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C O N T E N T S

P R O C E E D I N G S

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MR. BLUMENTHAL: Ladies and gentlemen, good afternoon. I'm Bill Blumenthal from the FTC, and I'd like to welcome you to the first of the joint Justice Department Antitrust Division and Federal Trade Commission hearings into Section 2 of the Sherman Act.

The purpose of these hearings is to explore how best to identify anticompetitive exclusionary conduct for purposes of antitrust enforcement. We are envisioning a series of hearings that will kick off today and will continue through December, probably two, three, four hearings a month, with the exception of August. After today's kick-off hearing, we are going to have another hearing on Thursday of this week examining predatory pricing, we will have a hearing in mid-July examining refusals to deal, take a little bit of a breather, and then resume in September with what would then be a series of examinations.

The agencies are expecting to focus on legal doctrine, on jurisprudence, economic research, and business and consumer experience. We have a Federal Register notice that is outstanding. We invite public comment on a wide range of topics, and we hope that those of you who are here, as well as many others, will

have an opportunity to submit comments on the topics that we address. We are open to receiving those any time through the final hearing, that is, through December, although the earlier the better for our purposes.

We are honored today to have a special panel to kick off the hearings. They probably do not need much introduction, so I am going to be very brief in offering the introductions. In the order in which they will be speaking, first we have Deborah Platt Majoras, Chairman of the Federal Trade Commission. Thomas Barnett, the Assistant Attorney General for Antitrust in the Justice Department. Herb Hovenkamp, who is probably known to most of you as -- as many things -- a professor of law at the University of Iowa, but probably better known as a co-author and a reviser of the leading treatise in the antitrust field as well as a prolific author of many, many other volumes, the most recent of which is recently out, The Antitrust Enterprise: Principle and Execution, available through Harvard University Press, with an imprint of this year.

And finally Dennis Carlton, also known to many of you in many capacities, most notably professor of economics at the Graduate School of Business at the University of Chicago, former president and still very

active in Lexicon, frequent expert witness, author of many, many articles, author of I guess two of the leading economics texts in the field. I'll leave it at that. You all know Den twis Carlton.36

7th and Constitution, and we will assemble there, where noses will be counted.

With that, it gives me great pleasure to turn

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markets."

In his book in which he reports the results of the study, Mr. Lewis says, "Most economic analysis ends up attributing most of the differences in economic performance to differences in labor and capital markets. This conclusion is incorrect. Differences in competition in product markets are much more important."

McKinsey also asked why the highly productive United States has higher competitive intensity than other nations. Mr. Lewis sums up the answer by saying that, in the United States, "Consumer is king." More specifically, he says, "[t]he United States adopted the view that the purpose of an economy was to serve consumers much earlier than any other society," and we continue to "hold this view more strongly than almost any other place." And he concludes that, in fact, "Consumers are the only political force that can stand up to producer interest, big government, and the technocratic, political, business, and intellectual."

This is why we are here. The FTC and the Antitrust Division have the responsibility to ensure that competition in U.S. markets is free of distortion and that consumers are protected not from markets but through markets unburdened by anticompetitive conduct and government-imposed restrictions. This work is

critical, indeed, to the well-being of the American people. Over the past few decades, the United States has substantially deregulated critical industries, including transportation, telecommunication and energy, to the substantial benefit of the economy and consumers. As government regulators have given way to free markets, much of the responsibility for protecting consumers shifts to competition agencies and courts. While competition is distorted when governments regulate or intervene excessively, it also is true that private actors can and do distort competition.

Breaking up cartels, preventing mergers that will substantially reduce competition, and halting conduct that goes beyond aggressive competition to distorting it is vital to promoting vigorous competition and maximizing consumer welfare, and we have developed a great deal of consensus regarding appropriate antitrust policy, I think, as it relates to cartels and to mergers and other horizontal conduct, as a result of which our enforcement has become more transparent and predictable, which then, in turn, makes it easier for market participants to make decisions about their own conduct.

Unilateral or "single-firm" conduct, however, still vexes us. Even though we can find some respectable meiln1.96 Tmnnsensus regaraestill vexes us9w-ereind som

should apply, we find a range of opinions from knowledgeable people about how to apply those principles to enforcement in the market, and the question of the proper test that our agencies should apply and that courts should apply to conduct of the single firm with market power now has dominated our antitrust debate for several years.

We are not alone. Across the globe, over the past quarter century, economic systems in which the state owns the firms and central planners set out prices and levels of output have given way to competition where the forces of supply and demand determine prices and allocate the resources, and we have worked hard to promote the economic and political benefits of markets. With attempts to introduce market economies have come new competition authorities, today numbering around 100, when only 15 years ago, we had just 20. And even countries that for decades have had nearly total state control over their economies, like China, are now dedicating substantial resources to drafting competition laws.

Currently, the issue of how to evaluate unilateral conduct is the most heavily discussed and debated area of competition policy in the international arena. Just to give you a few examples, last week, FTC

and DOJ officials attended the EC's hearing to review their policy under Article 82, which addresses conduct by dominant firms. Officials from both agencies recently held talks with our colleagues in Japan and Mexico and Canada on the issue. We recently had panels on it in the OECD. And since the International Competition Network established a working group on unilateral conduct in May, the FTC, which will co-chair that group, has received expressions of interest from more countries wanting to be involved than we have ever had in any other working group in the ICN.

So, why the strong interest? Well, first, many nations are facing the challenge of converting from state-owned or supported monopolists to markets with more than one participant, which is no small challenge, as we ourselves have learned in trying to deregulate certain markets like electricity. And, indeed, to enforcers in those nations, it then becomes companies with market power, not horizontal competitors, that are the evil that must be attacked. Second, disagreement among competition authorities about how to treat unilateral conduct produces uncertainty in national and international markets, which reduces the market efficiency and imposes costs. And third, the analysis of unilateral conduct in the identification of that

which is anticompetitive presents unique challenges that are not present or at least are less present in the core antitrust concern of conduct between competitors, and by now, these unique challenges I think are familiar.

First and fundamentally -- and we discuss it all the time, but that doesn't make it less difficult -- and that is it is difficult to distinguish between aggressive procompetitive unilateral conduct and anticompetitive unilateral conduct. As the D.C. Circuit said in the Microsoft case, "The challenge for an antitrust court lies in stating a general rule for distinguishing between exclusionary acts which reduce social welfare and competitive acts which increase it," and this is tough, because as Judge Diane Wood wrote for the Seventh Circuit, "distinguishing between legitimate and unlawful unilateral conduct requires subtle economic judgments about particular business practices." So, while it's difficult, it must be done and it must be done well.

Second, the process of distinguishing between permissible and impermissible conduct must be relatively consistent and transparent so that firms are able to incorporate it into their decision-making. While there are relatively few findings of Section 2 liability, there nonetheless are a large number of different types

of conduct that may raise competition concerns and would fall under Section 2.

And third, while antitrust practitioners have had substantial success devising remedies for joint conduct, devising remedies for single-firm behavior presents significant difficulties. As Professors Areeda and Hovenkamp put it, "By contrast with concerted conduct, unilateral behavior is difficult to evaluate or remedy by any means short of governmental management of the enterprise."

We have much to work with as we move forward with these hearings. Already a number of experienced experts have proposed the adoption of a single test for evaluating nearly all types of potentially exclusionary conduct. Some have argued for a test that focuses on the impact of the conduct on consumer welfare. Others support analyzing whether the conduct involves the short-term sacrifice of profits. Others support a no-economic-sense test, which asks whether the cost of engaging in the exclusionary conduct makes sense only because it serves to eliminate competition.

Judge Posner has written that the inquiry should focus on whether the conduct excludes other equally efficient rivals, and still other practitioners and scholars oppose the adoption of any single unilateral

conduct test and instead favor consideration of

different tests for particular type fovor xcThdjapT*(22

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just be something in which only about 27 people have an interest. So, we really want to be careful about that.

I do think we start with some substantial consensus about core underlying principles and factors that should underlie any evaluation of unilateral conduct.

First, the only type of unilateral conduct that should implicate the antitrust laws is conduct that produces durable harm to competition, leading to higher prices, reduced output, lower quality or lower rates of innovation. As much as we may value the success of particular companies, the health of the companies themselves is not the concern of antitrust law.

Second, there is consensus that antitrust standards that govern unilateral conduct must not in themselves deter competition, efficiency, or innovation, and this is what we mean when we constantly say that we worry about false positives. Obviously pervasive and aggressive competition in which firms consistently try to better each other by providing higher quality goods and services at lower cost is crucial to maximizing consumer welfare. So, the antitrust laws should then never condemn market power that is obtained through the development of superior products and services, regardless of how many competitors are driven from the

marketplace in the process, and that, of course, has been accepted by the courts.

Third, there is consensus that the standards for evalTd(evlTd0 -26t.8 it1/8ad, wtinn22 nsus that thet b)T 21 2236

at all in the boot sequence was a substantial alteration of Microsoft's copyrighted work that could produce harm that outweighs the marginal anticompetitive effect of the prohibition. The Court performed this same analysis across two dozen types of conduct, examining both the anticompetitive effects and procompetitive justifications, taking care, though, to ensure that it not chill procompetitive behavior.

And finally, the D.C. Circuit made clear that it did not consider all types of unilateral conduct to raise equal concerns under the antitrust laws. For example, the Court stated that courts need to be very skeptical about claims that a dominant firm's design changes harm competition and, by implication, violate the antitrust laws.

One final note about the hearings. I hope that our latest panels, which we will hold on remedies, will produce a productive discussion. It simply is not possible to implement sound competition policy for single-firm conduct without giving careful thought to remedies. Despite their importance, though, I think the issues relating to remedies have not received extensive attention. Take the Microsoft case, for example, which although it received and still receives a bit of notoriety, I have been stricken by how few productive

discussions of the remedy and the D.C. Circuit decision that accepted the DOJ remedy while rejecting other remedies have actually occurred, and while that might have stemmed from some of the market dissatisfaction over that remedy, I think these hearings should give the Section 2 remedy issue the prominence that it deserves in our analysis. After all, if you have done these cases, you know that devising and drafting remedial provisions in monopolization cases can be more difficult than determining whether a violation has even occurred.

At bottom, through these hearings and through our work, we need to remember that antitrust is the means, not the end. Rather, the end is undistorted competition driven by "king" -- and I would say "and queen" -- consumer, and the challenge is to keep competition undistorted while not distorting it ourselves in the process.

So, I thank you again for attending the opening of these hearings, and we look forward to all of your contributions. Thank you very much.

(Applause.)

MR. BLUMENTHAL: Thank you, Chairman.

General Barnett?

MR. BARNETT: I am going to attempt to be somewhat high-tech here. We will see if it works. Ah.

I want to thank, first off, the FTC for hosting the first of these hearings on Section 2 and for their help 12 ( )T

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promote or prevent harm to consumer welfare and that unilateral conduct is an important element of that.

I also agree that this is the area of probably the least consensus. I think there are large areas of consensus within Section 2, but there are significant areas where I think we have room for further understanding.

These hearings, with the combination of legal, economic, business and governmental/private perspectives, provide us with a unique opportunity to advance our understanding, and I believe that that will help us to advance the development of the law. It can provide helpful guidance to the courts, guidance to the business community, and as Debbie quite eloquently put it, to the international community that is now focused on this issue.

There is a long tradition of the agencies leading the development of competition law. I need only point to Don Turner and the 1968 Merger Guidelines and the formulation by Bill Baxter in 1982 to provide an example of what has become the standard reference for analyzing mergers, not only in U.S. courts, but really around the world in many ways.

With respect to the international community, again, I do want to both echo and underscore what Debbie

said. This is an issue that is at the forefront of people's minds as we talk to officials on every continent, and one example that sort of helped drive this point home a bit, I was at a conference a while ago in Budapest of Southeastern European former Soviet block countries, and we were talking about a topic that the Antitrust Division often talks about, which is the importance of cartel enforcement, and one of the officials approached me at a break and said, "I agree with you, cartels are a terrible thing. I just wish that our markets had enough participants so that they could collude together. They don't have anyone to collude with. So, we are focused on this dominant former state-owned enterprise and how we can introduce competition into this economy." It just drove home for me, at least, the importance of this issue. It is important here, but I think its importance abroad cannot be over-emphasized.

The Supreme Court, to its credit, addressed the issue of monopoly 96 years ago. That is when it decided the Standard Oil case, and while we think of it as a rule of reason case, it did talk about the three evils of monopoly. It talked about first the power to fix price and thereby injure the public; second, the power of enabling a limitation on production; and third, the

danger of deterioration in quality of the monopolized article, which it deemed was the inevitable result of the monopolistic control of its production. Price increases, output reductions, quality deterioration, those are still the same three touchstones that we look to that you heard Debbie talk about that go all the way back to the Supreme Court's discussion of the issue in 1910.

As we have talked about it in the 96 years since that decision, there has emerged I would say sort of a dichotomy or two different views of monopoly. While we would all agree that they can have their evils, and this was articulated in part by John Hicks in 1935, who talked about the evils of monopoly in the terms of a quiet life. He talked about the fact that the monopolist may not be out there trying to get the highest price he absolutely can get, maximizing in the short term the most profit that he or she can get, but really, it is the lack of competitive zeal, the ability to sit back and relax, to not have to research, develop, to innovate at a frantic level. That is a major harm of monopoly, and that is something on which we are very focused in terms of preventing.

Now, at the same time, the Supreme Court just last year articulated a different view of monopoly. In

the Trinko decision, the Court said, "The mere possession of monopoly power and the concomitant charging of monopoly prices is not only not unlawful, it is an important element of the free market system. The opportunity to charge monopoly prices, at least for a short period, is what attracts business acumen in the first place. It induces risk-taking that produces innovation and economic growth."

All the way back in 1942, in Capitalism, Socialism and Democracy, Joseph Schumpeter talked about a similar process called creative destruction or the gales of creative destruction, and I compliment my staff who came up with the tornado there, but I have always, since I read this in college, this -- be careful of the gale behind you -- I have always liked this image, because it talks about how the marketplace is a rough place. It involves vigorous aggressive activity, people fail, people are driven out of business, but it is through that destructive process that you get creation.

Indeed, a similar image I was thinking about recently, when somebody was talking to me about the National Forest Service, I grew up watching the commercials about Smokey the Bear and how forest fires were such a terrible thing. How could we be against forest fires? It turns out the National Park Service

realizes that preventing forest fires can be a bad thing; that if you prevent them for too long, you create much bigger, larger, hotter fires that cause more permanent destruction to the ecosystem when they do occur. Periodic smaller fires are actually a good and healthy part of the process. That to me is another illustration of this basic image. Competitive, creative destruction in the marketplace is something that we want to preserve and protect, not chill along the lines that Debbie was talking about.

So, how do we reconcile these two views of a monopoly, as a bad thing that causes sloth and relaxation and a lack of competitive drive versus the benefits of creative destruction, the opportunity to get to a monopoly? Well, this somewhat conflicting view was illustrated in a book written in 1964, and this was R.W. Grant expressing some frustration about the treatment of monopolies, and I will read this to you in a moment, but the basic story here is of a man named Tom Smith who invents a bread machine. It will produce terrific bread, it will slice it, it will wrap it, all for less than a penny a loaf, and as you can imagine, he very shortly owns the market for bread in the United States and is making large sums of money. He is ultimately, however, brought low by the men of antitrust who bring

an antitrust case against him for making too much money on the backs of consumers and driving everybody else out of business, and he crafts a poem here to illustrate this frustration.

"You're gouging on your prices
if you charge more than the rest
But it's unfair competition
if you think you can charge less!
A second point that we would make
to help avoid confusion:
Don't try to charge the same amount!
That would be collusion.
You must compete -- but not too much
for if you do, you see
then the market would be yours --
and that would be monopoly!

It's very similar in many ways to the admonition of Learned Hand in the Alcoa case who said that the successful competitor, having been urged to compete, must not be turned upon when he or she succeeds.

So, having expressed that frustration back in the 1940s and 1960s, where are we today? One of our esteemed both I would say academics and judicial members of the antitrust community, Richard Posner, Judge Posner, remarked just last year, "Antitrust policy

toward 'unilateral abuses of market power' is 'the biggest substantive issue facing antitrust today.'"

And if I can, if you will excuse me, preempt Herb possibly, last year Herb is quoted or wrote, "Notwithstanding a century of litigation," 96 years since the Standard Oil decision, "the scope and the meaning of exclusionary conduct under the Sherman Act remain poorly defined."

Now, there are areas where I think there are relatively easy answers. Doug Melamed has written about the concept of naked exclusionary practices. I mean, if you blow up your competitor's factory, few of us would find that to be defensible conduct. That's a fairly easy case for not finding liability. I also think there are some fairly easy candidates for safe harbor provisions. If you engage in conduct that merely reduces your cost of production, that seems to me beneficial to consumer welfare.

The difficulty lies in cases, as Debbie referenced, that have the potential for both beneficial cost reductions, innovation, development, integration, and at the same time potentially anticompetitive exclusion. How do we deal with those situations?

Well, some relatively recent Supreme Court decisions have shown progress in this direction. In the

Brooke Group case, which is, of course, a predatory pricing case, it dealt specifically with the issue of recoupment and holding that Liggett in that case had not shown the opportunity or the ability to recoup, but the case in my view, at least, stands for more than that and discusses, for example, specifically how harm to a competitor does not demonstrate harm to competition. There was little doubt in that case that there were discount programs aimed at and/or that had a harmful effect on Liggett, but the Court was quite clear that as long as that does not harm competition, that is not an antitrust problem.

Second, the Court also talked about the practical ability of a judicial tribunal to regulate a problem and avoid chilling legitimate price cutting. It's recognizing the limitations of the body that is administering the law. I would expand that to include the limitations of agencies as well as courts, but it's certainly a relevant consideration, and recognizing that aggressive price cutting can be beneficial for consumers and we do not want to chill it. Thus, it created effectively a safe harbor against predatory pricing claims where the prices were above so0 gces wuo sioveioveT- atureh

the safe harbor that there was at least the theoretical possibility that there could be harm to consumers, harm to consumer welfare, from some above-cost pricing, but recognizing it was likely to do more harm than good to try to ferret out those individual cases.

More recently, in the Trinko decision, the Court obviously had a somewhat more limited holding but discussed on a broader basis some of these same similar Section 2 issues. It underscored the need for administrable rules, clear objective standards. It talked about the fact that being able to craft a remedy that is both clear and administrable by the Court is very important, endorsing Professor Areeda, in that no court should impose a duty to deal that it cannot explain or adequately and reasonably supervise, and implicitly, at least, that not all problems may have antitrust solutions.

While I think there are many areas of consensus, there are many areas where we have a lot to learn. As Debbie indicated, our panels are going to focus on different aspects of conduct. We will start on Thursday with a panel discussing predatory pricing and predatory buying. Brooke Group answered a lot of questions. It did not answer, among other things, what is the appropriate measure of cost? Is it marginal cost? Is

it average cost? Is it average avoidable cost? Is it average total cost? There has been a lot of discussion about that, and we are looking forward to hearing people's views on that.

The question on predatory pricing or remedy, are you going to enjoin lower pricing? Weyerhaeuser is a case with which you may be familiar. There's a cert petition pending before the Supreme Court right now. It involves a predatory bidding situation. The Solicitor General's Office has filed an amicus brief on this front encouraging the Court to take cert and to examine it. I view it, at least, as an opportunity for the Court to reaffirm in the Section 2 context that clear and objective standards are extraordinarily important. There's a jury instruction at issue in this case that

Will the Court be able to administer it? A range of issues which we are, again, looking forward to hearing the experts' views on it.

Loyalty discounts, another area that we will be looking at. A couple of years ago, the United States urged the Supreme Court not to take cert in the LePage's case. That involved bundled discounts. That was not because we necessarily agreed with the Third Circuit's decision or analysis. Indeed, if you parse that decision, I think it is very difficult to come up with a clear standard of liability. There has been, in the wake of LePage's, a flurry of attention by academics, by legal scholars, on this issue of bundled discounts, loyalty discounts, and we are looking and hoping to see whether or not any consensus has developed on any of these issues.

Should it be viewed as a predatory pricing tactic, as exclusive dealing, as a tying tactic? Are there safe harbors that can be developed even if we cannot develop a single, clear answer for all cases? Tying and exclusive dealing, Debbie mentioned that you sometimes, when you see things in a competitive market, that ought to make you question whether or not there are benefits associated with it. Tying and exclusive dealing can have anticompetitive effects. Look at our

Dentsply case as a recent example. By the same token, we see these practices in competitive markets, and we need to better understand what benefits there are and when there are not.

Towards the end of the year, we expect to turn toward some more general principles. Is there an overarching standard for Section 2 cases and liability? We all agree that consumer welfare is an appropriate standard. Trying to operationalize that in a particular case with particular conduct is more challenging, and there is less agreement on that. Debbie outlined the range of potential tests. The Antitrust Division in a number of recent cases looked to the no-economic-sense test. As I have talked with people about that, one issue that I find is that people have different ideas of what the test is. So, over and above discussing what the appropriate test ought to be, there is some confusion about what is meant in terms of what are you going to look at and what the rules are. That may be part of the semantic difference that Debbie was referencing. Clarifying some of those things as well as the underlying substantive issues I think can be beneficial.

We may look at the issue of whether there are different duties or different criteria for tying claims

under Section 3 of the Clayton Act versus Section 1 or Section 2 of the Sherman Act.

Here, I have two reasons for putting this up. As you can see, this associate is responding to a request, "I'll be happy to give you innovative thinking. What are your guidelines?" An example of having too cabined an approach, too narrow a guidelines can be the antithesis of innovative thinking, can restrain the benefits that you may achieve through your innovation and development. That is part of the creative destruction that we want to encourage, not discourage, as this cartoon suggests may be happening. So, I raise that to say that while I am now going to talk about six possible principles to inform our discussions, I do not mean them to cabin or prevent a wide-ranging, open and frank exchange of ideas.

So, first off, individual firms with market monopoly power can act anticompetitively and harm consumer welfare, and we should seek to identify and prosecute such conduct. This is an important first principle. If it were not true, we could just abolish Section 2. That is not what we are here to do. We are here to better focus and identify those instances where there really is harm to consumer welfare.

Second, mere size, mere market share, does not

necessarily demonstrate competitive harm. It can demonstrate superior acumen, effort, zeal, et cetera.

Third, injury to competitors does not demonstrate competitive harm, a point that has been talked about in a number of contexts.

Fourth, the need for clear, objective and administrable rules, so that businesses, at the time they are taking actions, can understand where the lines are and can conform their behavior so they are not deterred from engaging in procompetitive activity, so that courts are not asked to do things that are beyond their competence, and that agencies can do the same.

Fifth, avoid chilling procompetitive conduct, and certainly an interrelated point, self-explanatory.

And finally, the remedy must promote competition. A remedy that harms competition can be worse than no remedy at all, an important point worthy of bearing in mind.

Again, I want to thank the FTC, our panelists for agreeing to kick off these hearings. We will continue again on Thursday. We very much are interested in a free, open and wide-ranging discussion of these issues and are excited about the prospect.

With that, I will turn it over to Herb.

(Applause.)

DR. HOVENKAMP: Thank you. I am very grateful and appreciative of being invited here, with particular thanks to Chairperson Majoras and General Barnett for extending this invitation.

In keeping with the thrust of this opening meeting, which I believe is quite general, what I would like to do is give kind of an overview of where I think the fault lines and concerns in Section 2 lie. In the future, future hearings, you are going to hear about specific practices such as predatory pricing or refusals to deal in considerable detail, and I am not going to do that today. I am going to go through them rather quickly and just point out where I think work needs to be done and where the FTC and the Antitrust Division and private litigants can use some clarification and understanding.

I am going to divide my talk into three parts, though the parts are not equal in size. First, a very short one on market power or monopoly power, then a rather long one on conduct issues, and then finally, a much shorter one again on remedies.

With respect to power, the Merger Guidelines, in particular the 1992 Merger Guidelines, the series of guidelines that began with 1984, did a remarkable job of rationalizing and simplifying the approach to market

delineation and assessment of the potential for collusion or other types of anticompetitive behavior that grow out of mergers. Some portions of the Merger Guidelines market delineation sections are relevant to Section 2 enforcement, but many are not, because the question that one asks in a Section 2 case is fundamentally different from the one that one asks in a merger case.

In a merger case, we generally start out with the presumption that a market is more or less competitive, it may be oligopolistic or moderately competitive prior to the merger, and what we really want to know is whether the quality of competition is going to deteriorate as a consequence of the merger. In keeping with that, the SSNIP test, small but significant nontransitory increase in price test, considers whether a further increase in price would cause new entry or other situations that would make this future price increase unsustainable.

In a Section 2 case, by contrast, the opening presumption is that the defendant or the firm under examination is already a monopolist, is already charging monopoly prices, and as a result, the SSNIP test is really not the appropriate one in most circumstances, although it certainly could be relevant in certain cases

like those involving an attempt to monopolize where the defendant is not a monopolist at the time the conduct is being assessed.

I do not have a solution to propose here. Those of you who are familiar with this area know that this involves something that in monopolization law we call the Cellophane fallacy or the fallacy of inferring that a firm lacks power because there is high cross-elasticity of demand with the products of others at current market prices, and, of course, if you multiply that examination by asking what the response would be to a yet further increase by a firm that is already a monopolist, you might very well conclude that the firm lacks this type of market power, because in response to a yet further price increase, there would be so much substitution away from the dominant firm's product that the price increase would be unprofitable.

Well, if you took that approach, you would be committing an error; namely, you would be ignoring the fact that that firm is already a monopolist and presumably already charging its profit-maximizing price. So, I think one of the things that ought to be of concern to the agencies as they go through these hearings is to pay some special attention to the formulation of usable presumptions that single firms can

produces harms that are disproportionate to the benefits; and finally, the assessment of the conduct must be within the administrative capacity of the antitrust tribunal.

Like I say, that test is very general. It is not particularly helpful to assessing particular instances of exclusionary conduct if it is the only thing you have. You certainly would not want to give a jury that test as an instruction and shut them up with no further instruction and ask whether the defendant's conduct was exclusionary, but the test was never intended that way. It was, in fact, designed to be a basic principle to be used in conjunction with specific rules for specific types of antitrust cases, and it is my view that that is fundamentally what Section 2 conduct jurisprudence needs to do.

I think there are very, very helpful general tests. I like Greg Werden's no-economic-sense test. I think there is much to be said for it. I think it produces a few false negatives. Nevertheless, it's a very, very good starting point. I like Judge Posner's test that Chairperson Majoras mentioned in her talk, which is conduct which under the circumstances is capable of excluding an equally efficient rival. Once again, I think it produces a few too many false

negatives, but they are good starting places.

However, none of them is a substitute for the formulation of good technical rules covering individual types of conduct; namely, pricing, abuses of the intellectual property system, refusals to deal and so on, okay?

In the few minutes I have, I cannot do any more than scratch the surface, but I would like to give you just a few observations about where we are in various areas involving specific exclusionary practices and where I think some of the problems lie.

With respect to predatory pricing, I believe that both the Areeda-Turner test, as it was formulated in 1975 and has later been incorporated into The Antitrust Law Treatise, plus the elaboration of the recoupment requirement in the Brooke Group case in 1993, fundamentally set predatory pricing law on the right track. I am a strong believer in the view that prices must be below some measure of cost. Furthermore, they must be below some measure of incremental cost; that is, pricing is driven by concerns for variable costs, not principally by fixed costs. That does not mean that there are not a few problems.

One problem that I think needs to be assessed is the problem of predatory pricing in oligopoly industries

by nondominant firms. That was, in fact, the facts of Brooke Group. Strictly speaking, that may not be a Section 2 issue. In fact, it may be an issue where the Justice Department might reconsider its long-standing opposition to bringing Robinson-Patman Act suits since the late 1970s report on the Robinson-Patman Act and create an exception for primary line enforcement given the premise that with respect to primary line enforcement, the principles that the Court follows are basically the principles that are laid out in the Sherman Act, and as a result, all of the overreaching that applies to secondary line enforcement of the Robinson-Patman Act need not apply here.

The problem with predatory pricing and oligopoly is that victims have a different set of incentives than they do in monopoly. Predatory pricing as a Section 2 problem involves predatory pricing designed to destroy a rival. That is a very, very difficult thing to do. The rival clearly has incentives to resist.

On the other hand, predatory pricing and oligopoly frequently is used simply to enforce or bring the oligopoly back into order so that the noncompliant firm will once again raise its price to the oligopoly levels; that is, the set of incentives that the target of predatory pricing and oligopoly has are incentives to

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industrial revolution, of the theorizing of economists like Edward Chamberlin and Joan Robinson, who were very upset about oligopoly and imperfections in the economy, and said, "You'd think to listen to these people that American consumers were much, much impoverished compared to their position in the 1870s, and, in fact, nothing could be further from the truth."

Well, where do all those gains come from if we are now in this oligopolistic era? And one of the things Schumpeter concluded is that they came from innovation. Schumpeter's premises were formalized and given empirical support in Robert Solo's work in the 1950s in which Solo himself concluded that as much as 80 percent of economic gain comes from innovation rather than simple improvements in price-cost relationships.

Now, neither Schumpeter nor Solo was talking about IP law. They were talking about innovation, and, of course, there is this enormous lingering question out there of whether the IP laws we have are sufficient to facilitate the optimal amount of innovation or whether they, in fact, may hinder innovation. Fundamentally, that is not antitrust's problem. The antitrust laws need to accept the existing IP laws, warts and all, and I personally believe there are a fair number of warts.

One thing, however, that that work suggests is

not need to prove damages, they do not need to prove causation in the strict private plaintiff sense. I think restraints on innovation are something that need far more development in Section 2 law than they have received in the past.

With respect to vertical exclusion, I just have a couple of comments. First of all, there has been a not so subtle move over the last four or five years in government enforcement to move away from Section 1 of the Sherman Act and Section 3 of the Clayton Act and towards Section 2 of the Sherman Act as a device for enforcing laws against tying or tying-like practices and exclusive dealing, and I believe that is the correct movement. Fundamentally, tying and exclusive dealing ought to be regarded as dominant firm exclusionary practices. They are rarely anticompetitive at nondominant levels, and fundamentally, they do not depend on agreement in any meaningful sense of the word. Unlike resale price maintenance or Sylvania-style restraints, they are typically not the product of bargaining and traditional agreement between dealers and manufacturers.

No, most tying and most exclusive dealing is imposed by manufacturers unilaterally on dealers. The dealers generally do not like it, but they accept it as

the entire discount to the product upon which exclusion is claimed, and then you ask whether the price of that product, subject to the full discount, has fallen below a relevant measure of cost, whatever cost measure you would use in a predatory pricing case, okay?

That gets you to bundling; that is, that predatory pricing test gets you an answer to the question, are the two firms -- are the two products bundled together? And if the answer is that no equally efficient firm that offered only one of the products can match the price, then they are bundled together, but that is only the beginning rather than the end of the inquiry. Tying is explicit bundling of products together, and yet most tying is perfectly legal. So, once we have decided that two products are bundled together, we have yet a further set of questions to ask about whether there is foreclosure, whether the foreclosure is justified under the circumstances by cost reductions, improvements in consumer satisfaction, quality control, in many instances price discrimination, and so on.

Finally, on conduct, on refusals to deal, my suggestion is that the Government simply get out of the business of enforcing the law against simple refusals to deal. Now, conditional refusals are something else.

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did we accomplish here in terms of making this market more competitive? And to the extent the market is more competitive, to what extent was it owed to the remedy?"

I would like to see some more serious attention be paid once again to structural remedies or at least modified structural remedies, things like compulsory licensing, as mechanisms for restoring competition. Compulsory licensing is a dirty word in the United States when we are talking about general forcing of firms to share their patents, but that is not what we are talking about here. We are talking about proven antitrust violators who are frequently forced to give up their plants and other kinds of hardware. Compulsory licensing under that set of circumstances is a perfectly viable remedy, and I would like to see us use it much more seriously than we have in the past.

I am afraid I have gone over my time, and so I will turn the floor over to Professor Carlton. Thank you.

(Applause.)

DR. CARLTON: Okay, thank you. It is a pleasure to be here, and I express my appreciation to the organizers for inviting me, and I am honored to sit with such distinguished panelists.

Exclusionary conduct is an important policy

topic. There is a great amount of debate as to what is an exclusionary act and how to deal with it. There is much less consensus on what bad acts are and how to adjudicate them in the context of Section 2 claims, than, for example, what cartel behavior is or how to handle cartl claims. The real problem is that competition harms rivals just like exclusionary behavior, and it is sometimes easy to confuse the two.

As a general matter, it is very hard to study what should be the optimal policy for exclusionary conduct. The reason, one reason, is that the biggest effect of any antitrust policy is likely to be, not on litigants in litigated cases, but rather, on firms that are not involved in litigation at all but are forced to change their business behavior in contemplation of legal rules. That means that although it is definitely informative for economists and lawyers to study the outcome of individual cases and you can learn a lot -- did the court get it right, did they get it wrong -- that is not really a study of antitrust policy.

To appropriately do a study of antitrust policy, you have to look at either times when the antitrust 0 a.or in c4av

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that harm welfare. Now, the use of tools necessarily entails errors. You are going to have false negatives and false positives. It is going to happen because, one, you do not always have perfect information. Even if you are the smartest economist, you make errors, and if you are a juror who knows no economics, you might make errors, and second, the tools are not quite the same as the objective. So, the tools will differ from the objectives sometimes, so there definitely will be errors, and the real question is whether and when tools should be used.

From an economic point of view, the question of whether a particular act harmed consumers is a very well-posed question that I could, for example, assign to

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the test and would carve out exceptions so it would not be misused.

What I worry about is when there is someone implementing the test who is not as smart as Greg. Suppose they have a judge or a jury who is not an economist? What worries me about the test is that it raises all the danger signs associated with possibly confusing competition with exclusionary conduct. Let me try and explain why, and I will give you two or three reasons.

First, all strategic behavior -- and every business school teaches this -- all strategic behavior is designed to improve one firm's position relative to the other one. It is relative position that matters, and that is what is going to often determine the outcome of a competitive battle. Investments in advertising, investments in R&D, price discounts, all of these could mistakenly and easily be condemned by jurors convinced that the firm engaged in the act could have been more accommodating, less exclusionary. That "but for" standard -- that is, would the act make sense but for the exclusionary effect -- that hypothetical thought experiment is actually quite a difficult one to implement. That does not mean if you are measuring harm to consumer welfare that you can necessarily get around

it. Maybe it is unavoidable sometimes, but I am worried

how the legal treatment of the act is creating special risks for chilling competitive behavior, and that is going to differ from act to act to act.

So, for example, to pick up on what Herb was saying, let us suppose you are looking at an industry that is undergoing rapid technological change, and there is an exclusionary claim that the way the product was designed is a problem. Well, you have to worry in that instance whether you are depriving consumers of a new product if you attack the firm for its product design, and that can lead to large losses. So, in that situation, I might want to give more weight to the firm's efficiency claim for fear of causing a large dead weight loss than in other situations.

Let me give you a second example. Let's talk about the Areeda-Turner test for predatory pricing. Basically that's a test that says if your price is below some measure of cost, unless it is, I am not going to worry. So, the implicit idea is that if you see price below some measure of cost, that is a big enough deviation from what we usually think of as profit maximization that there is something fishy, and the reason they chose price below a cost as the predation standard rather than above-cost pricing is because they were very worried about chilling competition that drives

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a merger case, it would be the current price, but since this is not a merger case, we say above the competitive price. Well, that is a very well-posed question, and in order to answer it, I have to say, "Okay, well, what is that competitive price?" Well, I do not know what the competitive price is. If I knew what the competitive price is, I could look and see, is the current price above the competitive price? And if it was, I would say, yes, it is above. I would not then have to define a market, take market shares and say, "Ah, you know, based on all this analysis, you know, 10 is above 5 when I started, and still, the market shares are so high now, I conclude 10 is above 5." So, there is a circularity to it that I find a little troubling. So, you cannot really directly answer the question, because the competitive price is not available. So, then, what do you do?

I think there are several alternatives. Herb mentioned some of them, and none of them I would say are completely satisfying. One alternative is to ignore the problem and simply say, "I am not going to use the competitive price, I am going to use the existing price," and Herb sort of indicated that this leads to the well-known what is called Cellophane fallacy in which it is possible that you will not find any market

power at the current price, but you do have market power because you have already raised the price above the competitive level. That is one thing you can do, with its problems.

The second thing you can do is you could say, "Okay, let me ask the following: Is price above marginal cost where marginal cost I will use as my proxy for the competitive price?" Of course, that kind of replaces one question with the other, what is marginal cost? Well, maybe you can go out and try and measure marginal cost. If you had access to firm information, you could try and sift through accounting information, you could econometrically try and estimate a cost curve. It's difficult, okay?

Moreover, suppose you do find prices above marginal cost. You have to face the realistic possibility that most markets are not perfectly competitive. In most markets, price will not equal marginal cost; therefore, and what you presumably must mean, is that price deviates a lot from marginal cost if you are worried about such a deviation. The amount of deviation, the deviating a lot from marginal cost, has actually never been articulated that I have seen in a quantitative way.

Okay, suppose you do not like marginal cost. Is

there something else you can do? Well, I think there is. Another thing you can do is you can ask, "Is the rate of return a firm is earning above the competitive rate?" We know what the competitive rate of return is. Is the rate of return the firm is earning above the competitive rate? This can be a difficult accounting exercise, or better put, this can be a difficult economic exercise using accounting data. You would have to ask over what period of time, how does my answer change depending on risk, not easy to do necessarily, likely to create a lot of controversy.

Finally, you could estimate the demand curve facing the firm, and the benefit of estimating the demand curve is you could determine the elasticity and the cross-elasticities that the firm is facing, and that I think gives you useful information about certain types of com36

market power and monopoly power? And then second, what does it mean to have individual market power in an oligopoly?

Well, let me just conclude, screens can help but can also become a danger if one loses sight of the ultimate goal of maximizing consumer welfare. You should create rules to fit the act, paying special attention to how the rules applied to this particular act will chill competition.

The profit sacrifice test worries me a bit for the reasons I have explained, and I would use it sometimes but certainly not regard it as a general principle. With regard to market definition, I still think it is a useful discipline, especially when you get to court, for judges and juries to go through, because it helps structure the analysis, but there is an inherent lack of precision in its application in Section 2 cases that might be worrisome, and there may well be cases where its use could be misleading.

Thank you.

(Applause.)

MR. BLUMENTHAL: Well, thank you to the panel for very, very interesting perspectives. We have about 20 minutes for panel discussion, and because of airline schedules, we are going to have to end promptly at the

appointed hour of 4:00, but I guess let me turn to the first two speakers, who are agency speakers, and ask whether you have any comments you would care to offer on the thoughts from either of the two professors.

CHAIRMAN MAJORAS: Wow, I have a lot that I could comment on. I thank both of them, because those were very thoughtful presentations, as we expected, and I very much appreciate that.

One thing that I was curious about is Herb's advice that the agencies should step in a bit more in looking at restraints on innovation, and I was wondering, Herb, if you had any particular hypothetical or context involved or if you can be even more critical of what we have not done in the past, if that is easier for you, in terms of where we could be looking for such a thing, because it is true that we constantly talk about promoting innovation and how important that is to our work and how important it is that we not inhibit it, but I find not only in enforcement but in forming policy and explaining to courts, it is very difficult for people to get their arms around it, because it is such an amorphous concept, and I am not sure we are very good at it.

DR. HOVENKAMP: It is an amorphous concept. In part, though -- and I think this is an important

large number of cases, that made it to the circuits against the cigarette companies in the late 1990s alleging various cartels to refrain from developing healthier cigarettes. To the best of my knowledge, every single one of those cases was dismissed, at least the ones that went to the circuits, were dismissed on

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reactions. First, I am extraordinarily pleased with the contributions that the two of you made. They not only frame some interesting issues and pose some hard questions, but in some instances, also provided suggested answers or even policy directions, which is a great way to start off the hearings, and we very much appreciate hearing it.

I think, Herb, it is interesting to hear your views on refusals to deal, whether we should be involved e iac1ank,t 18-e me himhe two of you made.

all caused me to want to clarify that I do not agree with everything that is in that book in terms of monopoly, but I do agree with the importance of innovation and not losing sight of that.

But talking about this, you just made a comment about remedies and a distinction, I think, between damages and the Government. I would be interested to hear more of your views on that point, if you think that would be a good idea, to draw such a distinction.

DR. HOVENKAMP: The distinction between?

MR. BARNETT: Different remedies for governmental ver -- well, for I would say maybe injunctive versus damages type relief.

DR. HOVENKAMP: It has always been my opinion, which the Supreme Court has rejected in California versus American Stores, that structural remedies should be the prerogative of the Government. That is not the law, let's make sure everybody's clear about that. In California versus American Stores, where the plaintiff was the Federal Trade Commission, so it's a private -- I'm sorry, was the State -- was the Attorney General of the State of California, so it was a private party in this rather unusual way we treat states attorneys general in antitrust, but I believe structural remedies ought to be something that only the Government ought to

do, because they have such extraordinary spillovers.

I mean, we have some confidence that the federal antitrust agencies, because of their diversity, the diversity of the industries that they represent, and because of the high quality of the people that run them, they are not captured industries, by and large, that we may not have that level of confidence about industry-specific agencies.

The one thing we know about private plaintiffs is that they are always captured, right? Private lawyers serve their clients. Their clients are completely self-interested, and as a result, they do not take overall effects into account, and as a result, my own view is that structural relief, such as divestiture, should simply be denied to private plaintiffs.

Is that an answer to your question?

MR. BARNETT: I just was interested in your perspectives, so thanks.

MR. BLUMENTHAL: Herb, Dennis had spoken after you did, so I guess I would ask whether you had any rejoinder to any of Dennis' comments.

DR. HOVENKAMP: No, and I mean, Dennis knows a million times more about this market definition stuff than I do, and so I am very elated that he actually agreed with me about most of it. I think you can

develop a few presumptive rules for dealing with market power issues. For example, where the defendant, the firm under investigation, faces competition from other firms that use the same technology and apparently have the same cost structure, then I think the inference of competition, competitive pricing, is higher than in a case like Cellophane. I think what makes the Cellophane case so extraordinary is that the defendants, DuPont, plus Sylvania as its licensee, produced Cellophane, but the stuff that the Government ended up throwing into the market was brown wrapping paper, tin foil, glassine -- I'm not even sure I know what glassine is -- but these were things that used different raw materials, they almost certainly used different technologies for producing them, and simply to conclude that such things are in the same market simply because of high observed cross-elasticity of demand is a very serious error. It's an error courts continue to make.

There are several cases, for example, that have concluded that rental videos, films shown in movie theaters, and films shown on television are all in one relevant market simply because they make the obvious observation that if you look at any particular person, sometimes she goes and rents a video, sometimes she goes to a theater, sometimes she wavfilmmensee, produced Ceklar person,

television, without asking the question whether any one of those technologies is sufficient to hold the other ones to cost.

I would rather hear Dennis talk about this.

DR. CARLTON: I agree, but I w t I d187Dfptl-130 1( )T8.apm

innovation market, but rather, a future product market. In drugs, you can look at the pipeline, and you know what is coming out. So, it is not really an innovation market as much as it is a prediction of future products.

It is much harder when you are looking at just firms doing R&D in a general area to say, "What are they doing R&D on? Is it even on similar products?" And if you ever go back and do an experiment, like if you look at major product introductions, who did them, sometimes the people doing them are often outside the industry, and no one predicted they would come in. So, I think the difficulty in this area, when antitrust tries to deal with it, is the difficulty that you have -- that anyone would have -- in predicting who is going to be the innovator. That is why I think it is very hard.

The other reason why I think it is very hard is innovation markets inherently involve intellectual property. People want to protect their intellectual property. There are a lot -- if you look at, you know, just -- there are some very interesting articles on the Internet, who has exclusivity rights on certain types of information that is generated. Restrictions, vertical restrictions on intellectual property, who can use them, who cannot use them, are very widespread, and therefore, if you do have a big success, that will complicate some

antitrust enforcer's life, because they will say, "Well, look, a big hit in the vertical restrictions, I am a little worried," but you have got to go back and step back and say, "Well, the whole idea of innovating was to get the returns from this intellectual property, and they would not have done it if they could not put the restrictions on it."

So, I think it is a very difficult area. I think it is made more difficult by our intellectual property laws, and the problem that I really see arising is that because so many patents are given for products that may not be all that valuable, you create the problem that the property right in a truly valuable innovation is not that valuable, because now you have to get cross-licenses from lots of other people, and that is I think creating a lot of the antitrust problems, and maybe the best way to fix it is not just through antitrust but through reforming IP.

CHAIRMAN MAJORAS: As long as we are on the subject of innovation, in the two minutes we have left, does either of you have an opinion on the recent phenomenon that we are seeing in the patent area known as patent trolls, people who go out and buy up what some people might term useless patents -- I don't know if you can go that far -- and some of those people doing it, in

fact, as I understand it are plaintiff's lawyers, and then wait until somebody creates an invention, and that bundle of patents might look, you know, like it could have been infringed, maybe it is, maybe it isn't, and then pounce and say, "Okay, now you owe me really high royalties."

And there are obviously many different variations on this theme, you know, those that have zero interest in ever making anything or innovating I think are the ones that people refer to as patent trolls. Do you have any comment on whether that is injuring competition or something that any of us should be worried about?

DR. HOVENKAMP: Well, my reaction to that is that whether it's good or bad, it is fundamentally not an antitrust problem. I mean, in order to be an antitrust problem, it either has to monopolize the market or create a dangerous probability of doing so or else it has to be an agreement that restrains trade, and simply surprising people with a patent and claiming high royalties in and of itself does not do that.

Now, that does not mean if it were not used in conjunction with some other practice, it couldn't sum up to an antitrust violation.

DR. CARLTON: I would just add, I basically

agree with what Herb said. I think that it is a problem for reform of the patent laws, and there are at least two thoughts I have. The first is that one of the things that gives a troll great power is the ability to get an exclusion right, and you might want to encourage the courts to give the surprised infringer time to invent around the patent if that is possible, and that can get rid of sometimes a lot of the pressure.

The other question you can ask is, are they ever intending to use this themselves and implement it, and that may influence how you treat them.

Having said that, you know, an economist always has two sides to a story. A patent -- you may call them a patent troll, but the flip side is I'm an inventor, maybe I want to give my invention to someone else to figure out, you know, all the licensing problems. So, I mean, there is a flip side.

CHAIRMAN MAJORAS: Yes.

MR. BARNETT: Can I just ask quickly if based on your remarks, Dennis, if you would be willing to get into a locked room with Greg Werden for a session with a tape recorder and we could solve nine out of every ten Section 2 problems.

DR. CARLTON: I would be delighted.

MR. BLUMENTHAL: Dennis, if I could I guess ask

one last question in the two minutes we have, you had thrown out a teaser at the end about the distinction between market power and monopoly power, an issue that was of some interest to the staff, although we had not quite posed it, and I might add, it was something I recalled George Stigler having denied as a distinction in the Data General case about 20 years ago, although the Ninth Circuit disagreed with that view. So, perhaps there is a distinction after all.

Did you have in mind something more than just quantum? Is it a character of the difference or --

DR. CARLTON: Yes, actually, it is in my textbook, so I know it very well. One definition of market power could simply be that price is in excess of marginal cost. That is a logical definition. Whether you want to use it in a court, you know, I think that is a different question. You might want to define it by how much before you say it is something that triggers some action, but you can distinguish market power from monopoly power by saying monopoly power is not just price in excess of marginal cost, but also, profits in excess of the competitive rate of return. So, that is at least a logical distinction.

I should say in the third edition of my book, I dropped that paragraph, because no one seemed to pay

attention to it. Now, I change a lot of things when I revise my book, and most people never comment, but on this, I did get some comments, and people said, "We thought it was useful," even though I had never seen anyone -- I was unaware anyone had cited it, and I think it is useful, so I have put it back in. Now, so, that is an answer.

Now, whether that should be what courts use when they are deciding on an exclusionary act is a slightly different question, because I think courts really should be asking a slightly different question, which is, let us suppose you are talking about exclusive dealing. I don't really care about what the rate of return is, I don't think. I think what a court is saying is if you are engaged in an act and there are other characteristics of the market that make that act have a greater effect than if you didn't, say, have as large a market share, then I am going to be worried about that, and that really does not have to do with rates of return.

So, you know, I can see why courts could be asking are the characteristics of the market that make the exclusionary act under discussion much more a competitive concern than not, whether that -- I don't know that that necessarily corresponds to the

distinction I gave you. The distinction I gave you does strike me as a sensible economic distinction.

MR. BLUMENTHAL: Well, thank you, and with that, we are out of time. Let me ask you to join me in thanking the panel for a great presentation.

(Applause.)

MR. BLUMENTHAL: We look forward to receiving your comments in the months ahead. We hope to see you Thursday and in the hearings to come. Thank you all.

(Whereupon, at 4:00 p.m., the hearing was concluded.)