UNITED STATES FEDERAL TRADE COMMISSION

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SHERMAN ACT SECTION 2 JOINT HEARING

UNDERSTANDING SINGLE-FIRM BEHAVIOR:

EXCLUSIVE DEALING SESSION

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PANELISTS:

Morning Session:

Jonathan M. Jacobson
Howard P. Marvel
Richard M. Steuer
Mary W. Sullivan
Joshua D. Wright

Afternoon Session:

Stephen Calkins
Joseph Farrell
Benjamin Klein
Abbott (Tad) Lipsky

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P R O C E E D I N G S

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MR. VITA: Good morning, everybody. My name is Mike Vita. I am an economist here at the Federal Trade Commission. My title is Assistant Director for Antitrust in the FTC's Bureau of Economics. My co-moderator is Dan O'Brien, Chief of the Economic Regulatory Section at the Department of Justice, Antitrust Division.

I am going to be leading the morning session, and Dan will be leading the afternoon session, and before we get started with the substance of today's hearings, I am going to cover a few housekeeping matters.

First, turn off the cell phones. You'll get detention if you -- the BlackBerries and any other devices that make noises, that's very important.

Second, for those of you who aren't familiar with the setup here at 601 New Jersey, the rest rooms are down the hall, past the guard's desk and to the left. I think there are signs out there in the lobby to guide you.

Third, a safety tip particularly for visitors. In the unlikely event that the building alarms go off, which they actually did yesterday, please proceed calmly

and quickly as instructed. Dan and I will keep everything calm and orderly. If we must leave the building, exit the New Jersey Avenue exit by the guards, that's where you probably came in, and follow the stream of people running to a gathering point where you can await further instructions.

Finally, we request that you not make any comments or ask questions during the session. Thank you.

Okay, today's session concerns exclusive dealing, one of the most interesting areas I think of all the various topics involving vertical restraints and vertical contracts. It has been an active area of economic research and an active area of antitrust as well. We are honored to have assembled a distinguished

Steuer, who is a partner at Mayer Brown Rowe & Maw, LLP. Next to Richard is Mary Sullivan, who is an Assistant Professor of Accountancy at George Washington University. Next to Mary is Josh Wright, who is Assistant Professor of Law at George Mason University School of Law. Next to Josh is Howard Marvel, who is a Professor of Economics in the Department of Economics at Ohio State and also Professor of Law in the Michael Moritz College of Law at Ohio State University. And at the very end is Jonathan Jacobson, who is a partner at Wilson Sonsini Goodrich & Rosati and a Commissioner of the Antitrust Modernization Commission.

So, I think we will just get right into it, and let me introduce in detail our first speaker, and in those handouts that you got, there is a more detailed biographical description of each of the speakers as well, and you can also find them on the FTC and Department of Justice web sites.

Our first speaker is Richard Steuer, who is a partner at Mayer Brown Rowe & Maw, where he specializes in the practice of antitrust law, including litigation, mergers and acquisitions, intellectual property licensing, franchising and e-commerce. Richard has written a book and several articles on antitrust law which have appeared in various journals throughout the

country. For three years Richard served as chair of the Antitrust Committee of the Association of the Bar of the City of New York.

Richard?

MR. STEUER: Thanks, Joe.

In baseball they say you can learn a lot by watching, and I have been fortunate over the years to have been able to observe a great deal about exclusive dealing and in various contexts, both in litigation and counseling, and I put what I knew into three articles that I have written, and I thought that the best way to try to present what I have learned about exclusive dealing would be to go through those articles and briefly outline what it is that I have learned from watching.

The first one was an article on "Exclusive Dealing in Distribution," focusing on how exclusive dealing works when you are talking about selling to resellers, and this appeared in 1983. I will not take very much time on the history, but it is interesting that once upon a time, the FTC considered most exclusive dealing to be virtually per se unlawful. The Standard Stations case in 1949 introduced the rule of quantitative substantiality. Then the major case of Tampa Electric in 1961 brought in qualitative

substantiality, and then we found a more nuanced rule of reason approach with the Beltone case from the FTC in 1982, Jefferson Parish in the Supreme Court in '84, and added to that are the nuances of rule of reason analyses we get from California Dental.

Now, what I have found is the level of distribution really matters in assessing the impact of exclusive dealing. What we are measuring with exclusive

Another variable that is important to keep in mind is alternate channels of distribution -- what is sometimes called intertype competition -- and there was a rather classic book that Palamountain published in 1955 on that. Today, the variation in intertype competition is richer than ever with the rise of the Internet and other alternate channels. So, one needs to look, when you are dealing with resellers, at what other types of means are there, direct sales and so forth, for getting the product distributed.

Another possibility is simply establishing new distributors. Is it more efficient, is it more competitive, to have competitors with other brands establish their own distribution networks than just piggyback on the existing distribution network and possibly compromising the amount of vigor with which the intermediate, the reseller, is pushing each brand? Are you better off having one brand at each reseller and having them competing against one another?

Foreclosure is measured in many, many antitrust defenses. There is a measure of foreclosure for monopolization, for attempted monopolization, under Section 3 of the Clayton Act, under Section 1, and I recently had an opportunity to study what the different tests are, and I will not belabor the point here -- we

do not have time -- but they are all over the lot.

The interesting thing is "foreclosure" is a term that is used throughout the antitrust lexicon, but it has a different meaning with each substantive offense, and that is important to keep in mind.

The procompetitive effects when you are going through distribution: Combating manufacturer-level free riding. This is not the kind of free riding that we were talking about in a case like Sylvania where one retailer free rides on the efforts of another. This is one manufacturer free riding on the efforts of another manufacturer, and exclusive dealing, by keeping other manufacturers out of a particular wholesaler or retailer, prevents that.

Of course, stimulate distributors. If the distributor only has one brand of a product, it is going to devote all of its efforts to that brand, but again, in measuring how valuable that is, there is a distinction between commodities and differentiated products. With a differentiated product, there is something more for the dealer to explain, typically, about the features of the product. With commodities, that is probably less so.

Stimulating suppliers. Exclusive dealing also stimulates suppliers to put more time and effort and

money behind their channels of distribution, because they know that other brands are not using the same retailer or same wholesaler, and they do not have to worry about divided loyalties where they are wasting their effort.

Protecting trade secrets is similar. To the extent that a manufacturer is providing trade secrets to a retailer or a wholesaler on how to sell, if that retailer or wholesaler is carrying other brands, it can use that kind of information for the benefit of the other brands.

Quality control as well is something that can be controlled more directly with exclusive dealing where there are not other brands in the house, and that is particularly true where retailers or wholesalers are doing things with the product, to the product, where, if there is some kind of adulteration, it is hard to control quality with other brands in there.

Resale restraints. There is a lot of talk and we were talking earlier about whether there is going to be a change in the rule on resale price maintenance. Some of these same considerations also go into the kind of resale restraints we looked at in a case like Sylvania, customer restraints, territorial restraints, resale price maintenance, but those are all restraints

on selling, not on buying. So, some of these apply, but they do not apply in the same way.

The next thing I looked at ten years later was "Discounts That Induce Exclusive Dealing," and this is a little bit different again, but yet another nuance. I started with single products. In the simplest case, there is one product involved. The grand daddy of the cases is United Shoe Machinery, 1922, but these cases still continue. The latest one, and I am not going to dwell on cases, but there is a case this year from the Sixth Circuit that the plaintiff won on essentially a single product. Big cases out of the U.S. were Nutrasweet, which involved one product, and Tetra Pak, packaging.

The important thing to know in these cases is whether or not there is an offer you cannot refuse. These are discounts to induce exclusive dealing. It is not an outright exclusive, but it is basically a deal saying if you buy 50 percent of your requirements from me, you get one price; if you buy 75 percent, you get another price; if you buy 100 percent, you get still another price. It does not sound like it is quite as much foreclosure as exclusive dealing, and in many cases, it is not as much foreclosure, it is perfectly fine.

even though it was not really a different product, analytically, it almost was a different product, because there was some quantity that they had to have from the other brand.

A little like bundling. Bundling is almost easier to see, because there are different products in the bundle. Some of them are products you have got to have because they are patented in some cases. Sometimes you do not have to have them, and there are ways of ameliorating it. I am not going to spend time on bundling, because I know you have another program devoted to that entirely, and I could spend a whole day on bundling.

The last thing I looked at was, who is instigating exclusive dealing, and should it make a difference? And particularly, "Customer-Instigated Exclusive Dealing." There are mixed motivations on how many suppliers you would like to have in the market. End users have two different motives. On the one hand, they would like to assure that there are plenty of suppliers, because they would like to have alternatives, and they want to play one supplier off against another to get the best price. At the same time, there may be cases where if there is a requirements contract -- and a requirements contract not only means I will buy

everything from you, but the seller promising I will supply everything that you need -- if one buyer can get a requirements contract and there are not enough other sellers to go around, it could have an impact harming competitors of the buyer. So, it is possible that there are situations where an end user would have a motive, at least in the short term, not to have as many suppliers survive.

Resellers, it is somewhat similar. In the short term, if you are an exclusive reseller of a particular brand, you would like to see all the other brands disappear. They only provide competition to you. In the long term, though, if that arrangement is not necessarily perpetual, the day may come when you would like to have some options with other brands that could supply you.

Now, why would a customer want exclusive dealing? The most obvious reason is to induce lower prices, to say to a supplier, I am giving all of my business to one supplier, and it may be you, but it may not be, so sharpen your pencil and give me your best price.

Another reason is to assure a dependable supply, and that is the requirements contract. Another is to assure quality, in that it is expensive to qualify

suppliers in certain very technical industries, and you do not want an unlimited number of them. In some cases, assuring uniformity is important. There is a case involving auto racing where it was felt to be important that everybody have the same tires so that there is a level playing field among competitors. And achieving logistical efficiencies. In some settings, just having fewer suppliers is going to wind up lowering expenses.

Now, how do you find an appropriate legal analysis where it seems that the buyer has instigated the exclusive dealing? The supplier's objectives often are twofold. One is to foreclose others, and that is the one we always look at when we are trying to see an impact on competition -- will exclusive dealing foreclose other suppliers from having customers or having distribution? Another is to achieve distributional efficiencies.

The reseller's objectives are the ones we just talked about, pricing, supply, quality, uniformity -- and there are mixed motives about how strong a reseller wants other brands to be.

The end user's objectives are a little bit different. Again, the end user of course wants better pricing, may have concerns about delivery, quality, uniformity, efficiencies. It is less likely that an end

user who is insisting on giving all of its business to one supplier is really in favor of weakening other suppliers. There may be those rare cases, but it is less likely that that is what you are going to find.

So, what is the right analysis? When should courts second-guess buyers for instigating exclusive dealing and replace the buyer's judgment that it wants an exclusive with the court's judgment? I think that certainly when the buyer has a demonstrable motive to eliminate competition at the supplier level so that it is helping itself in terms of competition, that is one to take a hard look at, but generally, I think it is important to trust the buyer's judgment if it is instigating exclusive dealing.

Let me just conclude by saying I hope this quick snapshot has highlighted some of the very many differences that exist among exclusive dealing arrangements. All of us as lawyers and economists are always searching for those unifying principles that make it easy to do the analysis, but I think what is important here is that we not get lazy and overlook that some of these variables that we have just been talking about really do make a difference to the analysis.

I will leave it there, and thank you very much.

(Applause.)

MR. VITA: Thank you, Richard. Insightful and on time, perfect.

Our next speaker is Mary Sullivan, who is an Assistant Professor of Accountancy at George Washington University. Mary received her Ph.D. from the University of Chicago, Department of Economics, and taught marketing at Chicago Graduate School of Business from 1987 through 1997. While at Chicago, she conducted research on industrial organization and marketing issues, such as slotting allowances, brand names and trademarks.

In 1997, Professor Sullivan left academia for the U.S. Department of Justice Antitrust Division where she worked on a variety of antitrust matters and served as Assistant Chief of the Competition Policy Section.

In 2004, she joined the Accountancy Department at George Washington University, and as many of you know, Mary's research has been published in numerous leading economics journals.

Mary?

DR. SULLIVAN: Thank you. I would like to start by thanking the DOJ and FTC for inviting me to participate in these hearings, and I need to keep track of the time very closely, because I have been threatened by Dan and Mike that if I go over my time limit, that

exclusionary, and the potential exclusionary effect is a major motivating factor in the regulatory scrutiny that each of these practices has received.

Now, oddly, despite their similarities, the practices receive different regulatory treatment. Slotting allowances are not regulated by the FTC. In the FTC's 2001 report on slotting allowances, they said that the fees need to be judged on a case-by-case basis with attention both to likely competitive harms and to likely procompetitive effects. So, they take a basic rule of reason approach.

Alternatively, the FCC does regulate payola. According to the FCC regulations, payments are prohibited unless an announcement of the endorsement is made every time a song is played, and this increases the cost of using payola. Now, in addition to the FCC regulations, the major recording companies have recently settled investigations brought by Elliott Spitzer, as many of you are probably aware. I think what is less well known about these settlements is that the terms of the settlements are more restrictive than the FCC regulations, with payola completely banned in most cases even if an announcement is made of the endorsement.

Now, given over the past few years we have learned a lot about slotting allowances, both in terms

someone will give the product financing in order to introduce the product. Therefore, I really don't consider this a valid theory of exclusion.

The other class of theories are the economic theories, and the two that I have really looked at for the purpose of this talk are Farrell 2001 and Shaffer 2005. Now, without going into much detail at all about these theories, all these theories share the feature that you need to have a contractual provision for the retailer to actually exclude a competitor in return for the fees. You must have a situation in which the retailer is reducing the number of slots available for exclusion to occur and for harm to result from it. So, one important conclusion that I take away from these theories is that simply paying a slotting allowance is not enough to cause exclusion.

So, the next thing I want to do is take a look at the evidence, what do we know about slotting allowances and payola, and ask the question whether the evidence is consistent with the Farrell/Shaffer type theories of exclusion.

In the case of slotting allowances, the answer is sometimes. Occasionally slotting allowances are accompanied by a contract to reduce the shelf space available to competing manufacturers which could weaken

them and potentially exclude them. According to the FTC's 2003 study of slotting allowances, such contracts are fairly unusual, but they do occur.

For payola, the answer is no. There is no evidence that exclusionary contracts are being used with payola. The evidence that I have seen suggested that recording studios are simply trying to use payola in return for getting the radio stations to play their songs, not that they would not benefit if they could exclude a popular song of a competing recording studio. I think, you know, if they could exclude a competing song, it would allow them to sell more records; however, there is simply no evidence at all that that is what is happening, and believe me, if you take a look at some of the Spitzer settlements, you will see that the evidence he collected was quite thorough. What I conclude from this is that according to the economic theories of exclusion, payola is very unlikely to be exclusionary.

Now, I also wanted to take a look at some of the evidence from the courts to see what the courts say about slotting allowances and exclusionary effects. This is not really intended to be a comprehensive review of the legal cases on slotting allowances. What I did do is I looked at two legal challenges to slotting allowances that are both important, have been very

influential, and I see cited quite often in other cases. In both of these cases, the courts found that the fees are a valid means of competing, and here are the two cases.

One of the quotes from the Gruma case is particularly revealing. In this case, the Court said, "Some of the plaintiffs' losses are due to a 'self-inflicted' wound -- they chose not to compete for shelf space."

Now, in this case, the plaintiffs were small companies, small tortilla manufacturers who were complaining that Gruma, the large manufacturer, was buying up all the shelf space and giving it unfavorable locations. The Court ruled, well, your tough luck. If you want to be in this game, you need to compete for shelf space.

Now, in the Reynolds Tobacco/Philip Morris case -- which is often referred to as the retailer leaders case, which was the name of the Philip Morris program that was being challenged in court -- it was a somewhat different situation, because Reynolds, the plaintiff in this case, was actually a large company, but the conclusion of the Court was the same. In this case, the Court concluded that the Philip Morris program that involved the payment of slotting allowances

increased industry competition.

Okay, so if the theory predicts that payola is unlikely to be exclusionary and the courts have ruled that slotting allowances are an efficient means of allocating scarce shelf space, then why -- this leads us back to the original question -- why does payola receive different regulatory treatment than slotting allowances? The answer seems to be that since the air waves are owned by the public, there is a belief that radio stations should select music on the basis of public interest rather than the radio station's commercial interest. This view highlights the difference between slotting allowances and payola.

The FTC and the courts see slotting allowances as a valid and efficient means of allocating shelf space, but the FCC believes payola results in an allocation of airspace that is not in the public interest apparently because it allows the radio station to play music that increases their profits. Now, does this make sense?

Another way of asking that is, will regulating payola cause radio stations to select music that is in the public interest, whatever that is? The answer is no. To see why, it is helpful to understand a little bit about how radio stations are going to decide what to

the goal of serving the "public interest." With or without regulations, radio stations will design playlists to serve their own commercial interests. This is unavoidable.

Third, prohibiting explicit payment for radio airspace will not make competition for airspace disappear. There is a scarce resource, and there is going to be competition for it. The competition will take a different form. To the extent that recording studios can find loopholes in the regulation, then there will be little effect on the regulation on what is played.

So, my own personal conclusion from this is that the regulation of payola it seems to me does not serve the public interest, appears to be wasteful, and leads to needless enforcement costs.

Thank you.

(Applause.)

MR. VITA: Thank you, Mary.

DR. SULLIVAN: No slotting allowance?

MR. VITA: You are off the hook, for now.

DR. SULLIVAN: Okay.

MR. VITA: Okay, our next speaker is Joshua Wright, who is an Assistant Professor of Law at George Mason University School of Law, where he teaches in the

areas of antitrust, contracts, and law and economics. Professor Wright's research focuses on the law and economics of the competitive process for product distribution, including slotting allowances, category management, exclusive dealing and other contractual arrangements. He has published in numerous journals.

Professor Wright received his Ph.D. in economics from UCLA, Department of Economics, and he also received his JD from the UCLA School of Law, where he was a managing editor of the UCLA Law Review.

Joshua?

MR. WRIGHT: Thank you.

Okay, so I am going to sort of hop on the back of some of Mary's comments on slotting and do a little less background talking about what they are, since that has already been covered. My comments here, just as a preface to get out of the way, are based on two papers that are up on the FTC web site, which has all of the slides and papers from the other panelists, both co-authored with Ben Klein, who I think will be here in the afternoon.

So, a tiny bit more detail on -- I am going to use a slightly different definition of slotting

So, the anticompetitive theories of slotting,

And the second is, and more related to the panel discussion today, is we see sometimes that these contracts include exclusivity provisions, unlike the payola contracts. We see provisions that say, give me 70 percent of the shelf space, give me a space to sales, give me the full exclusive, do not put anyone else on the shelf space. So, we see this additional variation in the contracts that we are going to need to explain. So, I will turn to that second. There are other interesting questions, again, the form of the payment and these things, which for the moment I am going to skip so I can focus on exclusivity.

So, the answer provided by Ben Klein and myself in the paper I alluded to earlier, the intuitive answer is what you see on the screen, and it is that slotting contracts solve this pervasive incentive incompatibility problem where the retailer does not want to supply the joint profit maximizing level of promotional shelf space under the conditions where the supply and the shelf space does not induce consumer switching. So, we have cases like McCormick and we have 90 percent of the shelf space allocated for spices. Well, supplying additional promotional shelf space to spices does not induce a greater number of consumers to say I will not shop at this retail outlet because they have given 90 percent of

to price competition, but there is a key difference as to why we see manufacturers in the retail setting, at least, allowing the manufacturers to set the retail price, and competition between retailers is sufficient to get an optimal jointly profit-maximizing price set but not the jointly profit-maximizing level of shelf space. So, why do we get prices right and shelf space wrong ends up being the question.

So, unlike the shelf space case, when we are talking about price competition, you see here we have got on the right-hand side is this large manufacturer's margin, that P sub W minus the marginal cost of the manufacturers. It is large. It is maybe 10-20 times larger than the retailer's margin for a good chunk of products. But we have this offsetting effect induced by customer switching. So, the intuition here is that while the manufacturer's margin is much larger, we have got this switching effect, so the quantity response faced by the retailer when it changes the price has these two different components.

One, when it reduces the price or increases the price of Coca-Cola, there are interbrand effects, so sales move from Coke to Pepsi, but there also are inter-retailer competitive effects, right? So, consumers may end up switching stores when we are

talking about price decisions or at least are more likely to do so than when we talk about moving Coke from the bottom level to the eye-level shelf space, right?

So, the key point and argument here is that because promotional shelf space does not involve large inter-retailer shelf space effects, we do not see consumers switching on a number of grocery products. My co-author on the paper and dissertation adviser likes to use the example of dog collars in the store, right? So, there is some exclusive space granted for dog collars, and people pay and they compete for this space, but nobody switches the stores because there is one dog collar versus two, okay?

And because we have this idea that there are these small inter-retailer effects, it is the case that we have this incentive incompatibility problem, right, and instead of this inequality, if we had the jointly profit-maximizing level, we would see at least this relationship be approximately equal. The big difference is this elasticity from the retailer's perspective of the shelf space effect, right?

And so this is all to illustrate the point that where we see these small inter-retailer effects, again, this incentive incompatibility problem is pervasive, and this is especially so in the supermarket context. Now,

there are some limits on this idea. We do not see -- the distinction here is not just because of price and nonprice competition, okay? There are elements of nonprice competition where there are inter-retailer effects because all consumers value the service.

So, the supermarket provides a free parking lot. You can go and you park and you do not pay for it, you know, when you go in to park. Everyone generally values that there is a parking lot, maybe there is lighting there so you don't get mugged when you go to the parking lot, and everybody values this, and this means, because consumers value some nonprice services, then they will induce some switching, that for those services, the incentive incompatibility problem is solved. The retailer will supply those because consumers are all willing to pay.

So, where we see this, the very idea of promotional shelf space is to give some sort of effective, targeted discount to the marginal consumers who are sensitive to allocations in the shelf space, right? They are sensitive to what is in the eye-level shelf space, and there is a substantial marketing literature which demonstrates sometimes some really surprising results about how large the effects can be in terms of changes in sales when we play around with the

least a full or a partial exclusive seems to be -- at least appears to be thus far -- a necessary condition for liability. So, we have some form of exclusive -- we have -- well, there is no liability, but Gruma, Conwood, McCormick, so we have these cases where the contracts do not just buy the shelf space. They specify a percentage. They specify a full exclusive. They specify limits on the placement of rival products.

So, there are a number of procompetitive rationales for exclusivity terms in these contracts, and Mr. Steuer went over many of them, and so I am not going to belabor them here, but the key, following from this sort of shelf space contracting model, is that an exclusive can help facilitate performance of the contract, right? The retailer pockets this money and can have some short-term incentives to not perform.

So, a couple of things that exclusivity can do, it can efficiently define exactly what the manufacturer is purchasing. Purchasing all of the shelf space, detecting cheating becomes easy. The other thing it does is it allows the retailer to say, you are bidding for all or 70 percent or some large fraction of the promotional shelf space, and this intensifies the bidding process between the manufacturers for the shelf space, and this is a good thing in terms of the

antitrust analysis, a good thing for consumers, because these shelf space payments are passed on to consumers, and that is whether they are discounts or per unit time payments.

Quickly, so I can end here, category management contracts are just a form of limited exclusive, where what we are doing instead of saying you get 50 percent of the space is the retailer delegates the function to the manufacturer to allocate the shelf space, and we see this in circumstances where consumers' demand for a particular brand is high. So, the implicit contract is, you get to feature your product, Coca-Cola, and you can allocate the shelf space, but if consumers come to me and say I have a high demand for Pepsi and you're putting it on the bottom or you have run out or you did not put it on the shelf, then I know and I terminate the agreement, okay?

Just to finish up, Conwood seems to get this all wrong. So, Conwood, despite the sort of atmospheric facts and the tortious behavior and lots of bad stuff going on, there is some bothersome language in the opinion about imposing a standard on category managers that is tougher than the standard on monopolists using full exclusives, and so the key idea is that exclusive dealing can make economic sense in these circumstances

and that we need to make sure that the plaintiffs are demonstrating an anticompetitive effect before we engage in any sort of balancing under the rule of reason analysis.

I think I went over, sorry.

MR. VITA: Not too bad.

(Applause.)

MR. VITA: Thanks, Josh.

Okay, our next speaker is Howard Marvel who is a Professor of Economics in the Department of Economics at Ohio State, and he is also Professor of Law in the Moritz College of Law at Ohio State. Howard's work on vertical restraints is very well known. He has written on a variety of different topics, including resale price maintenance and exclusive dealing, and I know those papers have appeared in some leading economics journals.

Howard also has advised the Japanese International Trade Ministry, had a post in telecommunications, the Federal Trade Commission and the National Association of Attorneys General law on vertical restraints issues. In addition, he has served as an expert in vertical restraint matters for a number of firms.

Howard?

DR. MARVEL: Okay, I have seen a lot of you

before. I am happy that you have invited me to come talk to you outside of the Third Circuit, and the topic for today is exclusive dealing.

It is obvious that exclusive dealing is a very common thing that we see every time, when you go to a MacDonald's, you do not find a Burger King hamburger, and Haagen Dazs has had the exclusive dealing in their distribution contracts, car dealers typically have it, there is exclusive dealing in beer distribution. It is all over the place, and ordinarily we do not think anything about it. You know, any business format franchise is basically franchise or else, and it is most commonly observed for our market leaders, the big guys.

Anheuser-Busch has it in the Chicago area, it is under study, and you don't see that elsewhere. Haagen Dazs had contracts with distributors with Steve's, which at the time was a premium ice cream. I do not know if it is still around. Anybody from Boston? Steve's did not have that. The big guys have more reason to foreclose, of course, but they have also more to free ride upon.

So, for a long time we had a rule that Richard talked about, how tough it was to engage in exclusive dealing. The rule seemed to be that if you had market dominance or a big share somehow, somehow, and you

Resale price maintenance is very similar. There is a property right for the services that the distributor provides, and Josh talked about how this sort of works in slotting as well, like exclusive dealing, that creates a property right for customers that the supplier's actions pull in, and I think that if you think about the -- almost all of the things that Richard included in his discussion from the 1983 paper, they all have that characteristic, that the supplier is doing something to pull in customers and those customers are being protected through exclusive dealing by -- from some sort of bait and switch approach.

Now, the problem with exclusive dealing and what makes it more serious and more of a worry than territories and RPM is that in territories and RPM, the supplier is creating a property right for somebody else. It says, you do this, and you get to keep the fruits, so I would police that. And I am an outsider, and I want to have the distribution system to be as effective as I possibly can make it be, but with exclusive dealing, the property right is for the creator and the monitor of the right.

I give myself the right, and then I protect that right, and we have a problem that can emerge there if the right is somehow something that you really don't

want the guy to have and be able to protect, and that is really what is at the heart of Aspen Ski, because in Aspen Skiing, Aspen Skiing and Aspen Highlands cooperated to develop the Aspen market as a destination for skiers, and then at the end of the day, Aspen Skiing said, well, gee, they passed a law here in Aspen where you have got to have a three-week rental instead of just a one-week minimum rental or a longer rental term, and so you essentially locked customers in. You didn't have to compete for customers so much, because they said, well, we will walk away with rents, and you can see that elsewhere.

If you have a patent holder who has accessories for his product, the patent is about to expire, the guy may decide to engage in exclusive dealing to try and freeze out the accessory guys that he's cooperated with to build that product, and believe it or not, I was an expert witness in a matter in which I thought exclusive dealing was used improperly in this way, so it's not clear that these are anticompetitive so much as fraud or contracting problems, but they are problems.

Okay, so the basic exclusive dealing story is simply that the manufacturer invests in a product or a reputation that brings in customers, if the manufacturer confers upon its customers -- its customers onto dealers

who are cloaked in its reputation. So, if I become a dealer for a particular manufacturer, then customers say, hey, that dealer is essentially certified as knowing what he's talking about, so the customer walks into the dealer, induced to do so by the manufacturer's efforts, and then the dealer says, by the way, I have got a better deal for you.

Now, a requirement for this to work is that the customer cost, the cost of generating the customers has to be included in the charge for the product. So, if you can charge for leads separately, no sweat, okay? You just charge for the leads, you do the promotion, the customers walk in, and if the dealer who's paid for those customers wants to switch them to some other product, hey, that's fine, okay, but there are a lot of circumstances in which you only charge for the customer when they actually buy something, so it is rolled into the product price, and this is, again, the way it works with royalties in business format franchises, right, because MacDonald's brings customers in, but they only receive a charge, a payment, for those customers when the royalty is generated, okay?

So, the dealer can avoid this particular charge through a bait and switch scheme in which he says, okay, you are a customer for firm X, firm X brought you in,

that is what you came looking for, but firm Y has got a product that is cheaper, because it does not involve any promotion, it is simply a free rider, so why don't you switch to that one, and you can trust me, because I am firm X's dealer, okay?

So, what is the evidence for this -- how this works, okay? Is there any evidence to suggest that this works? Well, you know, "can you hear me now" doesn't necessarily need to be Verizon's slogan, it also should be a slogan for the hearing aids manufacturers who were engaged in exclusive dealing, and they were going out and getting a lot of customers to come in, into their dealers, and the customer comes in saying I saw an ad for Beltone hearing aids or whatever, can you fit me with a hearing aid? And the dealer at that point can say, yeah, I am a Beltone expert, and by the way, I've got a better deal on another hearing aid.

Now, the interesting evidence on this is that the FTC decided to take four of the five hearing aid manufacturers who used exclusive dealing, take them out and shoot them, because the idea was if you agree not to use exclusive dealing, we'll let you off the hook, and at the end of about a year or so, the bodies of the companies had agreed not to engage in exclusive dealing washed up on the shore. They were out of the business.

So, that's a problem in these cases, the counterfactual, what would happen if the practice were forced to be given up, is very hard to prove until it is

lawyer guys. I just talk and talk. That's the way it works, but I'll be done.

Okay, so the Aghion-Bolton idea is that there is a contract that is written before the entrant shows up, and then we run off with the entrant's rents because of the existence of this contracting penalty clause, okay? The requirement for that to work is you have got to have a contract, right? That is what you have got to have before this works, because if the entrant does show up, then the dealers run to the entrant if he is better, okay?

There is a second set of theories that are contract-based, and you think of the names Segal and Whinston, Ramweyer, Rasmussen and Wiley, and these are train-leaving-the-station contracts. The train is leaving the station, I am the only guy in the market, you better sign up with me or else, and then you have got to stay with me if I am no longer the only guy in the market, okay? So, these both require contracts. All of these theories require contracts. No contract, no problem, okay? And that is the characteristic of the game theory counter-revolution.

So, is Chicago out the window? Oh, they are, because Professor -- or Mr. Jacobson -- what is the appropriate -- Mr. -- Mr. Jacobson --

MR. JACOBSON: Hey you, hey you is fine.

DR. MARVEL: Hey you? Okay, he says, but Chicago writers -- post-Chicago writers long ago debunked the Chicago School, and it is now common ground that in many contexts exclusive dealing can be deployed in a way that is both profitable for the dealer and that allows the defendant to reap gains from the arrangement that far exceed the associated costs. Guess what? I agree, okay? True. Absolutely.

Now, we will wait for the first one of these to come along, but it is possible, in principle, for this to happen. I do not have the slightest disagreement with that.

Now, a couple of examples of this sort of thing, the first from your vintage Chicago School nut case, we appreciate the potential reply that it is impossible to say that a given practice "never" could injure customers. A creative economist -- there are creative economists -- could imagine unusual combinations that would cause injury in the rare situation, but antitrust law applies rules of per se legality to practices that almost never injure customers, and who might that be? Yes, Chicago.

Okay, but then we also have this statement the literature on anticompetitive exclusive dealing, so

actually what we are talking about today, has focused on producing "possibility results" in simple settings to counter Chicago School arguments. It is possible that something can go wrong, says Mike, okay? Now, he is not a Chicago guy, okay, and he is right. He has written some of the possibilities, but the possibilities take contracts, okay?

Problems are possible, and the problems involve foreclosure. If you get foreclosure, that does not mean foreclosing a particular set of dealers. It means foreclosing the market. If you get that, that is a problem. The benefits are going to be really hard to prove from exclusive dealing up front. Again, like I said, until you see the bodies wash up on the beach.

The default rule in these cases is going to determine the outcome, okay? If the default is that exclusion could be bad, what will happen is that exclusion will be found to be bad despite the absence of factors suggesting the presence that we might have one of the bad theories of exclusion, the proof of concept or possibility theories, present. So, if we get the default rule wrong, what will happen is that we always find that possibility means exclusion, becomes the default rule, and we are back to where we started. Exclusion plus dominance will equal violation. That is

where we were before. One minute.

Beltone, forget them, okay?

So, what should we do about all this in the last minute? The first possibility is that all of the possibility results that I know of, and even this guy Joe Farrell back there who just walked in seems to know of, are contract-related, okay? So, why don't we start by requiring a contract? No contract, no problem, okay?

benefits that you are claiming are really present.

With that, we will be done, okay?

(Applause.)

MR. VITA: Our final speaker before we take a short break is Jonathan Jacobson, who is a partner at Wilson Sonsini Goodrich & Rosati, where he practices antitrust law and has taken a lead role in many significant antitrust matters over his 30-year career. Among other cases, Jonathan was lead counsel for Coca-Cola in Pepsico v. Coca-Cola, a leading Section 2 monopolization case.

Jonathan was appointed by Congress in 2002 to serve on the Antitrust Modernization Commission, which is dedicated to studying the nation's antitrust laws and considering several changes. He also is the editorial chair of the ABA's Antitrust Law Developments and has chaired a number of ABA antitrust section committees. He has written and edited numerous articles and books on antitrust, and his most recent paper co-authored with Scott Scherr is entitled, "'No Economic Sense' Makes No Sense For Exclusive Dealing."

John?

MR. JACOBSON: Thank you.

I also want to express particular thanks for seating me on the far left wing on this panel. I think

that is entirely appropriate, although I would comment that in exclusive dealing cases, I have never represented a plaintiff. I would like to, but it has always been defense representation so far.

So, let's talk about exclusionary conduct and exclusive dealing in particular. There are lots of different exclusionary conduct devices, and these hearings will cover most of them. I actually think ripping your competitor's racks off the shelves is pretty exclusionary, so maybe we can talk about that in the dialogue, but that is one example of exclusionary conduct. The other is price cutting, which is, you know, rarely, rarely, rarely harmful and yields, you know, major significant consumer benefits.

Exclusive dealing is in the middle, and it presents a real challenge, because what makes exclusive dealing potentially harmful is the very same mechanism that makes the arrangement efficient and may lead to lower prices for consumers.

So, what are the consumer benefits? I think Richard went through them and I will just go through briefly, but basically the distributor, if we are focusing on distribution, which is the typical case, the distributor focuses his or her attention on the supplier's product and becomes a more effective

distributor, and from the supplier's perspective, the supplier has an incentive to provide the distributor with information and displays and all sorts of that stuff without concern of free riding by competing suppliers.

summaries and some of the testimony, but I suspect that there is agreement on really four issues in terms of an

the efficiencies, is to raise prices or otherwise harm consumers. And I think, you know, if you look at the major exclusive dealing cases over the last ten years, the results largely -- not entirely -- but are largely consistent with that kind of paradigm.

So, the recent debate was spurred in part, I think, by the thinking of folks like Judge Easterbrook, who gave a talk a few years ago saying that we should abandon Section 2 enforcement entirely, but that has led a lot of conservative thinkers and some more mainstream and liberal thinkers, like Steve Salop, to try to determine whether there is a universal test for examining exclusive conduct, and at some level we have been searching for the universal rule ever since Learned Hand's decision in the Alcoa case.

I would commend to all of your attention an excellent article in the Antitrust Law Journal a few months ago by Marc Popofsky, that having a one-size-fits-all approach that can be applied equally to practices as diverse as predatory pricing, refusals to deal, ripping your competitors' products off the shelves, has proven to be elusive. And I do not think we have gotten there yet, and I question whether we ever will.

The main area of disagreement is the extent that

we need extraordinary screens to ensure that procompetitive conduct is not deterred. The sort of screens that I would add that we do not see in most areas of the law other than antitrust. Antitrust, at least in the last few years, has been very sensitive to avoid deterring procompetitive conduct at the cost, many recognize, of allowing the occasional illegal behavior to go through.

All right, so -- by the way, thank you for not allowing questions from the audience, because Greg Werden is here -- and it is with quite a bit of trepidation, although he and I have had a few discussions on this subject, that I challenge the no economic sense test or Doug Melamed's version, the profit sacrifice test. This issue has gained -- and appropriately so -- a lot of attention, and under at least one articulation of the no economic sense test, a practice is not exclusionary for purposes of Section 2 unless it would make no economic sense for the defendant but for the tendency to eliminate or lessen competition. And in varying degrees, some of the advocates of this test urge that it be applied to all single-firm and vertical conduct.

If you look at the certiorari brief filed by the Justice Department in the Trinko case and the briefs

filed in the Court of Appeals in the Dentsply and American Airlines cases, the Justice Department has argued variations on this test as a rule of law. It has not been adopted by any of those courts, but it has been argued with some vigor by the Department of Justice.

One of the issues I have with the no economic sense test is that it is fundamentally the Areeda Turner predatory pricing pricing test in new garb. Areeda Turner made a major advance in the law in 1975 when they urged that predatory pricing not be condemned unless it is below cost with a likelihood of recouping the lost profits through the market conditions that will result from the predatory pricing scheme. And their test was acknowledged and stated by them to be an extraordinary test reserved exclusively at that time for price cutting, because price cutting is so rarely harmful and so extraordinarily important to our economy that we want to have a test that really makes sure that errors are purely on the side of allowing the defendant to win rather than the plaintiff to prevail.

Now, there have been efforts starting with the article that Janusz Ordover and Bobby Willig put out a few years after that to apply this sort of analysis more regularly to other forms of exclusionary conduct, but in general, we have been asking ourselves the question

since the no economic sense literature came out, is this purposefully extraordinary test -- and it was designed as an extraordinary test -- is it appropriate to apply it to other types of exclusionary conduct?

In my view, as applied to exclusive dealing, the no economic sense test really does make no economic sense, and I say that because exclusive dealing arrangements make economic sense precisely because they lessen competition by rivals for the affected business. So asking that question tells us nothing about whether the arrangement is procompetitive or anticompetitive.

Exclusives are usually associated, even in extreme cases like Dentsply, I think you can say that exclusives are usually associated with real efficiencies and sometimes cost very little to implement. So, unless you apply the economic sense test with the rigor that a Greg Werden would, and if you apply it in the real world, it is very easy to come out with the determination that the exclusive makes economic sense for the defendant.

But the way in which those efficiencies are achieved, as I said before, is through this mechanism of exclusion. So, the judicial audience, the business audience out there, is wondering, how can I do this? This arrangement makes no economic sense to me unless I

can exclude my rivals, but that seems to be the test for illegality, so what do I do? And I think the answer to that is you apply a different test.

So, exclusive dealing is also interesting and different, as Steve Salop points out, because at least under some scenarios there need be no period in which profits are sacrificed during the course of the exclusive dealing arrangement. You can have simultaneous exclusion and recoupment.

All right, recent case, not a federal case, although I will tell you we did our best to get the Justice Department and Federal Trade Commission to file a brief and they politely declined, but the Court came out correctly I think anyway, although it was a 5-4 decision, and if you really want to read something interesting, read the dissent in the case. It is a decision that came out less than a month ago out of the Texas Supreme Court, and it involved exclusive promotional agreements with retailers, not exclusive dealing arrangements, but exclusive promotional agreements.

In some of the agreements, Coke -- in all of the agreements, Coke had to get a reduced price. In some of the agreements, it provided that the low price had to be the lowest in the store on that particular package. The

exclusives required the most prominent displays in the stores and also exclusive ads.

In return for this, Coke provided very significant lump sum promotional payments and deeply discounted wholesale prices. So, the result was to reduce the retailer's costs, both marginal costs and total costs. Coke had 70 to 80 percent of the market if you accepted the market definition in the case. The result of this was lower prices for Coca-Cola products, and it was not seriously disputed that the level of promotional activity resulted in overall lower prices in the marketplace for carbonated soft drinks as a whole.

Now, the exclusivity in that case, the agreements, made economic sense only because the exclusives made more -- made things more difficult for rivals, and the easy example is to ask why would Coke pay thousands of dollars to a supermarket for a promotion? Let's say the promotion is two-liter and you expect that the reduced price would be something like 99 cents. If the consumer is going to walk in the store and the first thing she is going to see is a Pepsi display of two liters at 89 cents, that promotion really is not worth very much for Coke. Why would Coke spend the money for that promotion? Why wouldn't it just figure out some other way to sell soft drinks?

The problem, as the dissent points out, is that this kind of exclusivity could fail an incautious application of the no economic sense test, but appropriately, the majority upheld the agreements under the rule of reason because there was no showing that they led to increased prices in the market as a whole.

Now, I will very briefly talk about Microsoft, and I am not going to go through the whole slide, but the basic concept here is a lot of what Microsoft was doing was virtually costless. Leaving Internet Explorer out of add/remove programs was virtually costless, and if you apply the no economic sense test to Microsoft, you can easily get a situation where the Court would say that this conduct makes economic sense and is, therefore, upheld. I think the Court went through an elaborate recitation of the rule of reason, and I think we have a good precedent there.

I had promised not to go over time, and I see that I already have. What I do want to point out is that the focus that we care about in antitrust generally and in exclusive dealing cases as one piece of that overall puzzle is does this behavior injure consumers? Does it raise prices? Does it otherwise injure consumers and the benefit of the bargain that they are going to receive?

The no economic sense test asks that we bypass that question. My point is simply, let's look at that question directly. Let's try to get to that analysis directly. The shortcut, which if applied incorrectly can lead to very questionable results, is not a necessary route. It does not protect competitive conduct any more than a careful application of the rule of reason would. So, let's just ask the question that we really want the answer to and guide our analysis on that basis.

Thank you.

dealing and at the places where the game theoretic models have found problems, they are all cases in which there is not an option today and I sign up everybody today and I lock them in, okay? And since that is virtually always the case in all these models, if you find another example of a circumstance in which you say there is a real economic loss that results from this, I would like to see an economic analysis of why there was an economic loss there. So, I wait for some economist, the clever economists that Easterbrook was talking about, to come up with the explanation.

I think I probably could for Microsoft as to why Microsoft's behavior might be a problem, but that is not similar to the ones that we have already talked about, okay? So, in -- I hate to do this with Gail here -- but in Dentsply, one of the things that was interesting about that case was that the Justice Department seemed to recognize early on that they needed to provide a de facto contract analysis as to why there was lock-in, okay? So, they said, okay, it is because of inventory investments. I bought so many inventories from these guys, from Dentsply, that if I walk away from them, I am stuck with the inventories, and the alternative explanation in that case said, hey, you really want those inventories to tide you over while you are trying

them in this sort of standard exclusive dealing context.

MR. JACOBSON: I don't want to hog the mike, and I know Dentsply, we would get a very different view of the facts from people like Gail and Mark Bodde (ph), but what about Lorraine Journal? No contracts, you know --

contract.

It was similar to a Colgate relationship that way. It was simply a unilateral policy, "Here is my price schedule if you do what I want you to do," and yet it seemed to have all of the foreclosure effect that a bilateral contract would. So, to some extent, maybe we are talking past each other a little bit in terms of the terminology and what is a contract and what is not.

DR. MARVEL: Well, maybe so, but one of the things that you brought up, Richard, in your discussion was this NicSand case, right? And one of the things that has really impressed me about the cleverness of the post-Chicago world is how really imaginative they are at coming up with sort of contract-based explanations for why you could have problems, but, of course, the Chicago side does that, too, and you look at Lepage's and NicSand, and those are matters in which the Justice Department says we don't know yet what we should be doing, so let's wait a while before we have the Supreme Court step into that, or at least that is what happened in Lepage's.

But, in fact, we are starting to figure out that those things involve -- I mean, maybe Lepage's was collateral damage, because there was a real problem with getting your entire line carried if you are going to a

discounter, like a WalMart or a K-Mart. So, it is very possible that in a case like that, what you are really trying to do is induce the discounter that you are dealing with -- and this is particularly true for discounters -- to carry a much broader portion of the line than they would otherwise carry, and that is going to increase consumer welfare even though it is going to increase prices or it is going to increase economic welfare.

So, I mean, you can get into these circumstances where you say, I don't understand yet why the manufacturer is doing this, so it must be foreclosure, but if you stand back for a while, maybe somebody will come along and say, hey, some of these bundling schemes have the efficiency effects that are pretty significant, and I think that cases like those may just be circumstances in which you are dealing with a guy who is going to carry a very narrow portion of your line, and you do not like that, so you pay him to carry a broader portion, and if somebody -- and you say, well, I am offering you this really good deal to carry the broader portion of the line, and maybe if that excludes somebody else, well, yeah, that could very well do that, but that is not the only effect of it, and so it is a really -- these are really tough questions.

MR. STEUER: Well, Lepage's had a "have to have it" kind of product in the bundle. NicSand is almost more interesting, because it was real competition for the contract, and I am not sure we have seen the last of that case.

MR. JACOBSON: Well, it was a 12(b), so...

MR. VITA: Anybody else? Josh, Mary, anything you would like to pose to the other speakers before we --

MR. WRIGHT: I have one.

MR. VITA: Yeah, go ahead.

MR. WRIGHT: I maybe was being too sensitive to one of the comments, so I heard it directed at me, but Jonathan had mentioned that he --

MR. JACOBSON: Ripping competitors' racks off shelves? Yeah.

MR. WRIGHT: So, I think you either mischaracterized what I said, but since I didn't say anything about the shelves, then maybe that's not it, but to be clear, what the paper is about and what we are arguing about in the paper is the economic analysis of category management contracts, giving a procompetitive explanation for why, under some conditions, the retailer may want to delegate to the manufacturer the responsibility of the shelf space allocation decisions.

That has nothing to do with the decision in Conwood.

What the point is about the decision in Conwood is -- and I agree, and I am happy to say, court reporter and everything, that I agree that ripping shelf space -- ripping displays down is bad, it is exclusionary. It would be bad --

MR. JACOBSON: Makes no economic sense?

MR. WRIGHT: -- it would be bad if -- also if the United States Tobacco employees sat out in the parking lot with bats and said don't come in and bring in product. All these things would be bad, but the point is about whether or not there is anticompetitive effect and whether or not there are any foreclosure effects and whether or not the conduct was sufficient or likely to generate anticompetitive effects.

I know I am to the right of you on the panel, so I will use someone else. Professor Hovenkamp, in Antitrust Enterprise, using the testimony in the record, estimates the distribution cost increase as something like 33 cents per store per month, and there is some other evidence we talk about in the paper, but the idea is that there is this other question about whether or not there is a likelihood of anticompetitive effect and that even in the case of really nasty, nasty, bad, wrong conduct, we should be asking the question.

MR. VITA: Mary, do you have anything?

DR. SULLIVAN: Ah, no.

MR. VITA: Okay, Brandon, why don't we move along then, and what we would like to do is put some propositions up and get some reactions from the panel, and I am going to go ahead -- I am going to read these, they have to be read into the record, so let me just go ahead and read the first one here, and this is a quotation from Justice O'Connor's concurring opinion in Jefferson Parish Hospital District Number 2 versus Hyde, 1984, and the statement is, "Exclusive-dealing arrangements are analyzed under the rule of reason."

Let me just pose probably a simple question to the panel, and this is more to the lawyers, I think. Does this statement from Justice O'Connor's concurrence in that case accurately summarize the law regarding exclusive dealing? Richard and Joshua, Jonathan?

MR. STEUER: I think it does. I think that the rule of reason is still a work in progress since Cal Dental, and we will see what the content is in judging these, but there really are three elements I think that go into it with exclusive dealing. One is the nature of the product and relationship, all the things that I talked about. The second is, of course, the percentage of the market once you have defined it that's

"foreclosed," and the third element is the duration, the time period. So, I think those are the big moving parts in a rule of reason analysis, and the nuances await the development of the case law.

MR. JACOBSON: Yeah, I agree with that. I was actually surprised, because this is also on the first of the questions that you sent out to us yesterday, that this would be perceived as controversial. I mean, the law is fairly clear about this, certainly under Section 1, and I think Microsoft and Dentsply, properly read, import this analysis into Section 2. The greater the market power of the defendant, the lower the degree of impairment of rivals you are generally going to require before you see a price effect, but I do not think this is a controversial proposition. So, I wonder what is motivating the inquiry.

MR. O'BRIEN: We didn't necessarily think it was controversial, but in this area where we are trying to build some kind of consensus in terms of what we all agree on, we thought we would start simple.

MR. JACOBSON: Well, I "concense" this.

MR. VITA: Josh, are you on board, too?

MR. WRIGHT: I third the motion.

MR. VITA: Let me follow up on that, then, and ask again, and anybody can step in here, does anybody

think there are exclusivity arrangements that should be per se illegal? And similarly, does anyone think there are exclusivity arrangements that are always or nearly always procompetitive and are thus appropriate candidates for a safe harbor? Just if anybody has any thoughts on that, you can step in.

MR. JACOBSON: Yeah, but dissent in the Harmar case, four Justices saying that exclusive dealing arrangements with multiple retailers are illegal because Klors as originally understood is correct, but I do not think anyone else believes that, and I think it would be really wrong-headed to circumvent, you know, 30 years now of rule of reason foray after Sylvania, to go back to a per se rule on exclusivity here.

I think there are going to be safe harbors, but they are basically going to be low market share safe harbors and in a properly defined market, and the open question in those cases is going to be, well, what if the whole market is tied up with exclusives as in Standard Stations? Do we really look just at the defendant's share of the market as a screen? I think the answer is yes, but I think it is a difficult question.

MR. VITA: Anybody else?

MR. WRIGHT: Sure.

MR. VITA: Josh?

MR. WRIGHT: The first question I think was are there any that should be per se illegal, no. And the second question is with respect to safe harbors, and I think in addition to the point about safe harbors for exclusives that do not foreclose some significant share of distribution, sort of foreclose trivial shares of distribution, then that is an appropriate place for a safe harbor.

And I know there is at least -- I mean, there is not a consensus on this point about the duration of the contracts, but I believe it is certainly the case that short-term arrangements, like the ones we see in slotting, six months in duration, may also be, though I recognize this is subject to probably more debate, may also be appropriate for safe harbors.

MR. STEUER: Some courts have misapplied the term "exclusive dealing" to both exclusive selling and exclusive buying. There is almost a safe harbor for exclusive selling other than those rare arrangements where one dealer has the exclusive for every brand there is, and there have been a couple of cases like that.

In terms of real exclusive dealing, exclusive buying, there is almost a safe harbor of a third coming out of Jefferson Parish, talking about 30 percent.

agreement with one manufacturer for one product and says "I want to be the exclusive seller of this product," it is rather limited what the impact is. In fact, I think the decree that was finally negotiated specifically provides for some limited exclusivity like that.

But if one chain were to become powerful enough to sign up as the exclusive seller of all the toys for all the major manufacturers, obviously everybody else is frozen out, and I think there actually have been a couple of examples like that.

DR. MARVEL: So, in Toys 'R Us, what happened, if I recall, was that the Seventh Circuit of all people said that the Toys 'R Us arrangement was not okay, and that is because Toys 'R Us did have this sort of monopoly position in the toy business, and it was unassailable -- because of their unassailable position, they really needed to protect the other poor souls like Sam's Club from the depredations of Toys 'R Us. So -- is that right?

MR. JACOBSON: Well, another way to --

MR. STEUER: Well, Sam's Club or consumers. I mean, the classic example, there was a wholesaler on an island, I think St. Thomas, that was the sole distributor for, it turned out, every single brand of liquor, so that it basically created a bottleneck and

had monopoly at the distribution level, and to the extent any of these examples approach that almost textbook model, then you have a situation where consumers really do not have other options at which to shop for those particular products.

DR. MARVEL: So, is it an advantage to consumers when Toys 'R Us contemplates getting out of the toy business?

MR. JACOBSON: Because of WalMart? Look, there were a lot of things going on in the case. One of them was that the facts supported a finding of a horizontal arrangement that was facilitated by Toys 'R Us, and I think that is what concerned Judge Wood most --

DR. MARVEL: Right, absolutely.

MR. JACOBSON: -- in terms of the significance, but looking at it purely on a vertical basis, at the time there was a credible theory that it was raising prices. Even though Toys 'R Us had a 20 percent market share nationally, there were pockets of the country where the share was in the high 40s, low 50s, and where they were a must-have retailer for Mattel and Hasbro and those other toy stores, and the result of this was that the real, you know, the real discounters were cut off by it, and you could make an arguable case that consumers were paying higher prices as a result.

So, it was not -- it is not a crazy case. I

you look at Conwood, for example, and what Josh was talking about, the Conwood case seems to me to have turned in part upon the, shall we say, hyjinks of the UST representatives who were trashing the Conwood racks --

MR. JACOBSON: Right.

DR. MARVEL: -- but what it really turned on was what was going on at WalMart, and that was a different tale entirely. They wouldn't dare trash the racks at WalMart, and so it kind of conflated those two things.

I mean, I have come up with a number of sort of hair-raising anticompetitive activities that firms used to engage in, and it is easy to come up with these things, but that one is tough, because you start conflating these things, and then you get a decision that is made more on emotion than on what the economics of it are.

MR. VITA: Let's go to the next slide, Brandon, and let me just again read this, but this discussion that Howard and Jonathan have been having I think sort of leads into this next proposition and some of the questions surrounding it. Let me just read it.

This is a quotation from Posner's Antitrust Law, Second Edition, 2001, and in that book, Posner says, "I propose the following standard for judging practices

the time the case was brought was very low, and that may explain why there was talk about monopoly power in operating systems, but if you look at it purely as a Section 3 type case and not searching for monopoly power, but even at a low market share, was there a danger -- an anticompetitive effect from the types of exclusivity that was being entered into? Purely on the numbers, you would say, no, the share is much too low, and come back when it gets higher, but we all know where that ended up.

MR. VITA: Well, let me ask this, and this may be a question more for the economists, although the lawyers are free to jump in, too.

Can we articulate or identify necessary

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what about downstream?

MR. WRIGHT: So, in downstream, you can have -- there are cases where if you have large economies of scale in distribution, you get -- you can have these exclusionary effects as well.

MR. VITA: I mean, if there weren't substantial scale economies downstream, or maybe some other factors as well, do you think it would be possible in the kind of long run or medium run for exclusive dealing arrangements to have an anticompetitive effect? I mean, why wouldn't -- you know, because if you don't have substantial scaled economies and/or sunk costs at the retailing level, why can't the -- supposedly the foreclosed manufacturer get around the --

MR. WRIGHT: Right, so if you have -- at the retail level you have -- I am going to frame this a slightly different way, but if you have -- even if you have the manufacturing scale economies but the retail level you have free entry condition, then you are going to have retailers who will re-align the supply contracts, new entrants into the retailers who will re-align the supply contracts, and so you need it at some level, and the theory is you can do it with economies of scale at the manufacturer level, but if you have free entry at the retail level, I think that is

another problem for the exclusionary dealings.

MR. VITA: Jonathan, you looked like you might have had something to add there.

MR. JACOBSON: No, I actually agree with that, but it led into one of my sort of favorite topics in the space, which is let's not talk about foreclosure, because if we look at the percentage of distribution or retail outlets foreclosed without examining entry, for example, we may get a large number that's meaningless, and that is why I think we are a lot better off if we get rid of the word "foreclosure" and think about the impairment of the rival, because that is the mechanism that is going to lead to the consumer harm, not the foreclosure, as such.

Foreclosure is a part of the analysis, but I think it is only part of the analysis. You have to look at the broader picture. Clearly there have to be impediments to entry downstream.

And incidentally, I would agree with Posner's book depending on the definition of "monopoly power." You know, I think if you change it to market power, I think, you know, a lot of people would subscribe to it. I certainly would.

DR. SULLIVAN: Yes, I have one comment to make on the -- following up on Josh's comment about free

that are sometimes discussed maybe in the academic literature in connection with exclusivity arrangements, but in all likelihood, really aren't likely to exist or likely to be very important empirically in real cases?

So, let me put that out there. Anybody --

DR. SULLIVAN: Yes, I will take that one just in the sort of specialized area of slotting allowances. In the academic literature, people make a big deal out of -- one of the efficiencies of slotting allowances is that it signals the product quality to retailers of manufacturers' new products in cases where product default is uncertain, and based on a lot of the empirical studies that have been done by people in marketing, that is simply not one of the efficiencies that pops up, and I think the reason is there are quite a few tools that manufacturers use to introduce their products in addition to slotting allowances, and that just -- so, I would feel comfortable ruling that out as an efficiency, although there are plenty of other efficiencies involved in slotting allowances.

MR. VITA: Howard?

DR. MARVEL: One of the cases that Richard mentioned is the first nuanced case of exclusive dealing I think was Beltone, and I think it is fair to say that if there had not been some very un-nuanced el1 griesn

that case, that Beltone would have gone down in flames, because by the time Beltone came up before the Commission, its four principal rivals in that particular channel that it was involved in had all met their demise, and so Beltone was left as the monopolist -- thank you very much, FTC -- and at that point, they didn't really have a good explanation for why they were engaging in the exclusive dealing that they were engaging in, but -- and so I don't see how they really could have prevailed in that case unless there was this evidence that was pretty clear that the companies that had to give up the exclusive dealing practice had gone belly-up.

So, in some ways John's paper talks about how there probably is not a case that you can find where you cannot determine that there are some advantages, but the real difficult problem is to figure out how important they are, and that is an incredibly difficult trade-off. It is very hard to measure these things.

MR. VITA: Let me ask a follow-up on that point. What significance, if any, should be given to observing a challenged exclusive dealing arrangement in a similar but somewhat more competitive market? So, you know, that is sometimes an argument you make or you hear, that, well, you know, this particular arrangement must

have some competitive benefits, because we see it over here in these other markets that are structurally competitive and where there is no plausible anticompetitive theory of harm. How much -- how powerful are those arguments and what weight should they be given?

MR. JACOBSON: I think it is a much more powerful argument if a small company is doing it than if a large company is doing it in the same market. I think looking at comparable markets and saying exclusive dealing works efficiencies there, therefore they must in this other market, really depends on how similar the markets are. I would not make that leap without, you know, a good deal of comparability evidence.

MR. VITA: Josh?

MR. WRIGHT: A related point, I mean, the nature of the exclusive deal to facilitate some sort of contract or performance, in the slotting example, again, where the contract is over some sort of form of promotion, and you see this a lot in exclusive dealing cases where the underlying relationship between the manufacturer and retailer relies on some sort of promotional effort of the retailer and, in fact, is contracted for, but the nature of performance in these different markets varies a great deal, whether we are

talking about putting a product on an eye-level shelf space or giving a product demonstration or some other form of promotion.

So, the contracted-for conduct varies so much market to market, I think the best you can make out of seeing exclusive in a more competitive but different market is sort of one of a cautious inference that we generally know that exclusives can be procompetitive, which I think there is not much disagreement on anyway.

MR. VITA: Okay.

MR. JACOBSON: I have a question for Mary. If we renamed it payola, from payola to music leaders or retail music program, do you think we would get a different result?

DR. SULLIVAN: No. I think the people at FCC and Elliott Spitzer would figure it out in a second.

DR. MARVEL: Why don't we call grocery store slotting allowances payola?

DR. SULLIVAN: Well, I think we could, and one thing you could do --

MR. JACOBSON: Because we would like to win the cases.

DR. SULLIVAN: -- if the FCC regulated slotting allowances, they would require the cashier at the checkout counters to tell the customer each time he or

she was buying a product for which a slotting allowance had been paid, then say, do you still want to buy it?

MR. WRIGHT: Well, as funny as that is, California had proposed at one point -- I think it is still kicking around in committee --

MR. JACOBSON: No, it was killed.

MR. WRIGHT: It was killed now?

MR. JACOBSON: Yeah.

MR. WRIGHT: Senate Bill 582, which would have made -- it would have been illegal for -- essentially a retailer would have to tell Pepsi exactly what Coke was paying in terms of its promotional allowances, in terms of the slotting fees, and if you conceive of these things, these payments, as I do, as part of the competitive process, I mean, this is a statute that is a -- it is, you know, a legislatively enforced collusion, right? And so it is silly, but, you know, not silly enough to write down in a bill.

MR. VITA: Okay, let's move on then. The next proposition is from Dennis Carlton from his article in the Antitrust Law Journal, "A General Analysis of Exclusionary Conduct and Refusal to Deal -- Why Aspen and Kodak Are Misguided," and Carlton's proposition is as follows:

"In the presence of scale economies, exclusive dealing can be a way of depriving Firm 2 (or its distributors) of the necessary scale to achieve efficiencies, even though, absent the exclusivity, Firm 1 and Firm 2 would both be large enough to achieve [illegible]

earn almost no profits because their segment was so competitive, and they could easily be coerced into going along with an exclusivity deal that would exclude one of the manufacturers because it simply would increase the industry profits, and he developed conditions under which this was true. One might argue that that would be fairly unusual, but it -- you know, it is there.

MR. VITA: Anybody else? Dan, did you want to add something?

MR. O'BRIEN: I would just like to ask, Mary, following up, in that kind of a theory, if a manufacturer could secretly get to a -- get with a retailer, okay, assuming that everybody else was being coerced into this exclusive with the manufacturer, and negotiate something on the sly, wouldn't they be able to undercut what, you know, the monopoly price that was presumably being set by the other guys?

DR. SULLIVAN: I think so, and I think there was something in particular about the nature of the game that Greg set up that allowed him to get this outcome, so I agree that might be -- it might not be that problematic in reality.

MR. STEUER: There are a lot of assumptions in here obviously. It makes a huge difference whether the exclusivity is with end users and for how long. If this

is simply competition for the contract, clearly if one manufacturer can get exclusive arrangements with the bulk of the end users and freeze out the other, that is going to have a profound impact, but if the second

suggests courts apply a 40 percent market share safe harbor, and if that -- you know, is that actually true, and does anybody have an alternative minimum requirement that they would prefer?

So, let me put those two out, those two propositions out there and see what the panel thinks.

MR. JACOBSON: Well, I generally agree with what I said.

MR. VITA: Glad to hear that.

MR. JACOBSON: I think this is a pretty good quote. I think "market access" needs a little bit of definition, because I do not think you need -- this was one of the other questions that we had talked about before the program -- I do not think you need total foreclosure. Again, I think the test needs to be the degree of impairment of rivals. So, as long as denying market access is read in that context, I think this is a pretty good analysis.

I think 40 percent is a pretty good rough screen. I think Richard's correct to point out that Jefferson Parish is a 30 percent number, but it does not say anything about a screen here or there, but if you look at the subsequent cases, you are not going to find any where the defendants have liability with less than 40 percent unless you consider Toys 'R Us an exclusive

dealing case, and there, you know, there were extenuating circumstances given the horizontality of the agreement.

MR. STEUER: And the term in here "significant rivals" is significant, because it really raises the question, who should have a cause of action here? At some point, if there is ample competition in a market and there is exclusive dealing going around, there may be some marginal players who claim that they are being excluded, and those can be emotionally appealing cases in terms of jury appeal, and yet in terms of what the actual effect is on the market, it may be very marginal indeed, and there are not very clear tests right now as to who should be able to bring a claim.

MR. O'BRIEN: If I could follow up with that, John, earlier you had said that one of the areas in which there was an agreement, you listed four points, one of which was we want to prevent the enhanced -- you

there is a significant enhancement or creation of market power, I think you have done that. So, I do not think this is inconsistent with that proposition.

MR. VITA: Okay, let's move on then.

This next proposition is from United States versus Microsoft, the D.C. Circuit en banc decision. The quotation is as follows:

"If the monopolist's procompetitive justification stands unrebutted, then the plaintiff must demonstrate that the anticompetitive harm of the conduct outweighs the procompetitive benefit."

A couple of questions, and again, this may be a little more for the economists, but anybody can step in.

First of all, does economics supply tools that would assist courts in making this kind of assessment, and do courts have the ability to apply these kinds of tests?

Let me stop right there and see what the reaction is from the economists on the panel.

DR. MARVEL: How about no?

MR. VITA: Say again?

DR. MARVEL: Do the courts have the tools? No.

MR. VITA: Actually, the proposition was, can we as economists supply tools that courts could use? I mean, what kind of analysis, if any, can we provide that

might have tools to supply with respect to understanding a monopolist's procompetitive justifications. Something we can do is understand why we might see exclusives, understand why conduct might be procompetitive, and the

point. So, it is a very rare case that requires balancing.

But if balancing is required, I think we need to do it, and to say -- to throw up our hands and say it is too complicated is just completely the wrong answer. We do it every day. This building is filled with people doing that in merger cases. It is done at the Justice Department in merger cases all the time. This is exactly what we do. So, to say that we are not going to do this, it is too complicated, we might as well just get rid of antitrust, because this is the guts of what hard antitrust cases are all about, and we not only want to do this, but we have to do it. This is one issue I feel very strongly about.

MR. O'BRIEN: So, I wanted to follow up with Howard, and, John, you may want to chime in on this, too. You are concerned that if we can establish that there may be an anticompetitive effect, that it is often very hard for defendants to come in and argue, well, no, in fact, there are efficiencies and that they offset the anticompetitive effect, and I --

DR. MARVEL: No, what I am saying is that if you can really show anticompetitive harm and --

MR. O'BRIEN: That may or may not be offset by efficiencies, okay, so that is what I am saying. It may

or may not be offset, and what I took you to be saying was that --

DR. MARVEL: That would make it really tough for -- once you have a compelling demonstration of anticompetitive harm -- and that is compelling for me, not for you --

MR. O'BRIEN: Right.

DR. MARVEL: -- then I am not so sure that -- it reminds me of the original merger guidelines when they did not allow efficiencies as a defense, and I do not think that that was absolutely nuts. So, if there is a strong demonstration of anticompetitive harm -- and that is not just locking up a channel, that is locking up the market -- then I am not sure how much balancing I want to do at that point.

MR. O'BRIEN: I see.

MR. JACOBSON: It is a rare case, Dan, it is a rare case where you need to do this, but there can be, at least in theory -- I will tell you, I have never seen one -- but there can be one, at least in theory, where the effect of the exclusives is to create a market structure such that the defendant can raise prices to some extent.

However, there may be sufficient dealer focus as one traditional efficiency or other effects that overall

output of the product is increased. Think about your resale price maintenance cases, the same -- it is the same type of analysis, and if you can show -- first of all, the burden is on the plaintiff, not the defendant, but if the defendant can put in evidence to say that notwithstanding the price increase, we are going to have a significant overall market output effect that is going to be procompetitive, I think you have got to entertain that defense, and then I think you have got to see whether that is true at the end of the day. Is the net effect going to be to increase output or not?

MR. O'BRIEN: I guess I -- I am sorry.

DR. MARVEL: I think maybe if I can go, John's point, I think part of the disagreement with -- the implicit disagreement here is in my determination of what constitutes an anticompetitive effect, because I certainly would not agree to that parenthetical remark that Hovenkamp had that said that prices are higher than they would have been if the restraint was taken away. Well, you cannot do that, because all of these explanations talk about setting up a property right that allow you to get a return on your investment which could very well take the form of, you know, if you shift up the demand curve, you are going to get a higher price and greater output. If you get more output, end of

story. If it is a higher price, that does not really tell you much of anything, and so that is I think part of what we are -- we may be agreeing, somehow have a different setup.

MR. O'BRIEN: So, following up on that, Howard, I am curious how you feel about something like the no economic sense test as a way to, you know, ask is there a plausible efficiency rationale and, you know, maybe

the panelists. This was a really great discussion, and I think everybody got a lot out of it. So, thanks very much.

(Applause.)

(Whereupon, at 12:19 p.m., a lunch recess was taken.)

AFTERNOON SESSION

(1:31 p.m.)

MR. O'BRIEN: Okay, let's get started. Well, welcome to the second exclusive dealing panel of the day in what is part of our ongoing series of public hearings on single-firm conduct. My name is Dan O'Brien. I am the Chief of the Economic Regulatory Section at the Antitrust Division, and I will be moderating this session along with Mike Vita, who is the Assistant Director in the Economics Group, the Bureau of Economics at the Federal Trade Commission.

The Department of Justice and the FTC are jointly sponsoring these hearings to help advance the development of the law concerning the treatment of unilateral conduct under the antitrust laws. Transcripts and other materials from the prior sessions are available on the DOJ and FTC web sites, and I just wanted to advertise that upcoming panels include a panel on bundled loyalty discounts on November 29th, obviously a practice that is somewhat related to exclusive dealing, which is the topic for today, and then there is a panel on misleading and deceptive conduct on December 6th.

So, today's session concerns the law and economics of exclusive dealing. It was 40 years ago in

the Brown Shoe case that the Supreme Court made a very strong statement against exclusive dealing, asserting that it conflicts with the central policy against contracts that take away the freedom of purchasers to buy in an open market.

Since that time, the treatment of exclusive dealing by the courts has changed fairly dramatically over time, and the economics of exclusive dealing has progressed, identifying both procompetitive and anticompetitive aspects of the practice depending on a range of circumstances.

We have a very distinguished group of panelists here this afternoon to talk about these developments and the current state of affairs from both the legal and economic perspectives. My goals from today's panel are, first, to highlight some areas hopefully where there is some consensus on the effects of exclusive dealing and how to treat it, but also maybe identify questions that remain unsettled so we can have some consensus about the questions that need to be addressed as we move forward.

So, before introducing the panelists, I just wanted to thank my colleagues at the FTC and at the Antitrust Division, particularly June Lee and the economics staff at the Antitrust Division and Joe

lot of the work in putting together this panel.

The organization of the panel is going to be as follows: We have four panelists. They will give presentations of approximately 15 minutes. Then we will take a short break. Then the panelists will have a few minutes to respond to the other presentations if they so desire, and then we will have a moderated discussion, and we can go until around 4:00 p.m.

So, the order of the panelists, in case people are wondering, will be Steve Calkins first, Tad Lipsky second, Joe Farrell and then Ben Klein. So, let me introduce Stephen Calkins. He is our first speaker.

Stephen Calkins is Professor of Law and Director of Graduate Studies at Wayne State University Law School where he teaches courses and seminars on antitrust, trade regulation, consumer law and torts.

From 1995 to 1997, Steve served as General Counsel of the Federal Trade Commission. Steve lectures widely throughout the U.S. and abroad, most recently in

tests.

You would look at "evidence that competition has flourished, despite use of the contracts," or you would look at the conformity of the length of their terms to the reasonable requirements of the field of commerce, or you would look at the status of the defendant as a struggling newcomer or an established competitor or the defendant's degree of market control, and you would go through all this sort of stuff, but the opinion goes on and says that to do this would just be extremely difficult and to sort everything out would be an immense challenge and, using words very similar to sort of the basic sort of Areeda Hovenkamp mantra, we need to have tests that are administerable by courts, we need to have rules that can be enforced without wasting a lot of societal resources on hopelessly complex litigation that can't lead to any predictable outcomes, and so for reasons of administrative efficiency, exclusive dealing contracts should almost all be illegal, because this was the original Standard Oil/Standard Stations case with those thoughtful observations about the procompetitive benefits of exclusive dealing, but the conundrum, the difficulties, of litigating.

So, when I sat down and took a look to start my sort of thinking about this and went back in time, I

As mentioned in the previous session, that call was picked up first in the courts or the adjudicative bodies in the Beltone Electronics opinion, where the Court specifically relies on Bork and the antitrust paradox to take a different approach to exclusive dealing, the Federal Trade Commission, leading the way to a new day of exclusive dealing decision-making, even if we learned in the last session at the cost of having sacrificed four of the five competitors, but nonetheless, having led the way, that was followed shortly thereafter by Jefferson Parish. Of course, it is always cute, we refer to the Jefferson Parish exclusive dealing holding, and it wasn't a holding at all. It was part of the concurrence of Justice O'Connor, but we all think of it as the holding from Jefferson Parish where she emphatically said exclusive dealing is judged more permissively than tying, it is rule of reason, and "exclusive dealing is unreasonable restraint on trade only when a significant fraction of buyers or sellers are frozen out of a market by the exclusive deal."

And since then, if you look at things that have happened and you sort of parade through the exclusive dealing cases that we know, which I throw up on the screen in front of you or I throw up more of the

all sorts of wonderful mathematical sophistication. I think of the lesson as a common sense story of collective action.

There was recently a case that Tad knows dearly, the Coca-Cola case just decided by the Texas Supreme Court. I do not know anything about the facts of that case, and I have no opinion on the case. I do not know what happened down there, but one of the things that allegedly happened was that Coca-Cola paid retailers not to allow 7-Up in its stores, and if you think about that for a minute, you know, it sort of sets out the collective action story very crisply. Why would a retailer agree not to carry 7-Up when it knows that if in the long run there is no 7-Up, that is probably bad for retailers? And the answer is, of course, that if a payment goes to a single retailer, that single retailer can collect the payment knowing that its excluding of 7-Up is not really going to make a difference in the long run, and you do not have all the retailers getting together and agreeing that they will resist Coca-Cola, because that would be illegal under the antitrust laws, and so each separate retailer looking at its individual self-interest can quite reasonably say, I will agree not to allow 7-Up in my store, even though in the long run, that is against the collective interests of all of them,

and it is because of that kind of a collective action problem that exclusive dealing can sometimes harm

lawful under Section 1, it could be unlawful when engaged in by a monopolist. The Court asked rather tough questions about the justifications for the practices going on there, specifically saying that with respect to one practice, where 14 of the 15 top Internet access providers had contracts to work only with Microsoft, the justification was to keep them focused on Microsoft's product, "which is to say it wants to preserve its power in the operating system market, that is not an unlawful end, but neither is it a procompetitive justification," thereby raising nice questions about the difference between a benefit to the seller and a benefit that qualifies as a procompetitive justification.

Also of interest to the Microsoft case is we had a very economically sophisticated court unable to resist quoting some language indicating subjective intent. "Kill the cross-platform Java by growing the polluted Java market," so on and so forth, finding some comfort in the words that business people had used to describe what they were doing, and then finally being troubled, even though we did not have total exclusion. So, we have a whole series of interesting points that come out of the Microsoft case.

In the Dentsply case, what did we have in

Dentsply? You had something where you had an at-will contract, and yet the Court of Appeals said that was not reason for the defendant to prevail, because realistically, wholesalers are not going to give up $22 million in sales in order to pick up $200,000, and so an at-will contract does not really give a new entrant realistic access to the market. So, also, there was talk about monopoly maintenance as a separate kind of problem, and once again, we had reference to subjective intent evidence.

So, where am I at that point in terms of, as I end, little lessons that I draw from my sort of going over things, and they are very tentative, because I really have not thought these things through all the way. I am learning, okay, but tentative things that I might throw out as propositions.

One, it should be possible for a short-term contractBv u-0 29ly give a new entrant

barriers and lots of power, it ought to be tougher than on a smaller, less powerful firm.

I hesitantly think that it is -- this will not be popular with some of my panelists -- sometimes it is interesting and possibly informative, if done very carefully, to look at subject intent evidence to help you sort through these difficult things. Clearly it makes sense to scrutinize the procompetitive justifications that are being offered up in a case that otherwise looks troubling. The classic procompetitive story is that the manufacturer has expended resources to bring a consumer into the store who will then be bait and switched off to another product. Well, you know, do the facts fit that story or not? In Dentsply, the Court thought they did not fit that story but went on to try to really sort of sort through what is the justification. It should not be enough just to say it is a nonprice vertical restraint.

I personally would not think that one should require a plaintiff to prove that prices have increased. I mean, think again about your classic exclusive dealing situation would be something where we are trying to cause problems in the future. Go back to my Coke paying to have 7-Up not around. The reason to do that is so that things will be better for Coca-Cola in year two or

three or four or five, and one can have a lessening of competition without prices today being affected. The hard question here is the long-run competitive effects, though, can't be a complete defense to say that current prices have not gone up.

So, also we would say that the legal standard really does matter in these cases. Going back to previous sessions that you have had, you heard a lot about the no economic sense test in the last session. Another standard that can make a big difference in exclusive dealing cases is whether you choose to adopt the Posner "Exclude an equally efficient firm" test. Were you to adopt that, which I would not favor, that would make it much harder for a plaintiff to win an exclusive dealing case.

And finally, in closing, pretty much on time, it is interesting as you survey the landscape that there is a whole lot of theory, not a great deal of empirical evidence, and so Amyou to adopt that, which I would not favor, t

Exclusive dealing is a very elastic label. It applies to a lot of different kinds of things. We have already heard mention of the fact that tying, certain kinds of bundling and price discounting can have effects very similar to exclusive dealing, and therefore, when you talk about exclusive dealing, you also need to be considering a bunch of its very, very close relatives, and so we are talking about implicitly, at least, a very broad category of business conduct and competitive phenomena.

Now, on the plus side, for our policy evaluation of exclusive dealing, it has never been a per se offense, which is a very good thing. It is a little like saying, well, in Eastern Europe, they have a little better luck re-adopting capitalism, because they were capitalists within living memory, whereas in the old Soviet Union, in the heart of Mother Russia, that was not the case, and so there is no great body of learning, there is no familiarity in the culture, and similarly, with exclusive dealing, although it is true that back in the Standard Stations days and when we were dealing with the International Salt comment, that under Section 3 of Clayton, you could condemn exclusive dealing either if the defendant had market power or if there was not an insubstantial amount of foreclosure, that is coming

within an eyelash of saying it is per se, but we never quite got there.

There was always a little bit of procompetitive culture left in exclusive dealing, and so -- as a matter of fact, even in the dark ages, between the decision in Schwinn, all vertical agreements are illegal per se, until the release from bondage in 1977 with Sylvania taking the nonprice verticals out of that category, I am not aware of any decision going whole hog and saying, well, that because of Schwinn, now we have to say that exclusive dealing is per se. Even in those dark days, we never had a rule for exclusive dealing that said

the antitrust enforcement industry, the enforcement agencies, the courts, counselors, what have you, and this is all very much to the good. This is as it should be.

But one result of this emergence into the more full-blown consideration of justifications and actual competitive effects is that the role of market power and monopoly power have been pushed to the fore, and for most kinds of exclusive dealing claims, you need to have market power or monopoly power at one level in order to have any kind of a plausible theory of restraint, and so now it has become a topic that is addressed more under the Section 2 standards than under Sherman 1 or Clayton 3, and that is fine. So, that focuses, to the extent that these issues come up under the Section 2 rubric, that focuses you on monopoly power, because it is a required element of proof in every Section 2 case, or in an attempt case, of course, the reasonable likelihood of monopoly power being attained -- and it also means that -- it really brings us down to I think the main discussion, the main subject of discussion, which is the definition of monopolizing conduct, and, of course, that is a much broader area, and let's see what light we can shed on the exclusive dealing aspect.

Well, one of my colleagues, Steve Calkins, has

already alluded to the fact that if you look at exclusive dealing cases, there are not many in which plaintiffs win, and it is interesting that some of those cases are really not Section 1 or Clayton 3 cases anymore, they are Section 2 cases, oddly enough, in which the decision-maker for one reason or another failed to condemn exclusive dealing under Sherman 1 or Clayton 3, but only under Section 2, and that would include U.S. v. Microsoft, Lepage's v. 3M, sort of in the margins of exclusive dealing, one of those forms of bundling, and then we have heard about U.S. v. Dentsply.

Now, within the broader debate about legal standards for monopolizing conduct, exclusive dealing I think is more or less kind of a classic example. What do we have to go on when somebody is challenged for their conduct under Section 2? Well, we have Grinnell, we have Aspen, exclusion on the basis of something other than efficiency; we have Image Technical Services, not the part that everybody has had seminars about and talked about for years and years and years, and Salop said this and somebody else said that and it is post-Chicago -- no, it is pre-post-Chicago -- okay, it is post-modernist Chicago, but the point is there is a second part of Kodak versus Image Technical, which say what you will about the tying part, the first part of

the Supreme Court opinion, there is that second part that makes some extremely broad characterizations of what it takes to -- broad and vague characterizations -- of what it takes to prove monopolization. That part of the opinion was so good that when Image Technical got to go back and have its trial, it did not even bother with all the hard post-Chicago stuff in the first part. It just relied on that great language in the second part of the opinion. So, it is really a question of deconstructing and coming up with a monopolistic conduct standard that can be applied sensibly to the generality of these cases.

Now, I will put all my cards right on the table and say I am not one of those who says there is salvation to be had in taking the vague language of Grinnell and the vague language of Aspen and the vague language of the second Section 2 part of Image Technical versus Kodak and trying to put some kind of a microeconomic overlay on it, whether it is no economic sense, profit sacrifice, exclusion of equally efficient competitor. I think all of those things can come in very handy. I mean, if you see a monopolist doing something that causes it losses, you are entitled to inquire, is it an eleemosynary motive, was it a mistake, or was the monopolist taking money and paying for

something, and was it a competitive restraint? So, I do

case dismissed, and the Supreme Court said, oh, no, oh, no, when you are talking about a horizontal restraint -- and it was a territorial restraint in that particular case -- what the Supreme Court said is you don't consider all that stuff, it is per se, and then they dropped a footnote that said, well, look, if Congress would like to adopt a rule of reason for this kind of restraint and send the courts off into the wilds of economic theory -- that's the exact phrase they use in that footnote in Topco -- Congress can go to that, but we are not going to, per se illegal, next case. So, we have got a similar situation here.

Exclusive dealing could be good, could be bad, depends on a lot of different factors, very hard to formulate a different -- a reformulation of a general standard that is going to apply in all circumstances, and so I have very little faith in any such reformulation. I think we are just stuck, you know, courts do what they do. You have got a difficult area where it is hard to make a judgment. Actually, as I think as I am going to talk about toward the end of my remarks, which will be soon, what I am basically saying is if the courts find it difficult to take such an amorphous standard and apply it to this practice, what we have to have is better courts.

Now, we have mentioned that defendants almost always win. So what? So what? I have no great faith in the numerology of one loss statistics. The real question is whether anticompetitive conduct gets struck down in these cases and procompetitive conduct is exonerated, and by that standard, as I read the same cases that Steve has obviously read -- and he has probably spent a lot more time reading them than I have and has read a lot more cases as well -- but I find it very difficult to say that something is seriously awry.

I have cases where I would disagree with what is going on, but there are two cases in the -- well, I have talked about Microsoft, U.S. v. Microsoft, Lepage's v. 3M, U.S. v. Dentsply. I have listed -- have I listed in my -- well, anyway, three cases I could name where the defendants won, three recent important cases where the defendants won, Pepsico versus Coca-Cola, this is the New York case affirmed by the Second Circuit where basically the Second Circuit said you do not get a trial on the proposition that the reason quick-service restaurants do not buy Pepsi-Cola is that Pepsi-Cola cannot figure out a way to deliver the syrup to the restaurants. Whatever reason there is for the relevant market shares in quick-service restaurants for carbonated soft drinks, it is not that Pepsi-Cola could

not figure out a way to get its product delivered.

Omega Environmental versus Gilbarco, I do not know any more than what you, the average case reader, knows. I had no involvement with that case. Then we have Harmar Bottling, which is, again, a case that I do know something about. I am not sure the facts bear the characterization that Steve was giving it. I do not want to get into a cat fight with him over that, but I will just say that I think the result in that case was correct, and so of the cases I know, of the cases I have read about and tried to understand, I do not think you can say that defendants are winning in cases where they should not win.

So, you know, we need to figure out a way to assess exclusive dealing efficiently, and basically, as I say, my message is there is some exclusive dealing that is good, some exclusive dealing that is bad. Harmar took about 14 years to tell one from the other, and my main message is that there has got to be a way of getting to an efficient resolution of these cases much more quickly. As a matter of fact, I would consider whether -- I might regret this if it became a sound bite, but if there is a sound bite I would give you, let's have the antitrust enforcement mechanism, let's adopt as a policy objective, that in the area of

exclusive dealing, we want to reduce the duration and the expense of deciding whether exclusive dealing in a particular case is good or bad. Let's reduce the duration and expense by an order of magnitude so that a Harmar, which took 14 years to litigate, takes, say, 14 months to litigate.

Now, in this column, I have very high praise for the Ann Bingaman suit against Microsoft which resulted in the 1994 consent decree. I know that there was some investigation prior to the time that the DOJ got the file in that case, but I remember being incredibly impressed for two reasons with that effort. Number one -- well, other than feeling that the result was right. It was a consent decree, but I think it did the right thing.

Number one, it was about exactly one year between the time that the Department of Justice got the file in that case and the date that the decree was entered, and number two, it was a very specific, targeted form of relief. It was a doable form of relief. So, if you can do an exclusive dealing case that quickly and come up with a result that concrete in a year, it forgives almost any other defect that you can find in that case, because on that time scale, you can correct for your mistakes. You can, you know, do in

year two what you failed to do in year one, or vice versa. So, litigation efficiency is an extremely important consideration, and we ought to figure out ways for a great increase in litigation efficiency.

One minute, that is exactly what I need.

So, here are some ideas for enhancing the efficiency of this process, and I think a lot of the tools are already at hand. Daubert, it has already been used in an exclusive dealing context. Let's have more of it. Let's make sure that expert testimony is forced to go through and survive a plausibility test, the Daubert standard. Let's make sure that the plausibility formulation in Matsushita and Brooke Group, even though that is relative to predatory pricing, a plausibility test should also be applied to other types of antitrust claims, including exclusive dealing, help filter out losing claims early, and focus remaining claims on alxt.d3wdnroc

in a matter in litigation, like Fred Kahn's testimony in the New York versus -- the Nabisco Brands case. That was a very effective use of a 706 expert, but we need ways to bring specialized knowledge about antitrust cases, discovery, theories, the nature of the market, we need to put those resources at the service of the courts that are having these exclusive dealing litigation things litigated before them.

And the last one I won't go through due to the shortness of time, but the Manual for Complex Litigation does contain a few things about antitrust, but perhaps of the ideas that we could expand, the sort of helpful guidance, the identification of issues, the suggestion of efficiency-enhancing methods of resolving complex litigation, expand it specifically in the area of monopolization and exclusive dealing for the use of the courts.

So, just to sum up, I do not think that our exclusive dealing jurisprudence is in crisis. I kind of like where the law is. Some exclusive dealing is good, some exclusive dealing is bad, it is not per se legal, it is not per se illegal, but if we could reduce the time it takes to tell the difference between good exclusive dealing and bad exclusive dealing by an order of magnitude, I think that would be a very worthy goal

for the antitrust policy.

(Applause.)

MR. O'BRIEN: Thank you, Tad.

Okay, our next speaker, shifting gears to a couple of economists, is Joe Farrell. He is Professor of Economics at the University of California, Berkeley, and he is a Fellow of the Econometric Society, former editor of the Journal of Industrial Economics and former President of the Industrial Organization Society. Currently he's the senior consultant for Charles River Associates.

Joe's published widely articles on a broad range of topics in industrial organization and microeconomics, including exclusive dealing. He has substantial policy experience as well, having served as Chief Economist at the Federal Communications Commission from '96 to '97 and Deputy Assistant Attorney General for Economics at

analysis has focused on the question, what should we do if we knew really quite a lot about the case, okay? And in the area of exclusive dealing, I think a bland and very fair summary of economics in this area is both efficiency and anticompetitive effects and explanations of exclusive dealing are very possible, and on both sides of that, the analysis is really quite subtle, and I am going to spend a few minutes on this. In terms of the efficiency explanations, I am going to focus on the investment incentive theory, which I think Ben Klein is also going to talk about a form of. In terms of anticompetitive effects, I am going to talk about what I think is the leading example, though not the only example, of an economic structure to understand anticompetitive effects of exclusive dealing.

So, in terms of the investment incentives, you will often hear it said that exclusive dealing is efficient if you have to motivate relationship-specific investment or some such phrase as that, okay? As far as I know, the state of the art in the economics literature on these arguments is the article by Elias Segal and Michael Whinston in the Rand Journal, 2000. They start out by showing that in what appears to be quite a general model, relationship-specific investments, that is, investments that have no value outside the

relationship, are not -- repeat, not -- an efficiency rationale for exclusivity.

They then continue to show that investments that are not in that strict sense relationship-specific, that have a spillover to deals between the customer and the potential entrant, might or might not be an efficiency rationale for exclusivity. It depends on quite a number of things. It depends on who is doing the investment. Is it the buyer or the seller? It depends on how it spills over. Is it a complement or a substitute with the efficiency of potential deals between the buyer and an entrant? It depends on the bargaining structure between the buyer and the seller. It depends on what is the nature of any investment by us absent the exclusive dealing. And that is all within their model. If you step outside that model, it also depends on whether their model sort of applies or sort of does not apply.

So, I am going to leave you for the moment with the thought, how is a court likely to be able to disentangle all this in addressing an asserted efficiency rationale along the lines of investment incentives?

Now, what about the other side of the courtroom, divide and conquer exclusion, Rasmussen and Ramseyer and Wiley, 1991, corrected, beefed up and radically improved

by Segal and Whinston in the American Economic Review, 2000, show that exclusion can profitably and harmfully work against end users; however, although I think that is very well understood and accepted, the fact is their models involve buyers who are end users.

In most cases that I am aware of, exclusive dealing is not a deal struck with end users. It is a deal struck with retailers or distributors or someone else intermediate in the value chain between the manufacturer and the end users. That makes a lot of difference.

So, interestingly, a year or two ago, there appeared to be economics literature, two broadly parallel articles, papers, one by Fumagalli and Motta, which I believe has been published or is about to be published in the American Economic Review, and one by John Simpson and Abraham Wickelgren, and within the last 24 hours, I have learned about other articles by Yong and Shaffer that may be somewhat along the same lines, and both of these articles address the question, how does the RRWSW theory of anticompetitive exclusive dealing change when you recognize that the buyers in the model, in practice, should be replaced by buyers who are not end users?

Well, there are two forces, okay? One force is

that intermediate buyers, nonfinal buyers, actually do not care that much if the price goes up or stays high, provided it goes up or stays high to all of them, because then it gets passed through downstream, okay? How much that is true depends on the details of the market structure and so on, but that tends to be true. That lowers their resistance to things that maintain monopoly upstream relative to what it would be if they were end users. So, that you would expect would make anticompetitive exclusive dealing easier.

Another force, however, is that if you have a nonfinal buyer who holds out and does not sign the exclusive deal, then an entrant can come to him and say, "Aha, I will give you a lower price than all your tied up rivals will be getting. You can expand. You and I can meet my scale requirements, and you will make a bundle of money." So, that dynamic potentially makes it harder to have anticompetitive exclusive dealing.

Well, Fumagalli and Motta found conclusively that it went one way, and Simpson and Wickelgren found conclusively that it went the other way, and which way Yong and Shaffer come out, I do not know yet. Which of them is right and when? Well, I attempted to diagnose this in my Antitrust Bulletin article last year. My attempted diagnosis is that it depends on whether in

that last situation where you had one hold-out buyer, the incumbent is then able to or does adjust the price that it charges the tied buyers. So, I believe Fumagalli and Motta assumed that it does not, and Simpson and Wickelgren assumed that it does, or maybe it is the other way around, okay?

When I put this tentative diagnosis to one of the four economists -- and I will not say which one -- the response I got was, "Ah, that is interesting, I am not sure." That is telling, I think, because it says that it is kind of unlikely that a court is going to do a very good job of disentangling all of these difficult concepts. Now, the optimistic view is this is just the beginning of the economic exploration of this topic, and come the year 2010, we will understand it well and in a way that is good enough for us to brief courts on it, and maybe that will happen, okay, but I take from this two things.

One is economics is making progress, that is great, I hope to participate, but the other is, it is pretty subtle and it will probably stay pretty subtle, if not get more subtle.

All right, so we are doing antitrust under uncertainty. We are not in the world where we can say exactly what is going on and work out the welfare

consequences, okay? Let's take that as an assumption for now.

Well, traditionally at this point economists plunge into Bayesian mode and talk about type one errors and type two errors and so on. Underlying what I am going to say, there certainly is a Bayesian framework, okay, but I am not going to talk explicitly in Bayesian terms. I am going to talk in jurisprudential terms, because my lawyer colleagues on this panel have been talking economics, so I want to get back at them.

So, I am going to talk about the role of presumptions and burdens of proof, and I am going to talk about two presumptions that should be extremely important in antitrust policy and about what I personally think -- although I cannot prove -- is a very worrying trend that has been taking place in the relative strength of these two presumptions.

So, what are these two presumptions? Number one, in economic policy generally, in market economies, we have a laissez-faire presumption. The Government should not intervene in stuff unless it is reasonably sure that intervention will help. I think that is a pretty good idea.

Number two, in antitrust particularly, we should protect competition unless we are reasonably sure that

some alternative is better, okay? So, I think at a very grand, 40,000-foot level, you can view a lot of what goes on in antitrust jurisprudence as being a tug of war or back and forth between these two presumptions.

Now, I put competition in quotes on this slide for a reason, and that reason is when you look at it too closely, things get a little out of focus, and you do not exactly know what that word means, okay? And that has led us, I believe, over the course of the decades towards the tempting solution of redefining the word "competition" to mean what is good. So, here is a test of that, okay?

What happens when you hear someone refer to the possibility that a merger to monopoly would reduce marginal costs so much that it would be good for efficiency and consumers? Well, if that were true, let's say you knew it was true, it would be a good thing. Would it be procompetitive? I think a lot of people would say yes, because it is a good thinge es, becausTjET

to be a little careful about doing stuff like that.

Now, of course, the antitrust law protects "competition," so tautologically, redefining the word would be a good idea, it would lead us to do good policy, if we always knew what was going on, okay? So, given that the law protected competition, it would be a very smart move on the part of benevolent antitrust enforcers and courts and so on to redefine the word "competition" so that the law then protects whatever is good, okay?

However, there is a problem with doing this. A, we do not always know what is going on exactly, and B -- B only applies given A -- attempting to have a presumption in favor of protecting competition makes no sense if you define competition to mean what is good, okay, because if you knew that something was good, you would want to do it, and that is not a presumption in favor of protecting competition. So, for there to be any meaning to the presumption in favor of competition, it has to be a presumption in favor of something that has not yet been proved to be good, okay?

So, this I think casts an interesting light on the slide that I heard this morning -- and I was not taking notes on who said it -- but somebody said something along the following lines, or if I misheard

it, it has certainly been said within the last week -- that because there are perfectly plausible efficiency justifications for exclusive dealing, plaintiffs should be required to prove that there is an anticompetitive effect, okay? That, of course, would be obviously right if we could always prove what is true, but if we cannot always prove what is true, it is not obviously right.

what they mean, and it is very dangerous -- it has had some good consequences, but it is nevertheless very dangerous -- to redefine words to make them do your policy analysis for you.

So, antitrust intellectual history, to the extent that I understand it -- in less than one minute -- in the bad old days, anything that could be presented as a reduction of competition was illegal. That was bad, because quite often, things that can be presented as a reduction of competition are actually good. The good new days, we have got to analyze the effects of things that seem to be capable of being presented as a reduction in competition, because you would not want to ban those things if they are actually good, okay?

What I am worried about is the possibility that we are drifting into the not so good new days where it is difficult to prevent things that are in some sense reductions of competition unless you can actually prove that those things are bad. Now, of course, you would not want policy to prevent those things unless they are bad, but that is very different from unless you can prove that they are bad.

Now, the final bullet on this slide, which is quite important, I talked about these ideas very briefly

make the argument you want to hear. I think there is truth out there. This is moving us along on coming up with what is the economic foundation for some commonly used procompetitive justifications.

This is a paper that I am working on with Andres Lerner. The paper is posted on the web site, and I think it is important to go through these procompetitive justifications in terms of the economics, because the danger I see is the exact opposite one. I think that we are moving in the direction that if you find a practice that does not have efficiencies, it is becoming a sufficient condition, if it is something that is being used by a firm, a large firm, it is a sufficient condition for antitrusts,T1.bilityecause the

justifications, and we do it in the paper.

So, in terms of Dentsply, as I said, Dentsply illustrates that actually the economic foundations for procompetitive justifications are actually pretty narrow, and the Court rejected Dentsply's claim, in particular, that exclusive dealing was used to prevent dealer free riding on manufacturer-supplied promotional investments. This is the classic Howard Marvel rationale, where the manufacturer makes investments in a dealer, you know, like they build out a dealership or engage in dealer training, and then the dealer uses those manufacturer investments to sell a rival product, and that is the classic free riding argument. The Court rejected that, and the Court rejected the undivided loyalty argument, that somehow you give somebody an exclusive so they will more actively promote Dentsply's product.

The Court rejected the free riding rationale basically because the Court found it was contrary to the facts, that number one, Dentsply did not make any investments in the dealers that they could then free ride on by using them to sell rival products. There was no evidence, essentially no evidence in the case, that the Dentsply dealers were actually switching buyers to rival products. And finally, that there was testimony

by Dentsply executives that if there was not an exclusive, they actually would have invested more -- you see, the usual economic argument is the purpose of exclusive dealing is to encourage the manufacturer to make investments, and one way it is encouraged to make investments is to prevent free riding that it knows that these investments are going to be used to sell its product, and the Court said, you know, the Dentsply executives actually testified that if we did not have exclusive dealing, we would have had to make more promotional investments.

In terms of the other argument, the Dentsply Court rejected the undivided loyalty argument, and here it was not really just the facts. It was basically the theory that this theory about enhancing dealer services cannot be a justification for exclusive dealing, because in general, competition between dealers is going to lead them to supply the desired quantity of promotional services, as the Court said, the dealers have the incentive in competing with other dealers to make sure that they supply the right kind of services.

See, basically the problem that Dentsply ran into is although this undivided loyalty argument has been accepted by a number of courts, Judge Robinson in this case knew a lot of economics, and in particular,

she knew Howard Marvel's argument and had read the article, and Howard Marvel was the expert that Dentsply had hired for this, and she said, no, even in your expert's article, he says that you can generally leave it up to competition to put dealers to supply the right services. It is only when you have this problem, this inter-dealer free riding problem described in Sylvania, you know, and that is a problem where the customer goes to one full-service dealer and gets some kind of dealer services and then goes to another dealer and buys the product, you have that inter-dealer free riding problem, and in that circumstance, maybe competition among dealers will not give you the right quantity of dealer services, but that is a problem that would not be corrected with exclusive dealing, because even if you had exclusive dealing and you had this kind of problem, the exclusive dealer would say, no, get the services from somebody else and then come and buy the manufacturer's product from me.

So, as I said, although this rationale has been accepted by a number of courts, Judge Robinson said, you know, basically you can leave it up to competition, and this undivided loyalty makes absolutely no economic sense.

In contrast to basically the established

economics, I think the expanded economic framework that I am going to present here shows that these arguments make sense, that free riding is much more general than you would think, and the dealer undivided loyalty makes sense, and it is based upon two common sense business propositions.

Number one, that manufacturers often want their dealers, even dealers that are competing with one another, to supply more promotion than the dealers would independently provide on their own, and number two, that exclusive dealing by creating this undivided dealer loyalty actually increases the dealer's incentives to

they adequately promote their product. That leads to these free riding problems, which I will discuss are much broader than the classic Marvel free riding problems. And then finally, that exclusive dealing is commonly an element in those contractual arrangements that gets the individual dealers' incentives then aligned more with the manufacturer's incentives.

So, let me do the first proposition first, that manufacturers often want their dealers to supply more promotion than the dealers would independently decide to provide, and the basic reason for this is that the dealers do not take account of the manufacturer profitability on incremental sales, that the dealer does something that increases the manufacturer's sales, and the dealer gets only a part of that incremental profit, in many cases only a very small part of the incremental profit.

Now, in general, this is not a problem for dealer price and nonprice competition that has significant inter-dealer quantity effects. So, in general, when a dealer provides a desirable service like free parking or lowers its price a little bit and makes a little bit more sales, even though they might have a small margin in terms of the total profit being earned by the manufacturer and retailer together when they make

that extra sale, because they are getting consumers to switch from other dealers, because there is large inter-dealer effects, you get an equilibrium where you get the desired quantity of the services provided, but with promotional activity, the primary effect is not really inter-dealer, but it is primarily inter-brand, that you just make an extra sale for the manufacturer, and there are no significant inter-dealer quantity effects. Then you have this problem where the dealer, by not taking account of the incremental profit, is going to supply less than the desired promotional services of pushing the manufacturer's product. In addition, dealers cannot charge consumers directly for those services, because the promotion is, in effect, a price discount.

So -- I am going to have to go faster -- manufacturers solve this problem -- although I am going to be talking about violating these contracts, I can always violate, you know, this one --

MR. O'BRIEN: There is no red string we can pull --

DR. KLEIN: No, there is no self-enforcement problem here, although -- anyway, I am wasting my time.

Manufacturers solve this problem of insufficient dealer promotion by contracting with and compensating

dealers for providing increased promotion, and the contract may be explicit or it -- you know, in plenty of the cases, like in Standard Fashion, they explicitly said you have to have a certain amount of display space, you have to have a "lady attendant" there full-time, they used a few words like that. Most of the times it is really understood that you are going to make your best efforts, and they compensate dealers in these things by giving them a valuable distributorship in the sense that if they get terminated because they are not pushing the product adequately, they are going to lose this future rent stream, and the threat of termination is what gets them to perform as desired.

However, because dealers are contracting to supply more promotion than they would otherwise, you know, do in their own independent interests, there is an inherent problem in that they have an incentive to violate the contract and free ride on the manufacturer's compensation arrangement, basically because you are getting a valuable dealership, like in Beltone, they gave them an exclusive territory. In Standard Fashion, they had minimum resale price maintenance. Whatever it is, you have something valuable, but you are getting it on all your sales, and you therefore have an incentive just to do that pushing at the end and save the cost if

you are a dealer, and still you are getting most of the compensation.

In terms of this contract, dealers may violate the contract and free ride in three distinct ways, and the first way is the standard case where the dealers use the manufacturer-supplied investments to sell rival products, and that is part of the contractual arrangement. Look, we will give you these complementary assets to help you push our product, and that is one that you know about, but there are two other free riding problems.

Second is the dealers may just use the manufacturer paid for promotion to sell rival products, that they are being compensated with this valuable dealership, and on the margin, they are just going to switch, and the profit incentive is really the same as one, but you do not have to find these manufacturer assets there.

And the third one is the dealers may just under-supply the manufacturer's paid-for promotion, as I said, because on the margin, they are getting paid on all these inframarginal sales, and on the margin, it really does not pay for them to spend all this money on pushing the products on the margin if it was not for this contract.

Dealer free riding need not involve manufacturer investments or dealer switching. That is the implication of this. So, for example, in free riding one, which is the one you all know about, that one involves manufacturer investments and dealer switching. That is what the Court in Dentsply said, there is no free rider problem here. But free riding, too, the dealers are just using the paid promotion to sell the rival products, and that one can occur without any manufacturer investments whatsoever. They are just free riding on the compensation arrangement.

Free riding number three, where dealers are undersupplying what the manufacturers are paying for, that one occurs without any manufacturer investments or without any dealer switching, okay, and exclusive dealing may be used to mitigate all thee forms of free riding, and it prevents free riding types one and two by just preventing the switching of sales to rival products, and it prevents free riding number three by creating this undivided dealer loyalty by promoting the incentive of the dealers to promote the manufacturer's product more intensively that aligns the incentives.

So, how does exclusive dealing, that third type, how does the exclusive dealing increase the dealer's incentive to promote? And remember, we are operating in

the context, you know, why did the Dentsply Court reject this as making absolutely no economic sense? And that is because there is all this competition between dealers, and that is all that is necessary to get the services provided unless there is a Sylvania type problem, and the example that we go through in the paper is this.

Consider this case where a customer is thinking about buying a car and is leaning towards the purchase of a Honda, and he goes into a Toyota dealership to check out the Toyota, but really, you know, it is -- but just to make sure, let me just check out the Toyota. So, that is the hypothetical example.

Then I have this -- look at that. So -- and under that -- there is a Honda and there is a Toyota, and Mdh is the profit margin that the dealer earns if it sells a Honda, and Mdt is the profit margin for the dealer if it sells a Toyota, and the Toyota dealer is deciding, what about this, even though they are leaning towards the Honda?

Well, a nonexclusive dealer will not make its best efforts to sell the Toyota if it has both cars there, and basically -- now, do not get scared -- but the dealer is going to choose a level of Toyota promotional service as S that maximizes its

profitability. So, it chooses S, that maximizes the profitability, which is the difference between the margin on the Toyota minus the margin on the Honda, times the probability that they will make the Toyota sale if he starts telling them how great the Toyota is, whether they will buy the Toyota, and that probability, p(S) is a positive function of how much S the person

the dealer's margin on the two cars were the same, so that Mdt and Mdh were the same number, that difference would be zero, and clearly the dealer would supply absolutely no services in trying to sell the Toyota. It would be cheaper for the dealer to just write up the sale for the Honda. But by selling the Honda rather than promoting the Toyota, the dealer is free riding. He is engaging in that third type of free riding that we were talking about. The dealer is not switching. The dealer is not actively promoting the rival Honda brand as an alternative to Toyota, you know, for customers who come in and want Toyota, as occurs in free riding one and two. Instead, the dealer is violating the implicit dealer contract for the Toyota by failing to actively promote the Toyota automobiles.

Alternatively, if it was an exclusive, you know that undivided loyalty is going to lead dealers to expand their promotional efforts, and it is just going to go to the point where the marginal costs of additional efforts in pushing the Toyota is exactly equal to how much it can make on the Toyota, times the increased probability that the promotion makes it more likely that they will make the sale. So, undivided loyalty is clearly in that case going to lead to that, and that is what you sometimes see courts saying, you

know, that if you do not make the -- you know, what happens if you are an exclusive Toyota, basically it means if you do not sell the Toyota, you do not make any sale, and so it is common sense -- and, you know, this is the business people who understand this -- it is common sense that undivided loyalty is going to give you an incentive to promote more, and in the paper, it is a function of -- you still do not get to the point where the dealer has the right incentive in terms of maximizing the total profit of the manufacturer and dealer together. That is the last thing on the left-hand side. So, they still have to have these -- the manufacturer still has to have these implicit self-enforced contracting and -- to go all the way to the end, but basically the role of exclusive dealing is that it aligns the incentives that are here.

So, I am done. The lessons, other than that I put too much down here, okay? Lesson one, the Court's rejection of Dentsply's procompetitive rationale is an example of a common error that I think occurs in cases of trying to fit the facts of a case into a preconceived economic model rather than developing a model to fit the facts of the case, and the preconceived theory, economic theory here, that the Court adopted was basically, you know, interdealer competition will lead dealers to

supply the type and quantity of promotional services, unless you had that Sylvania type free riding problem, and -- you know, because there are more likely to be valid procompetitive justifications for exclusive dealing, one of the implications I think is that this no economic sense test is less likely to be a useful test for antitrust liability, that there may be efficiency justifications for exclusive -- people talk about the Dentsply case as an easy case because there is nothing on one side of the scale. There is obviously something on one side of the scale is what I am trying to say, but clearly, even though there is an efficiency justification, you may have anticompetitive effects.

I think that the facts of that case, there were significant anticompetitive effects, and Jonathan Jacobson makes this point in his excellent latest article in the Antitrust Law Journal. What he doesn't do is he does not answer the Court's finding that there was absolutely no economic basis for Dentsply's undivided loyalty and free riding justification. So, in that case, you would not get the wrong answer if you used the no economic sense test, but the only reason you do not get the wrong answer is because you do not really understand the procompetitive justifications.

So, as I said in the beginning, I think the

greater danger is not that -- you know, the way some people are advocating this no economic sense test as a necessary condition for antitrust liability. I think the danger is that the courts are going to use a no economic sense test as a sufficient condition for antitrust liability when a large firm uses exclusive dealing, and it is not only that I am giving you that there are other valid procompetitive rationales, but I think as economists and as regulators we have to be more humble that just because we have not figured this out yet, there is lots of other procompetitive efficiency justifications, and we cannot assume that the purpose of a restraint is anticompetitive.

How much did I violate the contract by?

most burning comments to make about what someone else said.

Okay, Joe.

DR. FARRELL: Well, I have one question for a fellow panelist, which is relatively specific, I think.

Ben, in your model, you didn't have time to present all of it, but I would like to ask, have you offline, as it were, closed the loop and shown actual harm to buyer, or is it just that the buyer who was leaning towards buying a Honda ended up buying a Honda and, of course, the Honda -- Honda likes that, the dealer apparently likes that, the customer seems to like that, although the welfare economics of this promotion stuff, of course, are a little subtle. Toyota, of course, does not like it.

Where does this go and how does the whole thing play out with and without exclusive dealing as opposed to just Toyota would like S to be higher in the short run?

DR. KLEIN: All we do in the paper is present the procompetitive efficiency justification. We do not do the other side of the scale in terms of is there any anticompetitive effect. In some cases, there will and in some cases there will not be an anticompetitive effect, and, you know, and as I suggested in Dentsply,

would have to examine that particular case.

DR. FARRELL: But you say you only do the procompetitive justification. What do you demand of it in order to call it a procompetitive justification, just that Toyota would like it?

DR. KLEIN: Well, look, I do not want to get caught up in a language thing about --

DR. FARRELL: Okay, sorry, no.

DR. KLEIN: -- you know, we will do linguistic philosophy later. My feeling -- all I mean by it is that somebody doing what you would consider the right thing or the good thing or something and balancing it, I am just looking -- I am just presenting an economic foundation for this legitimate procompetitive justification.

I mean, the crazy thing is if you look in the marketing literature, people are talking about this all the time. It is just economists, you know, a little bit of economics can be a very dangerous thing, and it is only the economists that say competition should give you the services, everything is fine. So, if you talk to business people, marketing people, they all know that this makes -- and it makes a lot of common sense.

So, in some sense, as I said, Dentsply was unlucky enough to have the judge that knew economics,

and that is the only reason they got into problems in terms of the procompetitive justification, plus they were unfortunate enough to choose an expert that explicitly wrote in his article that the argument makes absolutely no sense. So, he could not present -- he did not -- Howard did not present the argument at trial, but the company did in terms of answers to interrogatories, and they said, what are you talking about? Your own expert says this makes no economic sense.

And then the other interesting thing about it, and this is the connection between anticompetitive and procompetitive justifications is strange, because the Justice Department -- and Gail would know this -- the Justice Department, in trying to demonstrate the anticompetitive effect, spent all this time in their findings of fact to show how important this dealer channel was to promoting the Dentsply products and how rivals would be at a competitive disadvantage because they did not have access to that channel.

So, you just look at all the findings of fact, and it not only demonstrates that there was a significant potential anticompetitive effect, but it also demonstrates that there is a significant procompetitive justification for motivating the dealers to do a good job. So, you have that tension, but

the second free riding did not exist basically because there was no switching to rival brands.

I mean, I think there was one example where there was some disagreement about whether they tried to switch it to someone else. So, I do not think those other two were there, but in terms of the third one, all the evidence you need for that is that promotion is

these consumers are being driven into the dealership and are getting their ears tested, and it is all sorts of wonderful stuff. And then, if, when the consumer gets there, there is the old bait and switch and they are sent off to buy the el cheapo discount brand, well, the bad consequence of that is there will be less of that advertising about the new, improved technology and, you know, science of hearing aids and such, which is something that is good for the whole industry, good for consumers, good for everybody, it will now be lost, because the manufacturer will not spend money on that.

So, you can easily tell a simple layperson story, if you let everybody get switched off, you will no longer have those ads being run, and I look forward to reading the article, but merely saying that -- I mean, if you then say that if you have exclusive dealing, it is good for RC Cola because they are going to make more money and have more sales, well, I can have

climbing, before I then sat back and said, boy, I am really concerned about maybe intervening and causing harm here, I would like to at least make sure I understood what is the equivalent of the lost nice advertising that is going to happen if you intervene in that type of situation.

DR. KLEIN: Well, Steve -- can I answer it, then? I mean, I agree with you on your main point, Steve, that, you know, with RC Cola, that we can be pretty much assured that inter-manufacturer cooperation or competition is going to pass on these benefits to consumers, but if you are talking about -- the analogy is really identical about lost advertising, because it

manufacturer, you know, when the consumers are switched to the discount brand, they almost always pay a lower price. It is not -- you know, they are not being deceived, that they think they are getting the higher --

DR. CALKINS: I understand. I think my problem, and I will confess, I was sitting here with my back to the screen, but I understood the Marvel advertising of hearing, you know, development is a good thing. When

was there another way for them to ensure that investment? I mean, it seems to be a bit of a leap to me.

DR. KLEIN: Well, that's --

MR. O'BRIEN: You know, and that sort of statement strikes me as, you know, it might not be hard to argue that that efficiency is there in almost every case.

DR. KLEIN: No, that is a problem that you have with these cases. That is why I said you cannot adopt --

MR. O'BRIEN: A no economic sense test?

DR. KLEIN: Yes, you know, because I think the efficiency is -- I would not say universally present, but it is a motivation. I forgot what your other question was, but, you know, it is important -- if it is important to the manufacturer, we just know from the economics that if there is an exclusive, the incentives are going to be aligned, and if they do not make the sale of that product, they are going to not make any profit. So, you do know that they are going to push it more.

So, I mean, it just follows logically, but you would need to see what they adopted -- oh, yeah, so you -- there may be a less restrictive way, and then we

can talk about a less restrictive standard here if that is the question you want to move to, but in cases where it looks like the practice might have also some foreclosure problems and anticompetitive effects -- I hope I am using the right language -- you may impose this burden on the manufacturer to come up with a less restrictive way of doing it, and, you know, maybe they chose this not just because of the efficiency effects but also because of the -- it increased their market power, so...

MR. O'BRIEN: Okay.

DR. KLEIN: I mean, it makes it very, very difficult in terms of this balancing. The important point is, you know, you are not going to have these easy cases anymore where there is nothing on -- I mean, you will still have easy cases where you do not have the anticompetitive effect on one side of the scale, but you are not going to have these cases, I think, if you

issues, and hopefully this will spawn some additional conversation about both what was said during the session and perhaps some new things.

So, let me start with -- where is our -- oh, you have got it, okay. Let's go to the first proposition. Okay, I am going to read it, because we need to read it for the transcript here.

Exclusive-dealing arrangements are analyzed under the rule of reason.

First, does everybody agree -- and this is really more for the lawyers -- that that is the way the analysis of exclusive dealing goes today?

DR. CALKINS: Yeah. I mean, that -- yes -- yes, I'll agree to say that, and B, for a whole lot of the cases, it is consistent with the general idea that under the rule of reason, the defendant always wins.

MR. O'BRIEN: Okay. So, nobody disagrees with that point. Well, perhaps the point that was just made, but nobody disagrees with the proposition, correct?

Does anybody think that there are exclusivity arrangements that should be per se illegal?

(No response.)

MR. O'BRIEN: No, I guess that is the answer.

DR. KLEIN: Move on.

MR. O'BRIEN: No.

Does anybody think there are exclusivity arrangements that are always or nearly always procompetitive and thus good candidates for a safe harbor?

DR. CALKINS: Well, presumably a very small exclusive would be -- would fit anybody's idea of a safe harbor.

MR. O'BRIEN: And when you say "small exclusive," you mean a small percentage of the market or --

DR. CALKINS: Yeah, it is very -- it is hard to imagine a court or an enforcer being concerned about an exclusive below -- choose your figures. Some might choose 20 percent, some might choose 30 percent, some might choose 40 percent, but I think everybody would agree that below some percent, no agency should worry about it, and no court should find illegality unless, you know, you have some reason to think that that number is just, you know, totally misleading and the real number will be totally different in six months when the contracts kick in or something.

MR. O'BRIEN: Okay, fair enough.

Anybody else? That one was --

DR. KLEIN: I would like to -- I would like to ask Steve a question on this one. You know, your

opinion about the foreclosure standard somehow being lower when it comes to Section 2 rather than Section 1, I mean, if somebody is a monopolist or is likely to be a monopolist, I could see that it is more likely that they are going to meet the critical share number, but why should that critical number, whether you say it is 40 or whatever, why should somehow it be lower? It sounded like that is what you said from your presentation, should be a tougher standard.

DR. CALKINS: If I did, I misspoke slightly. What I meant to say is that -- well, specifically, is that in the Microsoft case, the defendants argued that because this practice is lawful under Section 1, it must, as a necessity, be lawful under Section 2, and I was just saying that I do not think that is correct, that, you know, take your extreme of a dominant firm that everybody would agree is a monopolist on the one hand, and on the other hand, your RC Cola kind of a thing. I am not saying whether or not, you know, exactly where one would say there is a difference, but I would think that one should be much more likely to be concerned about something being done by a dominant firm that is --

DR. KLEIN: Right, obviously, but why should there be a different standard under Section 2 than under

Section 1? I mean, I think we are in trouble here basically because Justice did not appeal the Section 1 no liability in Microsoft and Dentsply, and if you read the Court, you know that the appeals court would have overturned both of those things, but -- you know, and then I think we would be in a lot better shape, but the idea that somehow we should have a different standard and principle when you are doing the first step of a Section 2 -- I agree, if somebody is a dominant firm, they are much more likely to have anticompetitive foreclosure under Section 1 and under Section 2, but why should there be a lower hurdle showing the anticompetitive effect under Section 2?

DR. CALKINS: Well, part of this goes -- I mean, in all of this, it is trying to make a judgment about how likely a particular practice is to be harmful to competition, and I was just saying that -- well, specifically, is that there are a whole series of sort of ways that firms with fairly modest market shares have been able to persuade courts to get rid of exclusive dealing cases, but where you have a dominant firm, I am not saying that there is a magic difference. I am just saying that, as you recognized, you would think longer and harder about something being done by a dominant firm that is a clear monopoly than by some firm that is a

trivial firm, and so just because you are told that something would be lawful under -- you find some Section 1 case out there where some foreclosure level was a motion for summary judgment for a defendant, that does not mean that in every case with the most extreme monopolist you would grant summary judgment without thinking long and hard about it.

MR. O'BRIEN: Okay, let's move on to the next proposition.

Okay, I think this one will be easy, too. The proposition is from Posner's Antitrust Law.

I propose the following standard for judging practices claimed to be exclusionary: "In every case in which such a practice is alleged, the plaintiff must prove first that the defendant has monopoly power. All the plausible cases of exclusionary practices involve defendants that have monopoly power."

First, does everybody agree with that?

MR. LIPSKY: Uh-oh.

MR. O'BRIEN: Can exclusive dealing involving a non-monopolist result in a substantial lessening of competition?

DR. KLEIN: Yes.

DR. FARRELL: All statements containing the word "all" are false except for this one and perhaps a

handful of others. I think there is a real problem with a subtle, complex and imperfectly understood topic having courts, judges, make grand and sweeping pronouncements. The law, as I understand it, in a precedent-based system tries hard not to change over time, and our understanding tends to change over time, and that creates a lot of trouble. So, it is not like I am out here saying, oh, and the following large category of cases, firms without monopoly power or without market power or something, can do a lot of harm with exclusive dealing. There have been some theories developed under which that can happen.

I think the consensus currently is that that is not such a big worry, but we do not really know yet, and freezing stuff in place by grand pronouncements that say "all," I am not sure it is such a great idea.

DR. CALKINS: The larger consequence, if that is the law, is that any time a -- well, any time a plaintiff has failed to hire one of these fancy economists and satisfactorily define a market in which the defendant has a well-defined market share of more than 75 or 80 percent, there is a very good chance that a Court would grant a motion for summary judgment or a motion to dismiss, because when you have rules like that, lots of courts operationalize it by saying, okay,

motion to dismiss, because when you have rules like

any market share below 70 percent, I grant a motion for summary judgment and do not explore anything else about what is going on, and that in my judgment is too sweeping a broom to use. That was a bad way to phrase that, wasn't it?

MR. O'BRIEN: Okay, Tad?

MR. LIPSKY: I think I can agree with the last sentence there, that all the plausible cases -- I am a little confused, though, whether this statement in context, was it limited to exclusive dealing or is it meant to be applied more broadly to other types of exclusionary practices? I guess that there -- you know, I am trying to recall. Wasn't there a -- there were some Commission consent decrees in cases involving water pumps for fire trucks. It was a multiple defendant situation where there was actually a fairly plausible theory of cartelizing, and I do not think you could have found, at least not with any logical consistency, that both of the competitors were monopolists.

So, I guess that is a limiting case, but I would be closer to agreeing with this if you were talking about cases other than those in which a cartelizing theory for challenging the exclusive dealing was the theory of liability.

Am I right about this FTC decree? Does anybody

remember that?

DR. CALKINS: There was a pump case. There was -- there was a case like that.

MR. LIPSKY: Okay, so it is actually -- it is probably real, presumptively real.

MR. VITA: It is called Waters Hale (ph).

MR. LIPSKY: Excellent, okay, thank you.

DR. KLEIN: If Posner had restated it in terms of market power instead of monopoly power --

MR. LIPSKY: That would be fine.

DR. KLEIN: -- I assume we could all agree, right?

MR. LIPSKY: Yes, that would be fine.

MR. O'BRIEN: So, this statement is about monopoly power or market power on the part of the defendant. I am wondering if any of you think that conditions relating to market power or market structure in the downstream market have an effect on the extent to which exclusive dealing can be anticompetitive. That was not stated well, but what should we make of the downstream market structure in terms of the likelihood that exclusive dealing can have an anticompetitive effect?

DR. FARRELL: Well, I mean, I talked briefly earlier about the developing economics of understanding

the role of downstream competition in that and, you know, fairly plausible seeming analyses have come out with very different answers so far, so watch this space, and that perhaps should be a pretty strong warning against making strong statements at this point.

MR. O'BRIEN: Would you be willing to say that some kind of barrier to entry in the downstream market is necessary for anticompetitive exclusive dealing?

DR. FARRELL: Well, I think -- see, you are talking about a lot of abstract nouns here, and I am sorry, I cannot put on a southern U.S. accent, but I would like to.

DR. WERTHER: Can you do any U.S. accent?

MR. LIPSKY: I thought that was a Berkeley accent.

DR. CALKINS: You have got such a lovely accent.

DR. FARRELL: I think Strunken White might have said if you are getting confused, try to decrease the abstract nouns and increase the active verbs, and I think that is a pretty good proscription for thinking straight. So, let's try that.

Instead of talking about market power and market share and dominance and exclusive dealing and so on, let's ask the following question: If I come up with a better way of doing things than the incumbent is doing

or I am less greedy than the incumbent and I am willing to give consumers a better deal, am I stymied in my attempt to do so by these deals that people have struck? That is the core question, and a lot of the time, the answer will be no, I am not stymied if there are small shares of this or that. Sometimes I will be.

So, for example, if you look at the Microsoft case, Microsoft had no need to completely keep NetScape out and wasn't trying to keep NetScape out and charge a

are dealing with subtle and difficult issues.

DR. CALKINS: Clearly everybody would say that it matters how easy our new entrant can gain access to the customers to whom it is trying to sell, and if it is very easy to do that, then exclusive dealing will not present any problems. As you phrased the question, you used the magic word "entry barriers," and as you know, that has lots of different definitions, and choose your right definition and defendants will almost always prevail; choose different definitions, and they might not.

It also raises the question as to whether you are looking at a total exclusion standard or at simply making it much more expensive, time-consuming and risky in order to gain access, and so you have staked out a position or the quote here has staked out a position which might mean things that I would not be comfortable with.

MR. O'BRIEN: Right. So, just one follow-up to that, I guess this is directed to Joe, the Fumagalli and Moa,,fod2c.71.00w,,foikson and Wickelgren,fod2c, in 0w, simplest cases, you have homogeneous producers downstream with no economies of scale or very small economies of scale, and it strikes me in 0w, context of those fod2c.7that it would be very easy for a firm to

enter at both levels and disentangle any anticompetitive effect that is being contemplated. I am wondering if you have thought about that, or maybe I am wrong.

DR. FARRELL: You know, it has been a while since I read the models, so I do not remember technically whether what you say is right. Clearly if you really have homogeneous products and fixed costs and sunk costs are very small, then you would think -- and you would want to know why not if somebody was claiming not -- that a firm could enter at both levels.

On the other hand, there certainly are industries where at any given time the industry may behave quite competitively involving the pass-through dynamics that we were talking about, and yet there are big sunk costs lying behind it, and that may be the more relevant case for that kind of analysis.

MR. O'BRIEN: Anyone else? Okay, next slide.

Okay, I think this is an uncontroversial slide as well. We will see. Maybe the questions will be more interesting.

"Exclusive-dealing arrangements --" this is a quote from Jefferson Parish. "Exclusive-dealing arrangements 'may be substantially procompetitive by ensuring stable markets and encouraging long-term mutually advantageous business relationships.'"

Yes, Joe?

DR. FARRELL: I hate to be a curmudgeon, but stable markets are not exactly what antitrust aims for. Actually, maybe we should try to encourage unstable markets where the status quo could be disrupted at any moment by some pesky firm that maybe has not shown up before, or maybe has, and is willing to take a lower margin or has a better way of doing things.

Now, I am not saying that the basic point here, that exclusive dealing arrangements "may be good" is wrong, but I do not like that language.

MR. O'BRIEN: Okay. Well, you pick the --

DR. CALKINS: And while you are complaining, you could complain about the mutually advantageous business relationship, because that could be good for consumers, and if it is just dividing up a surplus between two businesses, it could be bad for consumers.

DR. KLEIN: Yeah, I --

MR. O'BRIEN: Ben Klein, do you have a view on that?

DR. KLEIN: Well, who knows what Justice O'Connor is referring to, but if she means by encouraging long-term mutually advantageous business that it encourages people to make specific investments in the relationship, relationship-specific investments,

then I think she is correct and that she should not go through it now, but that is one of the problems I had with Joe's presentation, is that the Segal and Whinston criticism of that rationale for exclusive dealing is

best.

MR. O'BRIEN: So, what efficiencies are often asserted in exclusive dealing cases that you think may not actually exist very often? Anybody?

DR. KLEIN: I hope nobody says this focused dealer effort, but I guess one of the things I should say is the justification that Microsoft offered, the procompetitive justification for the exclusive dealing arrangement with the Internet access providers, sounded like a focus -- the way you presented it, it sounded like a focusy y.n3uo6sdeclusive dealing

be given to observing an exclusive dealing arrangement in a similar competitive market when you are analyzing a case where there is exclusive dealing, maybe in a market that exhibits some more market power in some ways than the other, but otherwise has similarities?

DR. FARRELL: Well, at a technical level, there certainly have been analyses that show that in some circumstances, exclusive dealing engaged in by, let's say, all members of an oligopolistic manufacturing sector, whether downstream industry, can soften competition and be in that sense anticompetitive, even conditional on, you know, a flourishing oligopoly structure, and let's face facts, we are never dealing with perfectly competitive industries when we are talking about these cases, so oligopoly is what you mean by the word "competitive" here.

There are other analyses that suggest that exclusive dealing can actually sharpen competition. I think it is fair to say that that literature is both unsettled and in a state of nonferment, the nonferment because nobody seems very excited about it. People are really more interested in the monopoly-preserving possibilities I think than the oligopoly-softening possibilities, and that may be a legitimate choice of emphasis, where to put our intellectual resources, or it

may just be, you know, what happens to be fun for assistant professors to do these days.

DR. KLEIN: I think we have to be very careful when we start talking about oligopoly-softening, and I guess Joe would say I have this bias, this laissez-faire bias, but I can imagine unilateral behavior -- you know, a gasoline company decides they are going to locate their station not next to another station but a couple of blocks away, because if they locate it next to the station, it is going to be more intensive competition. People are going to be able to compare the prices.

We do not want to go in and micro-regulate the competitive process. You know, you hire an economist, and let's assume they draw the welfare triangles, and they say consumers are better off if that person puts the station next to the other station, and even though it has -- let's assume it has the effect of sharpening competition if we do that, we do not want to regulate that behavior, at least I do not want to, even though the calculation would come out that way.

So, I think it is dangerous to start talking about oligopoly-softening of competition in general, and basically I guess I have a prior that we are just going to mess things up and we should just leave it up to the competitive process, unless there is a -- you know, you

have this first step where you need some major anticompetitive effect in terms of foreclosure.

So, I guess my comment was not totally irrelevant, because we are talking about Section 2 unilateral behavior, even though it has nothing to do with exclusive dealing.

DR. CALKINS: Trying to psycho-analyze your question, I think you were -- I am guessing that you were referring to the argument you sometimes see made that, look, over here in this market, which we all stipulate is competitive, this practice is occurring, and so, therefore, it must follow as the night follows the day that when that same practice is being engaged in by this complete and total monopolist, it deserves summary judgment very promptly on that ground alone,

RC Cola example somebody alluded to before, RC has some exclusive relationship with its bottlers or something, I think it was, and you look at RC Cola, and they are a small fry. I mean, they do not matter anywhere. So, you look at that and you say, well, obviously they are doing that. They cannot possibly have any kind of foreclosure mode or some monopolization motive. It has to be some sort of value creation that induces theso,mdion motiv

that does not mean that there is not monopoly preservation going on.

DR. KLEIN: Exactly.

development, and because the dynamic aspect is so important, I think this is a theme that needs to be hammered again and again.

So, what I guess I am saying, yes, I agree with this, but it is narrow -- I would like to make my agreement as narrow as humanly possible.

MR. O'BRIEN: Anybody else?

DR. KLEIN: Tad, you sounded like an expert witness there.

DR. CALKINS: I was hoping that Tad could tell me how to get a mobile phone bill that is 75 percent lower.

MR. O'BRIEN: So, Joe, based on your remarks, I guess I would ask, do you think this is the primary story of competitive harm that we should be focused on in analyzing exclusive dealing, or should some of the other theories that you mentioned, I guess in particular Simpson/Wickelgren, maybe some of these two-stage models of oligopoly where exclusive dealing can play a role, are those things we should be concerned about, or is this number one and number two?

DR. FARRELL: Well, I disagree with the question. I think the primary focus should be based on what is going on in the market at hand, and we should adjust the tools to fit the facts and not prejudge what

for the economists, although equally for the lawyers -- does economics supply tools to do this?

DR. KLEIN: Try Joe.

DR. FARRELL: Well, let's see. I mean, clearly in order to plunge into enforcement, we would not want to go ahead if the anticompetitive harm of the conduct is outweighed by the procompetitive benefit. Using the term "procompetitive benefit" in -- I am not sure whether it is the same way or not as Ben uses it, but I am using it to mean actual benefits to efficiency and consumers, not just kind of non-anticompetitive rationales.

This, of course, is part of a bigger decision tree that the Microsoft Court laid out. In thinking through a burden-shifting process like that, you have to think about a number of things, and I do not know how much the Court thought through these things. I am pretty sure I know how much they knew the necessary data required to do it exactly right, which is not a criticism, because nobody has that data either.

You have to think both about whether in most cases this is true or that is true, but also about if this is true, is it going to be easy to prove, or is it quite likely to be true but be hard to prove? And that really gets back to what I hope was the main theme that

came out of my talk earlier, that in my opinion, there are often benefits of open, free-wheeling competition that are very difficult to pin down and almost impossible to prove, and I think that needs to be kept in mind when we lay down these decision trees.

Did the Microsoft Court keep that in mind? To some extent. Did it do it the right amount? I have no idea, and I doubt that they really know either.

DR. CALKINS: If the question is should one think about the competitive harm that is likely, should one think about the procompetitive benefit, the answer to that is entirely yes.

On the other hand, can you read this statement to say that if there is any tiny procompetitive benefit, perhaps using anybody's definition of "procompetitive," does that mean that the defendant always wins unless the plaintiff is able, with great specificity, to precisely quantify the anticompetitive harm, precisely quantify the anticompetitive benefit, and then precisely calculate that one is more than the other?

Well, it may well be that if that is what one means, then what one is saying is that any time there is any benefit that can be characterized as procompetitive, the defendant will always win, and so if that is where you ended up, that might not be a good place, but that

does not mean that you should not think about the procompetitive benefit.

DR. KLEIN: Go ahead, Tad.

I mean, I am pretty cynical about this, because I do not know -- I do not think the courts have done this, and I do not know what to tell them to do. I mean, I think they go backwards, and they figure out -- you know, they do some kind of implicit balancing, and then they say -- they make it easy and they say it was not an anticompetitive effect or there is no procompetitive efficiency rationale, and I do not know what exactly we should have them do, other than we know we want them to hire more economists, right?

But it is a -- I think that is the ultimate question, because you do have to do the balancing, and I do -- I mean, it is a legal question, but I do think the burden should be placed on the plaintiff at that point, because I have this prior bias about the competitive process. So, I agree with the legal rule, but then what exactly are you doing -- and it should -- it should not be a close thing, because that is my -- and I think that is the way the law is or it should be, that it should not be a very close thing that we are balancing, and it should not be something -- you know, there should be this first step that you have to show a very clear anticompetitive effect before you go forward in any way, and that is going to get rid of most of the cases.

Steve will say that is why the defendants win

all the time, but they do not always win, because you have the Dentsplies and you have the Microsoft, and I think that is enough to get efficiency in the economy.

DR. FARRELL: There is this article by Priest and Klein -- I do not know if that is you --

DR. KLEIN: Yes, that is me.

DR. FARRELL: -- saying that whatever the rules are, the litigated cases are going to be close ones. So, I do not think we can have a rule that litigated cases are not allowed to be close.

MR. O'BRIEN: Okay, well, we have run past our time, and I think it is Ben's fault, by about four minutes. So, thank you very much everybody.

(Applause.)

(Whereupon, at 4:04 p.m., the hearing was concluded.)

C E R T I F I C A T I O N O F R E P O R T E R

DOCKET/FILE NUMBER: P062106

CASE TITLE: SECTION 2 HEARING

DATE: NOVEMBER 15, 2006

I HEREBY CERTIFY that the transcript contained herein is a full and accurate transcript of the notes taken by me at the hearing on the above cause before the FEDERAL TRADE COMMISSION to the best of my knowledge and belief.

DATED: 12/4/2006

SUSANNE BERGLING, RMR-CLR

C E R T I F I C A T I O N O F P R O O F R E A D E R

I HEREBY CERTIFY that I proofread the transcript for accuracy in spelling, hyphenation, punctuation and format.

DIANE QUADE