questions that
19 modern antitrust needs to address, and they seem a little
20 less difficult having the benefit of these exchanges.

21 So, thank you very much.

22 I think we are going to move up our starting time
23 this afternoon from 2:30 to 2:00. We'll resume at 2 o'clock
24 and perhaps be able to adjourn a little earlier on a Friday
25 afternoon.

1 Thank you.

2 (Whereupon, at 12:55 p.m., the hearing was
3 recessed, to reconvene at 2:00 p.m., this same day.)

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A F T E R N O O N S E S S I O N

2:00 p.m.

CHAIRMAN PITOFISKY: Good afternoon. We resume these hearings. We had a great session this morning, and I look forward to an equally great or greater session this afternoon.

We start with Steven Salop, Professor of Economics and Law at Georgetown University. He also serves on the Board of Directors of Charles River Associates.

From 1990 to 1991 Professor Salop was a guest scholar at Brookings, and in the spring of 1986, he was a visiting professor at MIT.

Before joining the Georgetown faculty in 1982, Professor Salop held various positions in the Bureau of Economics at the Federal Trade Commission, including the positions of Associate Director for Special Projects and Assistant Director for Industry Analysis.

Steve, welcome back to the FTC.

MR. SALOP: Thanks, Bob. You, too.

It's good to be back here at the FTC, back at the hearings as well. As I said the last time I was at the hearings, I think that it's terrific to see the FTC at the forefront of intellectual endeavor and antitrust; and I think you're going to do a great job with this in the staff report.

1 My topic today is antitrust analysis foreclosure
2 concerns in standards and network joint ventures. It has
3 been a longstanding interest of mine. There's a paper
4 outside that I've done with Dennis Carlton on network joint
5 ventures. And I've also done a recent paper on vertical
6 mergers.

7 I should say about the Carlton/Salop paper, it is
8 the Chicago/Chicago approach to network joint ventures. But
9 the testimony today are my opinions and not necessarily
10 those of Dennis.

11 What I want to talk about today are what I call
12 input joint ventures. I put up a basic framework for an
13 input joint venture.

14 The idea is that many joint ventures provide some
15 input to the members and then the members compete, or at
16 least potentially complete, in the output market.

17 There may also be rival input suppliers. And they
18 may supply inputs to the joint venture or simply to the
19 non-member. And, of course, in the output market there's
20 not just competition among the members and between members
21 and non-member, as there's just not intra-system competition
22 and inter-system competition; but there may be other
23 products as well.

24 So some examples of these things could be an ATM
25 network that this is the network switch and these are the

1 members. It could be credit cards. This could be the
2 standard. This could be like DOS-compatible standard, and
3 then these are the people that use it.

4 For old antitrusters, like me, Northwest
5 Stationers would be up here, and they provide stationery to
6 all the members. And then you have Pacific which gets
7 driven out of the co-op.

8 And one of the allegations is that Pacific gets
9 kicked out because they were vertically integrating to
10 becoming their own wholesaler.

11 Fashion Originators Guild, the situation where the
12 non-members are the style pirates; and then the input might
13 be retailing where we had the white cards and they refused
14 to provide retailing services to the non-members, who were,
15 instead, forced to rely on the red cards.

16 Now, for those of you who don't teach antitrust or
17 haven't had it, I commend Fashion Originators Guild to you
18 as one of the great cases of 30's, Associated Press and so
19 on.

20 My focus with this diagram is going to be on
21 exclusionary access rules. What I mean by that is
22 membership rules, primarily membership rules that have
23 exclusivities involved.

24 I want to first talk about anti-competitive
25 concerns. I'll lay a framework for that. I then will talk

1 a little bit about efficiencies. And then I'll talk about
2 how I think the Commission or the courts should analyze

1 that you would more likely view as kind of the central
2 concerns of antitrust.

3 The first is what I call "input market exclusion."
4 And that's a situation in which the joint venture passes a
5 rule or tells its members that they must buy exclusively
6 from the JV. They are not permitted to buy from rival input
7 suppliers.

8 Now, why would a joint venture -- what
9 anti-competitive purpose could it serve to not permit your
10 members to buy from outsiders?

11 Well, by doing it, by refusing to allow them to
12 buy from outsiders, you might kill the outsider or handicap
13 them. The outsider by be denied economies of sale and,
14 therefore, go out of business. And so the input JV would
15 gain power or maintain market power at the input level. And
16 that could be -- of course, if they have power in the input
17 level through two-tier entry, that could make entry by
18 non-members less likely at the output market as well.

19 Okay. So the first exclusionary theory would be
20 that you cause exclusion at the input level. Again, that's
21 one interpretation of what was going in Northwest, was that
22 they were trying to prevent Pacific from entering at the
23 upstream level.

24 Now, this morning, Chairman Pitofsky asked a
25 question to Christine Edwards about what Dean Witter's

1 concern was. And what the Chairman focused on was exclusion
2 at the output level where these are VISA members here,
3 here's VISA; and then Dean Witter is here, Discover; and
4 that's going to be the theory of output market exclusion I
5 talk about next. But what Ms. Edwards said was -- what she
6 was talking about in her testimony today was ways in which
7 VISA's conduct was going to deter Dean Witter from entering
8 with its NOVUS Network, which is at this level. But that's
9 what she was concerned with.

10 Now, the third theory -- which is the one that
11 people talk about the most -- is output market exclusion.
12 And in that situation the input joint venture refuses
13 membership to non-members. And that is to say just refuses
14 to sell them input; and, under certain circumstances, that
15 can give the members market power in the output market.
16 Sometimes, not always. And those are the conditions I want
17 to talk about.

18 If the non-members can get equally good input from
19 rival input suppliers, then they will be not be harmed, no
20 harm to competitors even. There's only going to be harm to
21 competitors if, for some reason, what the joint venture
22 sells, given its price is better and more efficient, as if
23 the rival's are less efficient.

24 And in the VISA case, which I worked on for Dean
25 Witter, Dean Witter's argument was that the economies of

1 scope with the VISA card and issuing other cards so that
2 they would be more efficient as a VISA issuer, that it was
3 not a perfect substitute for Discover.

4 But, in any event, that case aside, you need to
5 prove harm to competitors.

6 Secondly, even if you prove harm to competitors,
7 even if you knocked this non-member out, there may still be
8 ample competition in the output market to prevent any
9 anti-competitive effects.

10 If the input joint venture is selling, for
11 example, the input to its members at cost and these members
12 are competing against one another, then competition among
13 the members could prevent any anti-competitive effect.

14 In addition, there may be other products that
15 could prevent prices from rising.

16 Okay. So input market exclusion, in order to
17 prove market exclusion to the competition that has harmed
18 the consumers, the plaintiff would need to show not only
19 harm to the competitor, the non-member, but also harm to
20 consumers as well, prove a harm in the input market and then
21 also in the output market. You need to show limited
22 competition in both markets.

23 Now, the key to understanding that -- I think now
24 I can sit down -- is the concept of exclusionary market
25 power. Exclusionary market power is the ability to raise

1 prices by raising the cost to the competitors. In order to
2 have exclusionary market power, you need not have classical
3 market power, that is the ability just to restrict your own
4 output.

5 In classical market power, you restrict your own
6 output. In exclusionary market power, you restrict your
7 competitor's output. What John Baker has called, getting
8 your competitor to involuntarily join a cartel.

9 And Carlton/Salop, in our paper, propose a merger
10 test to measure exclusionary market power in the context of
11 network joint ventures. And it's a merger test that's
12 different, say from the Jorde and Teece -- quite different
13 from the Jorde and Teece merger test.

14 I want to make three points about exclusionary
15 market power.

16 The first is -- and it follows from my analysis --
17 exclusionary access rules can harm competition, that is can
18 harm consumers, even if it does not cause the firm to exit
19 from the market. Creating barriers to expansion can harm
20 consumers as well as driving the firm out of business.

21 So that is, if you handicap the non-member, raise
22 its costs but you don't raise it so much that he's driven
23 out of business, nonetheless, the members may be able to
24 raise price in the output market.

25 So an implication to that is that the essential

1 facilities standard that we talked about this morning is too
2 permissive on joint ventures, even if the input provided by
3 the joint venture is not essential, there, nonetheless,
4 could be harm by denying that input to rivals because it
5 disadvantages them because it raises their costs.

6 Second point, the harm to competition that may be
7 at issue -- and is an issue in many joint venture cases,
8 especially network joint venture cases -- does not involve
9 raising price above the initial level. Rather it involves
10 preventing further -- rather, it involves maintaining high
11 prices, preventing price from falling.

12 So you could have a joint venture that the members
13 are competing against one another, but along comes a very
14 efficient new firm that if they are permitted to join the
15 joint venture, they'll lead to more intense competition,
16 which will lead prices to fall.

17 By denying that firm access to the joint venture,
18 by denying it membership, the members are able to maintain
19 high prices rather than leaving prices to fall.

20 So, again, essential facility is not the issue.
21 And, again, on market -- this has important implications for
22 market definition, because the question is not whether the
23 joint venture has the ability to raise price -- that's
24 classical market power -- rather, the issue is whether, by
25 the conduct, they are going to prevent prices from falling.

1 And there are many antitrust cases in which what's at stake
2 is maintaining prices at the monopoly level rather than
3 forcing them above.

4 If this issue is ignored, the exclusionary market
5 power often involves preventing price decreases, then the
6 agencies and the courts will fall for the Cellophane

1 at cost. Rather it takes its profits upstream. That's a
2 point that's made in Carl Shapiro and Bobby Willig's article
3 on joint ventures.

4 If you take your profits upstream, and even if the
5 membership is unconcentrated, you can still achieve the
6 monopoly price. You can simply bump up the input price to
7 the monopoly level, and then the members pass it along.

8 So the implications of this are, one, you need to

1 Efficiency rationales. Well, you know, most joint
2 ventures are efficient; and most exclusionary access rules
3 can contribute to efficiency. The question is finding the
4 ones that don't or the ones where the efficiency benefits
5 don't outweigh the anti-competitive problems.

6 Two basic classes of efficiencies: one,
7 efficiency from cost reduction, eliminating duplicative
8 costs and so on; and, second, broad classes maintaining
9 investment incentives.

10 Now, I am not so taken with efficiencies that I
11 would give joint ventures a free pass to set whatever access
12 rules they want. Instead, I think the efficiencies should
13 be subject to a reasonable necessity standard where the
14 joint venture has to show that the exclusion is reasonably
15 necessary, not the joint venture.

16 The joint venture may be highly efficient, but the
17 exclusionary access rules may be chosen not for the
18 incremental efficiency benefits but rather for
19 anti-competitive harms.

20 I would not require the joint venturers to show
21 that the exclusives are essential for viability of the joint
22 venture. I think simply "contribute to" is enough for it to
23 be a cognizable efficiencies.

24 At the same time, I'm quite skeptical -- and I
25 think courts should be skeptical -- of investment incentive

1 claims, that you need exclusion in order to maintain
2 investment incentive claims where it's a large network joint
3 venture.

4 I think for a small joint venture, you know, kind
5 of the three semi-conductor firms that get together, I think
6 investment incentives is a good reason to have exclusionary
7 access rules. They bore the risks, and nobody should be
8 allowed to force themselves in.

9 But if it's a dominant network joint venture
10 that's always been open, well, then that joint venture has
11 not been worried about investment incentives in the past
12 because it's been open. The existence of network
13 externalities would suggest that they benefit from
14 additional members. And in those cases, I would be quite
15 skeptical of the investment incentives justification for not
16 permitting somebody in.

17 So that's my basic economic analysis.

18 The legal analysis, I think the per se standards
19 in Northwest and in the recent VISA case are not good
20 standards. I think these things should be rule of reason
21 but not an open-ended Chicago Board of Trade rule of reason,
22 but rather one that's structured over proof of
23 anti-competitive effects, proof of efficiencies; and if you
24 prove both, both efficiencies and anti-competitive effects,
25 then a balancing.

1 I'd require the plaintiff to state claims with
2 specificity, as I said before. I would recommend the
3 balancing be down without regard to the essentiality.

4 I would not require the plaintiff to prove that
5 membership is essential for its viability in the market;
6 that is, I would reject the essential facilities approach.

7 Similarly, I would not require the defendant to
8 prove that the exclusion was essential to the viability of
9 the venture.

10 I say it's not essential versus essential, rather
11 it's balancing with the proper weight being placed on
12 efficiencies and anti-competitive effect.

13 I think this morning we talked a little bit about
14 treating the joint ventures as a single firm. I think that
15 would be a mistake. I think it should be recognized that a
16 joint venture is a group of competitors getting together,
17 and we should not create the fiction that they're a single
18 firm.

19 As Areeda has quite cogently pointed out,
20 mandating access to a single firm raises remedy issues that
21 mandating access to joint ventures does not.

22 The fact that it's a joint venture proves that
23 sharing is possible. Whereas, with a single firm, you can't
24 tell. If it's a joint venture, you don't need to set price
25 the way you would, you know, as Janusz discussed this

1 morning. You don't need at set a price with a joint
2 venture. Instead you could just require a
3 non-discrimination rule. Tell them they need to -- they can
4 charge the same price to the excluded firm that they charge
5 to anyone else.

6 Based on my experience, I think that where there
7 is a dominant network joint venture and if it's shown with
8 good evidence that there's a significant anti-competitive
9 harm arising from the exclusion, I doubt that the benefits
10 of maintaining investment incentives will very often be big
11 enough to compensate for the proven anti-competitive harms.
12 But there's no reason why defendants should not be allowed
13 to try in a particular situation.

14 I stated earlier why I think it would be unlikely
15 to succeed, but I wouldn't rule that out. At the same time,
16 I would not rule out the plaintiffs getting an opportunity
17 to prove anti-competitive effects that's larger than the
18 efficiency benefits for the exclusion.

19 Thank you.

20 CHAIRMAN PITOFSKY: Thank you.

21 A couple of questions. First of all, on setting
22 the price, I presume you would allow the entrenched joint
23 venture to charge the new entrant some premium, some risk
24 factor that the originators had taken?

25 Doesn't that throw you right into the soup in

1 terms of who's going to decide what the premium is? how much
2 it can be? and so forth?

3 MR. SALOP: No, I don't think it does. Because
4 most joint venture exclusion cases do not involve joint
5 ventures that are closed and someone's trying to force their
6 way in. They're very commonly situations where the joint
7 venture has been opened so there is a membership price, but
8 then they selectively discriminate.

9 Where you have a closed joint venture and there is
10 no price, well, yeah, then you run into the price setting
11 situation -- you run into the need to set a price; and
12 that's a thorny issue, I agree.

13 CHAIRMAN PITOFISKY: How do you respond to the
14 charge that you have converted every large dominant joint
15 venture into a kind of public utility, taking everybody in,
16 so long as the party that's coming in is likely to result in
17 a reduced price to consumers?

18 MR. SALOP: Well, I guess I say that's what
19 antitrust is all about. Where there is anti-competitive
20 harm proved from excluding a firm, then it's the proper role
21 of antitrust to prevent that consumer harm.

22 CHAIRMAN PITOFISKY: But you wouldn't do it with a
23 shopping mall, for example? That's not your big network,
24 dominant network situation?

25 MR. SALOP: No. I mean where there's internetwork

1 competition that's intense, no, I wouldn't do that.

2 And in the shopping mall, there's going to be
3 somebody in the -- with a shopping mall problem, if it's is
4 there going to be Store A versus Store B, that's of course a

1 to bring them in?

2 MR. SALOP: If they concede the offense.

3 Under your situation, they conceded the offense.
4 They conceded that the entry of the new store would benefit
5 consumers.

6 CHAIRMAN PITOFSKY: Right. And, therefore, since
7 you're skeptical that it had any impact on their original
8 decision to --

9 MR. SALOP: I'm sorry. You conceded there was no
10 efficiency benefit.

11 CHAIRMAN PITOFSKY: Well, I was thinking of the
12 investment.

13 MR. SALOP: Well, if they make out a credible
14 investment incentives argument, yeah, they're allowed to
15 make that.

16 CHAIRMAN PITOFSKY: Well, I think others will
17 chime in with questions a little later.

18 Our second speaker is Robert Willig, Professor of
19 Economics and Public Affairs at Princeton University, a
20 position he's held since 1978.

21 From 1989 to 1991 he served as Deputy Assistant
22 Attorney General at the Justice Department.

23 Professor Willig is a member of the National

1 Force on antitrust aspects of defense industry
2 consolidation.

3 Professor Willig.

4 MR. WILLIG: Thank you, Bob.

5 The title of this session is an intriguingly
6 challenging one. The title bonds together, with open
7 access, the notion of the network along with the entire area

1 notion of, quote, "network externalities," the notion that
2 the more players there are of the right character in the
3 network, the more beneficial is the network to the others
4 who are associated or who are members of it.

5 Now, these are all economic elements that we have
6 a lot of experience with, but they're all pretty tough nuts
7 in other context, too, when it comes to antitrust; and here
8 they all come together and pose one great big bundle of
9 challenges.

10 But I personally don't think that these challenges
11 are in any way unique or different in character than the
12 same challenges when they appear in other instances, other
13 industries, other settings, having all of or some of those
14 characteristics.

15 I'll try to remember to keep coming back to that
16 list as we think about some of the antitrust applications.

17 The first application that I wanted to mention
18 avoids the notion of access. Soon enough I'll take that
19 plunge.

20 But, first, when I think about a network, the most
21 obvious example is computer networks that we all love to
22 plug in. And I like to keep track of what goes on. And I
23 think about some of the disputes lately over joint ventures
24 maybe even mergers involving network industries that
25 actually employ competing network technology. And I ask

1 myself what special competition issues are posed by a
2 network joint venture or a network merger?

3 I think there is something different there, but
4 it's not unique to networks. It's something which I think
5 is part of the technology trend of this part of the century.

6 A bunch of years ago, I went through the Wall
7 Street Journal and tabulated joint ventures, for one reason
8 or another, back over the prior 20 years, putting them into
9 various categories. And recently I repeated that exercise
10 for a different purpose. And I was quite struck at the
11 differences.

12 The kinds of joint ventures that we are seeing
13 today, statistically, as reported by at least the "Wall
14 Street Journal have changed the locus of industry away from
15 metals, away from smokestack industries, away from
16 chemicals, away from energy; and, instead, moved more toward
17 the higher technology sectors of today. Biotech,
18 pharmaceuticals, medical equipment, financial services,
19 computing, telecommunications: These are the industries
20 where the joint ventures take place today. And, of course,
21 they're also industries with lots and lots of examples where
22 network technology or the network metaphor does apply.

23 What I like to call these joint ventures is
24 "complementarity merges," or "complementarity combinations"
25 because these are not joint ventures among people who would

1 otherwise be building separate factories. Instead, these
2 are people with complementary technologies who are coming
3 together to provide some sort of bottom-line service or
4 product that draws on their separate elements of expertise,
5 puts them together in a complementary way and perhaps can do
something different than either could do alone.

1 market for the end user service?

2 Just because Network A and Software Producer B
3 together could provide us End User Service X doesn't mean
4 that two entirely different sources of competitive advantage
5 might not be able to come together and provide End User
6 Service Y that would be competing with End Use Service X.

7 So the relevant market and the notion of what is
8 horizontal versus vertical relationships in a setting like
9 this breaks out of some of our old rhetorical boundaries.
10 But I think the bottom line antitrust analysis is really
11 nothing very surprising nor especially difficult if you just
12 keep your eye on the ball of asking the question: What
13 could be the diminution of competition from the combination?

14 I think the same sort of run of conclusions comes
15 out of the intrinsically more difficult area of what might
16 be special about networks as a locus of vertical practices?

17 If we have a network that's involved in
18 exclusivity practices, foreclosure, alleged refusals to
19 deal, some sort of bundling or tie-in activity and these are
20 vertical practices that might fall into the precise subject
21 of this afternoon's session. Because that's really the
22 reverse of open access. If we're going to have some sort of
23 impacted access which poses an antitrust problem, then there
24 must be a more conventional vertical practice that underlies
25 the closure of the access that others might like to see.

1 To me, the most clear example of that sort of
2 issue comes when the network could be labeled as a true
3 essential facility. Someone really needs access to the
4 network, really needs a cooperative relationship or a joint
5 venture perhaps with the network in order to compete
6 successfully in a truly relevant market; and the question is
7 whether something special comes out of network analysis that
8 poses a special challenge for that analysis.

9 And I think the answer is, well, yes and no.
10 Again, this is an issue that comes up whenever access to an
11 important asset is on the table as a question. And yet it
12 takes on a particularly severe and complex form when the
13 asset is inherently a network.

14 When a network is formed, because it has
15 externalities intrinsic to its structure, the pricing of the
16 relationships within the network, must, as a matter of
17 logic, involve pricing that is well outside the domain of
18 anything close to marginal cost pricing. It may very well
19 involve not only linear pricing, multi-part pricing,
20 discriminatory pricing of all different kinds, in order for
21 the network to be able to cover its total costs and make an
22 entrepreneurial profit, in the face of all of the
23 externalities involved among the members.

24 What that means is that if someone is to be given
25 access to that network, that the internal pricing of network

1 services may very well be undermine severely and drastically
2 for the finances of the network, if that access pricing is
3 too heavily regulated or too much seen as a source of
4 anti-competitive forces, if that pricing is difficult or

1 consumers.

2 Janusz and I, a long time ago, came to a
3 formulation of the idea of compensatory pricing.

4 And, Janusz I understand you put some of this on
5 the record this morning.

6 MR. ORDOVER: Meekly.

7 MR. WILLIG: I would like to just repeat it
8 equally briefly right now in this context.

9 What we were able to prove in economics language
10 is that if a network were going to be forced to open itself
11 to access that it would be seriously threatening of
12 anti-competitive views of antitrust law to force that
13 network to open itself up on terms that were anything less
14 than fully compensatory.

And the notion of fully compensatory is this: The56931itr.

1 less desirable to the network than those that would return
2 to the network its costs of giving that access and also the
3 lost profits or the opportunity costs from the membership of
4 that new player.

5 The good properties of that rule are, first of
6 all, that it honors the ability of entrepreneurs to build
7 the asset to create the network in the first place without
8 being concerned that there will be a taking of that property
9 through inappropriate use of antitrust or regulatory rule.

10 But second, and most important from the economic
11 point of view, given that the network is already there, is
12 that that rule tends to conduce to efficiency in the
13 selection of activity between current members of the network
14 and those who would wish to become members or wish to have
15 access to the network. Those who are truly more efficient,
16 if they are paying a compensatory price for access to the
17 network can succeed in the final product or service market.

18 And those who are not efficient, as compared to
19 those who are presently in the network or have access to it,
20 those who are not efficient cannot make it, given that they
21 are being asked to pay a compensatory price for their
22 access.

23 And so that's a good baseline rule. And if one
24 sees a network offering access on compensatory terms, even
25 though some complainants may not be able to pay those terms

1 or may not wish to, according to the Ordovery-Willig theory
2 -- which Janusz may want to repudiate as soon as I'm
3 finished -- according to that theory, there's really no
4 anti-competitive practice or anti-competitive effect from
5 holding out for truly compensatory terms.

6 So I think we have gone a long way towards solving
7 that complex set of problems with that line of work.

8 The other area that comes to my mind on the
9 subject network access has to do with the terms of access,
10 beyond mere price.

11 I think one of the more challenging examples of
12 terms comes up in the bevy of antitrust concerns in the last
13 few years surrounding vertical mergers. On the subject of
14 the terms that others outside the vertical combination have
15 imposed on them by the vertically merged company or by the
16 court or by an agency in their relationships to the
17 vertically merged company after the fact of the merger.

18 So A and B merge, they're vertically related. A
19 or B could be a network. In some of these examples they
20 certainly are. And there's a worry that Firm C, which is
21 not integrated, in dealing with the integrated Firm A-B,
22 will somehow convey through dealing with A-B competitively
23 sensitive information that, say, Firm A, or Division A, can
24 use gainfully later in some additional market activity in a
25 fashion that impedes competition.

1 There's a pharmaceutical manufacturer and a
2 distributor of pharmaceuticals, they merge; another
3 pharmaceutical manufacturer is bidding to the distribution
4 arm of the vertically integrated company. The concern is
5 that, through that bidding for the business, information is
6 conveyed that softens competition between the two
7 pharmaceuticals manufacturers in their bidding activity
8 later to a different distributor, would be in our typical
9 example.

10 Or two electronics firms and they are selling
11 systems to an aircraft manufacturer, one might worry about
12 the information being revealed after the merger that,
13 before, would not have been available and that revelation of
14 information later harming competition, harming consumer
15 interests in some fashion.

16 I assume everyone in this room is sensitized to
17 that kind of issue from a number of interesting cases in the
18 last few years.

19 So the terms on which the information is made
20 available to the firm is one example, more generally, of the
21 terms of vertical relationships; and this is a particularly
22 interesting and challenging one to me.

23 I think we all have some instinct that suggests
24 that if that information from the outside bidder is
25 revealed, then it might, in fact, influence the way

1 be no wall and certainly no wall imposed from the outside.

2 Now, I say that in this room to this audience with
3 the full respect of what you have all been trying to do, no
4 matter what the defense economists have said from time to
5 time. But, nevertheless, this is certainly a challenging
6 area; and I think it's fair to say that economic theory has,
7 in no way, closed its book on the area. And my student's
8 work, while stimulating, is certainly not the final answer.
9 It's a very simple model. And who knows what Steve could do
10 it if he were on the other side of some such issue.

11 What this teaches me, though, is yet another
12 instance of respect for the difficulty of figuring out the
13 full effect of vertical practices.

14 I gave a speech at Georgetown about a year and a
15 half ago back to back with Steve on the subject of our
16 ignorance as economists in general of the empirical
17 correlates of what facts to you use to help us reliable to
18 separate out vertical practices that are efficient,
19 pro-competitive, pro-consumer from those that are the
20 opposite.

21 Especially in the context of practices that a
22 vertical merger might or might not make possible in terms of
23 practicality and might or might not stimulate in terms of
24 the incentives the merger would create.

25 And this comes back, I think, in the network

1 context even more strongly than in other context. And that
2 is my belief that we do not have a checklist of empirical
3 facts to go after as antitrust investigators to teach us
4 reliably whether or not a practice is good or bad and
5 whether or not a merge that makes the practice possible and
6 predictable is a good or bad thing.

7 So a process comment, if I might put on this
8 record, is my suggestion, or my proposal, or my desire, most
9 personally, that as a continuation or an afterward to this
10 process of hearings that the FTC, either alone or together
11 with Justice, in cooperation with the Bar and in cooperation
12 with academia, undertake a process of organized thinking
13 about vertical practices and about vertical mergers that
14 make those practices possible and maybe stimulate them to
15 drive toward a better understanding, with all sides
16 represented, to an understanding of what facts really are
17 critical for reaching good antitrust conclusions.

18 And this is beyond networks, but networks would
19 certainly be an element of the checklist of factors that
20 would be pushing us one way or the other in coming to a
21 judgment about those practices.

22 I think companies certainly ought to be involved,
23 perhaps through learned counsel, who, if they have nothing
24 better to do, could certainly be spending lots of times
25 gainfully for participants, are bringing some facts or some

1 business stories from either their own experience or from
2 their clients' experience to the table as a form of data for
3 those who prefer to take a more theoretical approach to work
4 over; but also how great to have the talent, which is just
5 amazingly well stocked in Washington right now, on both the
6 economics and the legal side in the antitrust community,
7 have that talent going to work in a rather organized way on
8 these most important questions of antitrust enforcement.

9 Nothing could please me more than to be some small
10 part of that and to see you folks undertaking it with some
11 real energy.

12 So let me close on that thought, and thank you for
13 the opportunity to say these things to you.

14 And thank you.

15 CHAIRMAN PITOFISKY: Thank you. As someone who has
16 managed to change the antitrust world through the writing of
17 guidelines, it's encouraging that you think another process
18 like that would be useful.

19 MR. WILLIG: I didn't want to call them
20 guidelines, though.

21 CHAIRMAN PITOFISKY: Let's see, we have one more
22 speaker and then Professor Ordoover gets to comment.

23 Our third speaker is Tom Rosch who we already
24 introduced for the record earlier today but who will address
25 some of these vertical questions.

1 Tom.

2 MR. ROSCH: Mr. Chairman, once again, thank you.
3 And, once again, I'm cowed by the world class economists
4 that you have assembled here; so, frankly, I'm not going to
5 touch most of what Steve said or Bobby said with a 10-foot
6 pole.

1 exists in networks that exist when you're talking about
2 exclusive dealing arrangements, packaged pricing
3 arrangements, and even most favored nation clauses. As I
4 see it, it's the same thing.

5 What catches my attention -- I'm going to,
6 incidentally, completely depart from the paper here because
7 I'm sure that's available if you want to read it. I'd just
8 like to muse about some other things.

9 First of all, what catches my attention is the
10 anomaly between the Supreme Court case law on vertical
11 mergers, on the one hand, and the Supreme Court case law on
12 other forms of vertical restrictions and, more particularly,
13 the more recent Court of Appeals case law on vertical
14 restrictions. They are totally different.

15 The case law on vertical restrictions is basically
16 Brown Shoe and Ford Motor. And virtually any kind of
17 vertical joint venture or merger that I know of today would
18 probably violate Brown Shoe and Ford Motor, that the amount
19 of foreclosure in those markets was de minimis: 5 percent
20 in one I think and 3 percent in the other.

21 Contrast that with Tampa Electric, which sees
22 efficiencies -- or at least the possibility of efficiencies
23 and exclusive dealing arrangement -- and in the recent Court
24 of Appeals law, the "Barry Wright case in the First Circuit,
25 Rowland Machinery in the Seventh Circuit, U.S. Healthcare in

1 the First, and Barr v. Abbot Laboratories in the Third, all
2 by very distinguished judges, Justice Briar in Barry Wright,
3 Judge Posner in Rowland, and Judge Boudine in U.S.
4 Healthcare.

5 And they're all taking a very, very hard look at
6 claims about market foreclosure. And for the most part,
7 they are all stressing that it has to be foreclosure, not of
8 a competitor, but of competition. Every single one of them
9 is saying that.

10 They are stressing that the foreclosure has to be
11 enduring. Both Judge Boudine and Judge Posner set up,
12 essentially, a presumption in favor of vertical
13 arrangements, completely exclusive arrangements which last
14 for less than a year.

15 Barr v. Abbot Laboratories blessed a package
16 pricing arrangement which it analogized to an exclusive
17 dealing arrangement where the party had 50 percent of the
18 market, but it did so because the exclusive dealing
19 arrangements only covered 15 percent of the market so that
20 the rest of it was contestable.

21 Now those are very, very different views from the
22 old Supreme Court cases. And so I think the first lesson to
23 be learned is that, quite frankly, the vertical merger law
24 is a relic of a bygone era. It's a relic of the era that
25 produced Standard Oil in the Supreme Court, one in which the

1 Supreme Court was simply, generally hostile to vertical
2 arrangement restrictions generally.

3 And I think today that any exercise of
4 prosecutorial discretion has to take into account this
5 modern trend, this modern case law that recognizes that
6 vertical arrangements are, number one, efficient; and,
7 number, two is very skeptical about claims of market
8 foreclosure.

9 Now that brings me to the four-step process with
10 respect to vertical mergers or vertical networks, if you
11 will, that I think is kind of byproduct of that law.

12 Step number one, again, is focus on efficiency for
13 the same reasons that we discussed this morning. The only
14 difference is that I think that the absence of efficiencies
15 doesn't have quite the weight that it has in the horizontal
16 context.

17 As best I can determine, there really is no per se
18 rule that operates any more in the vertical context. So I
19 just don't see that the absence of efficiencies can have the
20 effect of ending the inquiry.

21 Step two is that if there are efficiencies and
22 especially if they look like they are real and substantial,
23 there should be a presumption in favor of the transaction.

24 Now I would suggest that that's especially
25 important here. With respect -- and I do mean this -- I

1 respect what Steve has written. I think it's
2 extraordinarily powerful and interesting. But the fact of
3 the matter, I think, is that in large measure and in many
4 settings it is theory. And the flip side of Kodak is that
5 economic theory, to be sure, doesn't trump facts in order to
6 produce antitrust defenses; but neither does economic theory
7 trump facts in terms of presenting a case.

8 And I'm inclined to think that in many settings,
9 at least, theories of foreclosure simply do not take account
10 of the countermeasures that are available to competitors,
11 particularly in this fast-moving world or with other factors
12 which produce the same kind of results.

13 Let me just touch on a couple of examples. In the
14 case of package pricing arrangements, which are one of the
15 threats that can occur from Steve's chart up there, where
16 the joint venturers, by virtue of having -- the input joint
17 venture, by virtue of having available to it a broad variety
18 of products, can make those products available on a package
19 basis.

20 Whereas one other -- there may be no other
21 competitor in the market that can make those products
22 available itself. Should that be thought to be a viable
23 form of market foreclosure with respect to the competitor
24 that doesn't have the ability to produce those products
25 itself? The answer, at least from the package pricing case

1 law -- the most recent package pricing case law -- is, no,
2 those folks have countermeasures available to them; they can
3 marry other people who have those products available or
4 create new entry; and thereby create the same array of
5 products.

6 It seems to me that the burden is going to have to
7 be, on whoever is attacking the transaction, demonstrate
8 that that is not feasible.

9 Similarly, if I could take a jab at the most
10 favored nation cases and decrees, to be perfectly honest,
11 it's not clear to me how most favored nation clauses, even
12 in the most concentrated markets, produce much results that
13 are much different from what the Robinson-Patman Act does.

14 Essentially it imposes on the industry uniform
15 pricing, if at least the Robinson-Patman Act is being
16 enforced.

17 The long and the short of it is that, again, I
18 think where you have efficiencies present, you ought to look
19 long and hard about whether or not the foreclosure claims
20 really are viable.

21 Step number three, the presumption, however, is
22 rebuttal. If the phenomena that Steve has talked about
23 exists, then I think that, under those circumstances,
24 structural relief is appropriate.

25 Step number four is that that high presumption

1 need not necessarily extend to practices which may occur in
2 the course of the vertical joint venture.

3 I'm looking forward eagerly to hearing what

1 practiced consent decrees, which do not impinge on the
2 efficiencies involved, are perfectly appropriate.

3 But let me say one final thing, and then I will
4 stop. I wonder, quick frankly, why those practices decrees
5 need be imposed at the threshold.

6 The agencies don't need to obtain consent decrees
7 at the time that a vertical network is established in order
8 to preserve the option to attack anti-competitive practice
9 if, as, and when they occur.

10 And I think there's a danger to a hair trigger
11 approach. I think in most circumstances, it's better to
12 wait and see. There is simply too much uncertainty, in most
13 circumstances, I would suggest, as to whether the practices
14 will occur; what their affect on competition, not just
15 competitors, will be, if they do occur; and, for that
16 matter, what the effect of the decree might be on either
17 efficiencies or competition.

18 Thank you.

19 CHAIRMAN PITOFSKY: Once again, thank you for
20 enlightening us on these issues. I agree with Bobby, these
21 are the toughest issues of those that we have been talking
22 about in the last two days.

23 Jon, would you like to start off?

24 MR. BAKER: I have a question that Janusz could
25 just as well answer it

1 CHAIRMAN PITOFSKY: What's that?

2 MR. BAKER: I said I have a question.

3 CHAIRMAN PITOFSKY: All right.

4 MR. BAKER: Would that be all right?

5 Okay. I just want to say first that I am thrilled
6 to sit at the table with so many of my mentors. I was
7 Special Assistant to both Bobby and Janusz when they were
8 Deputy Assistant Attorney General in the Justice Department;
9 and Steve has been my mentor in so many things -- even
10 though never quite formally -- that I have to count him as
11 well.

12 But it does distress me, though, when colleagues I
13 respect so much don't perfectly agree. But now that I've
14 turned 40, I suppose I have to think for myself. So I will
15 ask my question.

16 As I understand the state of play on one of the
17 issues that's under discussion here, that Steve has
18 highlighted that the potential for exclusionary market power
19 from input joint ventures in network industries and
20 otherwise; and Bobby says, well, yes, in principle, but you
21 can't practically remedy it or, in any event, don't worry so
22 long as the joint venture uses the compensatory pricing rule
23 to price to everybody.

24 And my question is really about that. And Janusz
25 or Bobby could answer it because it's about the compensatory

1 pricing rule, which is: How does the compensatory pricing
2 rule work to solve all of our problems here if the joint

1 And, Steve, I think it's covered among one of your
2 antitrust --

3 MR. SALOP: Ancillary.

4 MR. WILLIG: -- and I would like -- ancillary
5 market? Is that what you call it?

6 So here's a part company, and the part company is
7 selling some special parts to an automobile manufacturer;
8 and there could be network in here some place; but it's all
9 the same thing.

10 And the parts company sells these wonderful parts
11 to the car company and refuses to sell the parts to some
12 other competing automobile company.

13 And the foreclosure issue arises, the exclusivity
14 issue arises.

15 And the question is: What are we trying to do if
16 we consider forcing the parts company to sell its parts to a
17 different competing automobile maker? Which market are we
18 trying to save from anti-competitive harm?

19 My view of that situation is that it's very
20 dangerous, as a matter of policy, to try to save competition
21 in the market in which the automobile manufacturer that is
22 affiliated with the parts company, and the other automobile
23 manufacturer. The direct market in which the two of them
24 compete is a dangerous one to try to save from these
25 exclusive relationships with the parts company.

1 And the reason for that is that the relationship
between the parts company and the first car company may very

1 Maybe there's only two possible players, the original car
2 company and this other car company so that the weakening of
3 the outside car company and its ability to compete in the
4 truck market actually, substantially diminishes competition
5 in the truck market.

6 Now, enter the efficient component pricing rule or
7 access pricing. I could imagine thinking about imposing on
8 the parts company the obligation to sell parts to the other
9 automobile company for the purpose of saving competition in
10 the truck market, not competition in the auto market.

11 Question: What's an appropriate price for the
12 parts under those circumstances?

13 And my answer is -- and this comes out of Janusz'

1 of the car that the outside company achieves at the expense
2 of the original car company.

3 And now you would say, quite properly: But
4 doesn't that involve market power? Isn't that price a price
5 that includes some sort of profit from the same of cars into
6 the car market? And my answer is: It my very well; but the
7 aim here is not to impose some new, pseudo competition into
8 the car market. The aim is to accept that market as we find

1 on.

2 MS. DeSANTI: Janusz, would you like an
3 opportunity at this point to comment on your friends'
4 positions?

5 MR. ORDOVER: Let me just say a couple of words.

6 See, the reason I'm here is I am probably the only
7 person in the world that wrote papers both with Bobby and
8 Steve.

9 But I would like to pick up on the point that
10 Jonathan raised because it really goes to the heart of the
11 compensatory pricing approach that Bobby and I have been
12 working on now for about 15 years, with breaks.

13 And we should be grateful for Steve because he
14 actually paid for the first paper that we wrote on the
15 subject when he was at the FTC.

16 MR. SALOP: I didn't pay.

17 MR. ORDOVER: Oh, you didn't pay.

18 MR. BAKER: The taxpayers paid.

19 MR. ORDOVER: The taxpayers paid at Steve's
20 suggestion.

21 MR. BAKER: And we want our money back.

22 MR. ORDOVER: You're getting it in spades.

23 Well, the point, I think, that emerges is that I
24 don't think either Bobby or I claimed that one can give a
25 very clear answer to what the compensatory price can be or

1 how it should be calculated in every conceivable scenario.
2 And, indeed, we have been working our way through a whole
3 litany of those. And in every case, additional issues
4 arise.

5 But what -- I don't really want to talk about the

1 or not a particular entrant is going to be the one who is
2 going to cause the prices to fall. Everybody is going to
3 cause prices to fall if they don't have to pay for the
4 input.

5 MR. SALOP: I don't assume he doesn't pay for the
6 input. I assume he pays the same price everybody else does.

7 MR. ORDOVER: Wait. You can respond. There was a
8 pregnant pause. That was not the end of my statement.

9 MR. SALOP: I was just trying to help you along.

10 MS. DeSANTI: It was a rhetorical pause.

11 MR. ORDOVER: No, you're not helping me along.

12 So the point I'm making is I think both the lens
13 through which Bobby and I have been viewing some of these
14 issues and the lens through which Steve is viewing the issue
15 is not, in many ways, that distinct. Because it all brings
16 us back to the question on the terms of access.

1 issue comes up of what are the prices for the parts that
2 this horrible monopolist Kodak -- who has 20 percent of
3 markets for copiers and 3 percent of some micrographic
4 markets -- will have to charge to the independent service
5 organization.

6 And I put in an affidavit saying that they should
7 charge prices that are equal to about 20 times what they are
8 charging themselves, given the margins which they are
9 earning in their service operation.

10 Of course, everybody's going to go berserk once
11 they read what I said; but if that's what the margins are,
12 that's what you're supposed to be allowed to pick up from
13 pricing the parts.

14 Obviously, the ISO's are going to be rendered
15 poorly competitive vis-a-vis Kodak under this pricing
16 scenario. And I have no doubt they are going to be asking
17 for different access terms than the ones that I have
18 suggested.

19 And the same problem is going to come up in
20 Steve's diagram. Every time there's going to be a request
21 for entry, there's going to be a statement made: I'm going
22 to bring prices down. Of course I'm going to bring prices
23 down if you let me come in at preferential terms. But
24 there's absolutely no reason why preferential terms should
25 be given, terms that are anything but compensatory to the

1 members of the joint venture.

2 And I think that once we begin to join these two
3 approaches, perhaps the kind of work that Bobby has been
4 suggesting for us will result in a coherent -- set of
5 consistent and coherent set of answer as to how and when to
6 price -- to force access to a network joint venture or any
7 joint venture that access is required.

8 MR. BAKER: Let me interject. Your Kodak example
9 reminds me. I think there's a useful clarifying comment I
10 could make here for the record, which is this discussion of

1 MR. SALOP: I'm really very confused. I mean,
2 it's -- my understanding is Bobby is now saying we should
3 write Vertical Merger Guidelines.

4 MR. WILLIG: Realizing that we can.

5 MR. SALOP: But let outsiders in this time.

6 MR. BAKER: And he volunteered to help, as recall.

7 MR. SALOP: Yeah, I think you volunteered to be on
8 the committee.

9 And Janusz said he never understood this paper we
10 wrote anyway.

11 I agree that the access price is key to this. And
12 the way I thought to handle it is that, in the case of the
13 applicants to new joint venture, that they would pay the

1 would be the price on which I propose you let the person in
2 on.

3 With respect to Kodak, how does this play with
4 Kodak, well, I mean whenever you mandate access for a
5 single-firm monopoly, there's this problem. Usually we say,
6 you're a monopolist; you can charge whatever price you're
7 allowed.

8 Now, for some reason your monopolist was told he
9 had to give access. And to the extent that you need to come
10 up with the right price, it would seem to me the obvious
11 first step on the price would be to let Kodak charge
12 whatever they charge the self-servicers.

13 It's not as if Kodak's not selling those parts to
14 anyone. They are selling the parts to lots of other people.
15 And why not that price?

16 MR. ORDOVER: I have an answer. Can I give an
17 answer why not? I that's a very simple answer, that even I
18 can understand.

19 And that is that the reason Kodak is selling parts
20 to self-servicers is because if they don't sell parts to the
21 self-servicers, they will go to Xerox. They will not go to
22 the ISO to service their machine.

23 MR. SALOP: Can I answer?

24 MR. ORDOVER: Just one second.

25 And, therefore, the compensatory price and

1 therefore the context of the transaction is quite distinct.

2 I can let my kid drive my car for free. I
3 certainly would not let my drunken friend drive my car for
4 free.

5 So there are two different issues. There is the
6 self-servicers that, if I don't sell, I lose all the margin
7 on; and there are the ISOs, that if I sell, they take my
8 margin away.

9 I think even simple-minded economics would teach
10 us that these transactions are so distinct as to provide no
11 guidance to anything that is at all rational, because what

1 would be simply to charge the ISOs the same prices you
2 charge the self-servicers, but you increase the price to the
3 self-servicers to the monopoly price.

4 And then who are you helping?

5 MR. SALOP: Well, let me -- I take it you also
6 worked for Kodak?

7 MR. ROSCH: No. I'm just trying -- actually what
8 I --

9 MR. SALOP: I'm just kidding.

10 Okay. Look, I understand why Kodak wouldn't want
11 to charge that price. Okay? I mean, the compensatory price
12 is, after all, kind of their minimum reservation price.

But the thing is that, ver t911s

1 of that equipment business.

2 And so there's no reason to think that Kodak would
3 destroy that market.

4 MR. BAKER: We need to get the self-servicers out
5 of the example in order to make Steve's point a little more
6 clear -- or question a little less loaded.

7 Suppose Kodak was only able to do its servicing
8 east of the Mississippi but allowed ISOs west of the
9 Mississippi to have access to its parts? Then what would be
10 wrong with requiring Kodak to sell to ISOs east of the
11 Mississippi where it's doing its own service at the same
12 terms at which it's selling west of the Mississippi?

13 Is that a --

14 MR. WILLIG: That's a terrible example, Jon.

15 Who knows why they're doing it differently in the
16 east and the west, and you're going to have to put that in
17 and deal with it before you can come up with too glib an
18 answer.

19 MR. SALOP: Well, suppose --

20 MR. WILLIG: It's my floor.

21 MR. BAKER: History

22 MR. WILLIG: I think this discussion actually
23 highlights the necessity of paying attention to what the
24 coercion here is trying to do in the way of solving a market
25 power problem.

1 And we, to discuss this intelligently and courts,
2 when they're applying these ideas, to save the public
3 interest, need to be very, very clear about what is the
4 offense and what is the relevant market in which that
5 offense is alleged to be harming competition.

6 The way I articulated my example, it was very
7 clear in that way. And let me just remind you of it. There
8 the harm was alleged to be to competition in the truck
9 market. And so the opportunity costs in the car market was
10 a perfectly appropriate baseline for saving competition in
11 the truck market.

12 The reason the discussion so far of the Kodak case
13 here, and maybe elsewhere, is so painfully confusing is that
14 no one is being clear in this discussion about what's the
15 market in which competition is being saved by the coercion
16 to Kodak on parts pricing?

17 So if you could start there, I think maybe the
18 question would answer itself thereafter.

19 MS. DeSANTI: I'm wondering if we can actually
20 move to a different topic, briefly? I'm sure we'll get back
21 to terms of access.

22 But I wanted to ask you, Tom -- I didn't have a
23 chance this morning; sorry I missed part of your testimony
24 -- just a few questions about your focus on efficiencies.
25 Because it seems to me that it sounds very easy the way that

1 you've put it; but I'm not sure that it always is. And,
2 obviously, the results would depend a great deal on what
3 courts or antitrust enforcers consider to be efficiencies
4 and what they didn't consider to be efficiencies.

5 And I would just like to probe -- there's another
6 part of your paper that talks about the efficiencies needing
7 to be substantial. And I'd just like to try probing with a
8 few examples -- and maybe others can think of better ones as
9 we go along -- to see sort of what passes the laugh test in
10 your lexicon of efficiencies.

11 Just one example, suppose you a small rural town,
12 the nearest down is 50 miles away -- sort of like the town
13 that I grew up in -- and there are only three garages that
14 repair cars in town and they get together and there's no
15 financial integration but they all agree that they're going
16 to hire one answering service and, you call that answering
17 service, and they're going to rotate who's going to be
18 available to service your car, depending on when you have an
19 emergency during the night.

20 Is that sufficient? Is that enough that we should
21 then apply a presumption that this is a legal arrangement?

22 MR. ROSCH: Well, I'm you sure exactly -- you've
23 got two joint arrangements there. One is the hiring of the
24 answering service, which is obviously an efficiency I think.
25 You have a cost saving in that respect.

1 But you build into it a market allocation, however
2 -- at least a customer allocation scheme, if you will; and I
3 can conceive of a circumstance in which that might be an
4 efficiency.

5 For example, it might be an efficiency if demand
6 for these services was far less than supply so that you have
7 a tremendous deficit between the available supply and
8 available demand.

9 Under those circumstances, it may well be that one
10 of those buildings, if you will, could be used in a more
11 optimal fashion if there were some sort of allocation
12 method.

13 So I wouldn't write that off all together.

14 Does that pass the laugh test? No, I'd at least
15 want to hear about it.

16 On the other hand, we do have rules against
17 horizontal customer allocation; so I would think that I'd be
18 pretty skeptical about it.

19 MS. DeSANTI: And what kind of evidence would you
20 want to see that would tell you about demand and supply and
21 whether you'd go beyond?

22 MR. ROSCH: Well, frankly, the example you give is
23 one that we see a lot of today in the hospital context,
24 where you have small communities that have three hospitals,
25 and you have large communities that are 50 miles away and

1 two of them are merging, two of the three are merging; and
2 one of the reasons they're merging is because the demand for
3 hospitality services in that community is far less than what
4 capacity is.

5 Is there less competition after that? Yes.

6 Does it violate the Merger Guidelines? Yes.

7 Probably. Unless you conjure up, as in Dubugue, some kind
8 of a hospital market that includes the bigger city.

9 But the fact of the matter is that there is a
10 tremendous amount of over-capacity. That's an inefficiency.
11 And it may well be that that other facility can be used in a
12 higher and more appropriate use in the community.

13 I wouldn't just write that off, no.

14 MS. DeSANTI: How would you do the balancing?

15 You wouldn't write it off, and then you go farther
16 down the road in the analysis.

17 MR. ROSCH: Susan, what I would do is I would
18 allow the efficiency to trump whenever there is enough
19 competition left that there was some prospect that the
20 efficiencies would be shared with consumers.

21 And it seems to me that that can be the case even
22 in a market where there's just one other competitor left.

23 MS. DeSANTI: Thank you.

24 MR. COHEN: I have got a couple of related
25 questions, one of which I direct to Professor Salop and the

1 other to the panel as a whole.

2 I'm wondering if you could try to summarize for
3 us, or highlight for us, any aspects of your analysis which
4 are affected significantly by the presence of network
5 externalities. How that fits in, it at all.

6 And for the panel as a whole, very much related,
7 Herbert Hovenkamp has given us some testimony in which he
8 suggests that exclusion from a network joint venture is
9 different from exclusion from a traditional joint venture in
10 that costs climb as the number of network members increases
11 so that exclusions of a network joint venture is tantamount
12 to exclusion from sizeable portion of the market.

13 And I wonder if you would like to comment on
14 whether you regard this as significant

15 MS. VALENTINE: And that's probably in a
16 horizontal context that he was thinking of. But you could
17 apply it in either place.

18 And that will bring us back to your initial point,
19 which I'm not sure we ever really answered, which is the
20 role of all those economies of scale, which can be demand or
21 supply side.

22 MR. SALOP: Okay. Where I think the -- well, I'm
23 not sure whether I would count this as two or three things
24 that are special about networks.

25 First is that where you have a network there's

1 often barriers to entry upstream. So you're less likely to
2 have the rival input suppliers as a viable and equally
3 efficient source, because of the natural monopoly of network
4 externality aspect.

5 The second -- I guess this is really the same --
6 that it makes it more important that the applicants, who I
7 listed as a non-member -- get into the venture or get access
8 to the venture in order to compete.

9 And then the second point is that where you have
10 network externalities, then the efficiency justification for
11 the exclusivity is weaker. You should be more skeptical of
12 the efficiency rationale -- of the efficiency claims,
13 rather, for excluding the guidelines.

14 So those two aspects.

15 MR. BAKER: So if there's only one car, Janusz has
16 to take the drunk?

17 MR. SALOP: But he can charge an appropriate
18 insurance premium.

19 MR. BAKER: I just wanted to clarify that.

20 MR. SALOP: You know, I mean, I don't think you
21 should let the applicant in on preferable terms. And, you
22 know, the applicant has to pay the risk-adjusted cost.

23 But I don't see why the applicant should have to
24 pay the monopoly price for, you know, a non-profit joint
25 venture that's charging everybody else marginal cost.

1 MR. COHEN: Anybody want to comment on the
2 Hovenkamp approach?

3 MR. WILLIG: I didn't read that paper, frankly;
4 but I heard what you said, though.

5 I think you're right that where the aspect of
6 network creates overwhelmingly important scale economies,
7 that that's a route to an issue which comes up in a variety
8 other ways as well, but might be, conceivably, more likely
9 to arise in the context of a network industry.

10 Unless the circumstance where foreclosure or
11 exclusivity or tying or bundling or any one of those many
12 practices might be especially likely to weaken a competitor
13 who is being allegedly denied access to some major part of
14 the market, a market in which scale economies, by
15 assumption, are very important that might weaken the ability
16 of that competitor to function well in the market where
17 we're concerned about market power being elevated by the
18 this foreclosure.

19 So I'd worry about the rest of the market. It's
20 relatively small because the network is big. And it's not
21 big enough, maybe, in some hypothetical for the excluded
22 competitor to achieve a good level of cost or a good level
23 of product quality or to lay off the R&D costs or the
24 acquisition of some product with a lot of fixed cost.

25 And so the excluded competitor is substantially

1 weakened in a way that diminishes competition outside the
2 domain of the network. And that might become the motivation
3 for the exclusion from the network, as well as the principal
4 effect.

5 And now we're back to something like my truck and
6 car example because there, if we found, as a matter of
7 analysis, the network to be an essential facility for
8 competition in the part of the world outside of the network,
9 we wanted to force access to cure that problem, it makes a
10 lot of sense to apply the idea of access pricing in a way
11 that does permit compensation of all costs, including
12 opportunity costs, from within the network but not including
13 the monopoly effect as part of the compensatory price that
14 rises from the world outside the network.

15 It does fit, I think, in an interesting way.

16 Let me try to answer the externality question a
17 different way. It's a classic example.

18 Imagine we're talking about competition, open
19 openness of market, regulatory and competition rules
20 involving a telephone network starting up in some part of
21 the rest of the world where network externalities are all
22 important because they've got 7 percent penetration of the
23 population right now. And it might very well make sense at
24 that stage of development of a telecom network to,
25 essentially, give away the instrument, give away connection

1 at a price that's well under anybody's view of physical
2 marginal cost like it was said was done by some observers in
3 our phone network in this country a long time ago. You
4 might still do it, but it might not be a good idea any more.
5 But in some underdeveloped country, it might still be a fine
6 idea.

7 Now, how is the network operator to cover those
8 costs which are not being covered directly by the pricing of
9 the membership in the network which confers all these
10 positive externalities?

11 Well, it might be a good idea to, in essence,
12 overcharge or put the markup on network use -- like on long
13 distance back in the good old days -- in sufficient amounts
14 to recover the losses on the access account.

15 That could be rational pricing if there's no other
16 way to get those costs covered. If the Treasury is not
17 willing to cut in with some general money or you don't have
18 the power of taxation, that could be the only source of
19 money to cover that deficit. And with those restrictions on
20 the structure, it might be an efficient solution to the
21 network externality problem.

22 Now, along comes another person who wants to sell
23 transport, long-distance services. The MCI goes into an
24 underdeveloped country and says: I need access to all of
25 your subscribers. Now, what's a fair price? What's an

1 efficient price?

2 And this is an example where the externalities do
3 come into play because, as a result of the externalities,

1 cents; they charge \$1.50.

2 Now, MCI comes along and I would agree that MCI
3 should have to compensate AT&T for the phones that AT&T gave
4 away to get the network started. But I would think the
5 proper compensatory price, the competitive compensatory
6 price would be based on the 50-cent figure not on the \$1.50
7 and that where the objection seems to be is, not that AT&T
8 get compensated for what it put out, which is the 50 cents,
9 but rather it also gets to keep that dollar in monopoly
10 overcharge.

11 MR. WILLIG: It could be. This discussion is a
12 great example of why the idea of what is an efficient price
13 for access depends upon the policy circumstance.

14 If this Thailand telephone monopoly is regulated
15 and if the regulators think they're doing a good job of
16 regulating prices but along comes the idea from some U.S.
17 consultant, why don't you open up the competition also,
18 then the regulators might say, well, gee, Steve thinks \$1.50
19 is too high but we just had a year's worth of proceedings
20 saying that's right.

21 MR. SALOP: Suppose it's not regulated.

22 MR. WILLIG: Then the question is whether the best
23 way to bust the monopoly, which is no longer thought to --

24 MR. SALOP: Suppose they gave AT&T the franchise
25 and said, get the thing started for us; and we're not going

1 to regulate what you charge for long distance for now.

2 MR. WILLIG: Well, the important point here is
3 that, in your scenario, the decision would be made to, in
4 essence, regulate the long-distance price through mechanism
5 of the regulation of the access price, because the moment
6 the regulators listen to you and say, I'm sorry, 50 cents is
7 the right access price, not a dollar, they are, indirectly,
8 but very forcefully, in essence, regulating the
9 long-distance through the evenhanded mechanism of regulating
10 the access price.

11 Now, conceivably that's the best way to do it
12 under some circumstances. But a more natural impulse might
13 be, if the regulators think pricing is out of line, then
14 regulate the long-distance price directly and then infer the
15 correct access price from what is the finding about the
16 correct long-distance price.

17 I'm not clear which is the better regulatory
18 architecture. And it's a mistake to forget that that is the
19 relevant issue.

20 MR. BAKER: Would your have changed if the way
21 phone service evolved in Thailand was a bunch of guys tried
22 to start up numbers and one of the them got a little bit of
23 a lead and everyone tipped to it because that was the best
24 way to reach everyone else; and so, quickly, it got to be 70
25 percent or 80 percent penetration and nobody else wanted to

1 join the other phone, they didn't interconnect, so that
2 there was never any regulation? Would that affect the
3 answer here?

4 MR. WILLIG: Well, still, the fundamental question
5 would be: Is this a society in a circumstance where -- can
6 somebody quote judge Lazinski -- the fact of the dominance
7 of the successful network is to be honored as the success of
8 an honest business enterprise and, therefore, not subject to
9 regulatory or even antitrust control; but where there is
10 some limitation on the ability of that operator to lever
11 that monopoly power which was obtained through honest
12 foresight, business acumen, et cetera.

13 But the issue is: How do you lever that into a
14 different market? Or is society looking to strip away the
15 consumer harm after the fact from that market power in the
16 first place.

17 MR. BAKER: I'm postulating a natural monopoly
18 that was allowed to become one without regulation. And now
19 someone wakes up to the fact that, yeah, it's sufficient to
20 have one; but they sure are charging a high price.

21 MR. WILLIG: And we want to regulate.

22 MR. BAKER: And we want to regulate.

23 And the way we want to regulate is to allow MCI
24 access.

25 MR. WILLIG: Hu-hu-hu. No, no. Two separate

1 thoughts. And it's very important to keep them separate.

2 Let's have a discussion in this country about
3 whether we should be regulating the successful network
4 operator.

5 If the conclusion of that discussion is, yes, we
6 should, there's an enormously constricting natural monopoly
7 there. It made enough money for God's sake. We're not so
8 worried about chilling investment for the next network
9 industry, let's really regulate the son-of-a-gun. Fine.
10 That's the first answer.

11 Now begins a second dialogue: What's the best way
12 to regulate this new natural monopoly on the block?

13 One way might entail access prices but no direct
14 regulation of end user prices. That's a conceivable option
15 for this group to consider.

16 But another, I submit, more natural option -- not
17 necessarily better but a more natural option -- is to
18 regulate the end user prices directly, and then perhaps back
19 out of those end user prices what might be a compensatory,
20 corresponding access price for those who just want to the
21 jump in at that level.

22 MR. SALOP: Bobby, let me ask a question in a
23 slight different way.

24 Suppose these regulators say the following: If
25 MCI comes into long distance, then the next thing you know,

1 they're going to be able to enter in the local loops as well
2 -- whatever they would call that in Thailand.

3 MR. WILLIG: Well, make up a name, Steve.

4 MR. SALOP: Are you going to permit AT&T, in this
5 compensatory price, to also charge MCI an even higher price
6 to account for the fact that they're going to lose their
7 local loop monopoly if MCI comes in? Is that also
8 compensatory?

9 MR. WILLIG: I don't think so.

10 MR. SALOP: Why not?

11 MR. WILLIG: Because in your example, that would
12 be analogous to my trucking market, that what we're trying
13 to protect here with this regulatory apparatus is the
14 competition that we think might occur in the, what you call,
15 "ancillary," I call "non-coincidence" market.

16 In your example, that's the market for loops. And
17 so any profit that the firm might, on that theory, be hoping
18 to gather for itself through the creation or protection of
19 market power in the ancillary market should definitely not
20 be in the efficient component price.

21 MR. ORDOVER: Can I just elaborate on that and
22 change the situation a little bit more?

23 As opposed to having MCI, something coming in and
24 saying, I would like to rent a loop from you, and that, of
25 course, changes the calculus quite significantly, right?

1 MR. SALOP: You can screw him on the loop.

2 MR. ORDOVER: You can screw him on the loop
3 because that's a diversion that is going to occur as a
4 result of entry, which may have implications for the
5 long-distance business, obviously, as long as you are
6 pricing the route.

7 MR. SALOP: I think where the difference is, you
8 assume it's a legitimate monopoly and so he's entitled to
9 the monopoly profits.

10 Whereas Jon and I start off with the examples --
11 or we were trying to construct examples in which there's no
12 reason to think it's a legitimate monopoly who -- and that
13 deserved the profits.

1 So you split it when we do the downstream, when we

1 profits. My immediate reaction is, well, if they're giving
2 them the lost profits, how are consumers benefiting?

3 And maybe if you could explain to me how this
4 filters down to consumers and how they ultimately get lower
5 prices or better services, that might be helpful.

6 MR. WILLIG: Let me go back to my car and truck
7 example. If you were a lawyer bringing that case, the case
8 I'm imagining you bringing is a leverage case, that there is
9 a market power that's been created through innovation at the
10 parts level; and CarCo, which is an affiliate of PartCo has
11 a legitimate relationship with the part company, you're not
12 attacking any of that. But, instead, what you're attacking
13 is leverage of that market power in the parts and car
14 market, into an adjacent market, into the truck market.
15 That's what you're attacking is the creation of new untoward
16 monopoly power in the truck market off the base of
17 legitimate market power through innovation at the parts
18 level.

19 So that's what you're attacking, the creation of
20 monopoly in the trucking market.

21 And so now I say, well, yeah, I mean, the
22 compensatory price of those parts permits the same markup in
23 those parts that is earned in the legitimate car market
24 because of the superiority of those parts in the car market.
25 Those are legitimate profits. If you want to use fairness

1 kind of language, they're efficient profits because they
2 result in an efficient entrepreneurial process.

3 What's not a good idea for customers, consumers,
4 for antitrust is the leverage off of that honest power into
5 a separate market.

6 And so consumers in the trucking market are being

1 big subject. I mean, there's a lot of controversy in the
2 80's and now again, for some reason. And we can trace it.
3 But there's about 20 new working payments by disparate teams
4 of authors, all of whom come out with models with variety of
5 fascinating features to them; and all of them again finding
6 that this is not an efficiently perfect rule. And that's
7 part of what's stimulating our latest back-to-the-wall,
8 draw-the-swords-in-the-hand with 20 more papers attack.

9 The one-liner in terms of what's going on -- and
10 this is slightly self-serving, but I think it's accurate --
11 is that all of these attacks are being based on models where
12 there's lots of other things going on.

13 And the question is: Can the sufficient component
14 pricing rule solve all the problems at once?

15 And the answer is: Absolutely not.

16 Our Yale journal paper, a long time ago, wa
17 brilliantly crafted. It stated one problem, one instrument,
18 we can solve it. The moment you start putting in other
19 problems, even ones that we're used to putting in our models
20 -- like market power here and there monopolistic competition
21 issues, quality issues -- the moment you start putting more
22 things in, the one instrument fails to handle everything
23 perfectly, naturally enough.

24 And that's what seems to be going on in this
25 literature, as far as I can tell.

1 MS. DeSANTI: Well, given that these are the most
2 difficult topics that we've been trying to address and there
3 may be any number of problems that we could add into the
4 equations and probably go on forever, I think we will draw
5 this to a close now.

6 But on behalf of the Commission, thank you very
7 much for coming. And I certainly would never -- I don't
8 know what will happen to Bobby Willig's proposal, but I
9 would never want to discuss vertical restraints issues
10 without all of you at the table.

11 MR. BAKER: And Janusz' drunk friend as well.

12 MR. ORDOVER: And then we know who smashed up the
13 car.

14 MS. DeSANTI: Thank you.

15 (Whereupon, at 4:06 p.m., the hearing was
16 concluded.)

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