Monopolies, Innovation, and Predatory Pricing:
Observations on Some Hard Questions in the Section 2 Context

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before the

Antitrust 2010 Conference: New Administrations, New Cases, and New Economic Realities in Global Markets

Los Angeles, CA

March 25, 2010

I've been asked today to provide some perspectives on unilateral conduct enforcement. I've spoken about this topic on many occasions – including, in fact, here in Los Angeles earlier this week where I opined about the extent to which the Commission should use Section 5 to reach anticompetitive unilateral conduct that Section 2, with its current common law baggage, might not reach. Rather than revisit that topic (my remarks will be posted on the Commission's website), I'd like to take a different approach today and discuss the extent to which we at the enforcement agencies, as well as federal judges, have a particularly heavy responsibility when it comes to hard cases

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The views stated here are my own and do not necessarily refl

(including those in the Section 2 context) to make sure that the rules we are applying in a particular context actually make sense. My remarks will proceed in three parts. First, I'll discuss the deference that we, as public enforcers of the antitrust laws, should pay to the patent laws in the Section 2 context. Second, I'll discuss what degree of deference the existence of a patent should get in the context of our Section 2 enforcement. Third, I'll discuss the application of the antitrust laws, and specifically Section 2, to firms that make huge upfront investments in developing and exploiting their intellectual property.

I.

The extent to which deference should be paid to firms that enjoy monopoly power has been the subject of extensive debate, including comment by the Supreme Court. In the *Trinko* case, for example, Justice Scalia suggested that those who enforce the antitrust laws ought to be deferential to firms with monopoly power, which he characterized as "an important element of a free market system."[1] The reason for that, he said, is that the opportunity to acquire monopoly power and charge monopoly prices is "what attracts 'business acumen' in the first place" and "induces risk taking that produces innovation and economic growth."[2]

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in *Alcoa*,[3] have argued that monopoly power incentivizes conduct that is inefficient and thereby harms consumers and society as a whole.[4]

Perhaps both sides have painted with too broad a brush. I'd like to suggest today that it may be the case that monopolies are neither presumptively good or bad but instead that if we're going to defer to monopoly power (and create rules that protect it), we need to conclude that monopoly power does, in fact, in the industry at hand, drive innovation. If the opportunity to charge monopoly profits isn't driving innovation, then arguably protecting those monopolies makes no sense. At that point, not only are the aims of the antitrust laws not being served, but on balance, the aims of the patent laws are arguably not being served either.

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[3] *United States v. Aluminum Co. of America* ("*Alcoa*"), 148 F.2d 416, 427 (2d Cir. 1945) (identifying three evils associated with monopoly power: (1) that a dominant firm has excessive power over price; (2) that excessive prices reduce efficiencies and create deadweight loss; and (3) that monopolies "deaden initiative," "depress[] energy" and eliminate[] rivalry"); *see also Standard Oil Co. v. FTC*, 340 U.S. 231, 252 (1980) (citing the danger that a monopoly will "fix the price," impose a "limitation on production," or cause a "deterioration in the quality of the monopolized product").

[4] To this end, it is not clear that greater concentration impedes optimal dynamic performance. *See* Fed. Trade Comm'n, *To Promote Innovation: The Proper Balance of Competition and Patent Law and Policy* Ch. 2 at 12-15 (2003) [hereinafter FTC Innovation Report] ("Statistical cross-section studies examining multiple industries have not identified any clear relationship between concentration and innovation."); *see also Federal Trade Commission and Department of Justice Hearings on Section 2 of the Sherman Act: Single-Firm Conduct As Related to Competition*, Sept. 26, 2006 Hr'g Tr., Empirical Perspectives at 13 (Scherer), *available at* http://www.ftc.gov/os/sectiontwohearings/docs/transcripts/sept26EmpiricalPerspectivestrans.pdf (observing that reluctance to "cannibalize the rents that they are earning on the products that they already have marketed" may make monopolists "sluggish innovators"); Statement of Chairman Timothy J. Muris, Genzyme Corporation / Novazyme Pharmaceuticals, Inc., FTC File No. 021 0026 (Jan. 13, 2004), *available at* http://www.ftc.gov/os/2004/01/murisgenzymestmt.pdf ("[N]either economic theory nor empirical research supports an inference regarding the merger's likely effect on innovation (and hence patient welfare) based simply on observing how the merger changed the number of independent R&D programs. Rather, one must examine whether the merged firm was likely to have a reduced incentive to invest in R&D, and also whether it was likely to have the ability to conduct R&D more successfully.").

II.

That leads me to the second topic I’d like

market structure to occur or for the efficiencies to materialize. Otherwise, consumers are likely to suffer an inordinate amount of injury while we dither. On the other hand, it's equally clear that in some circumstances—for example, when there is concrete evidence that innovation is likely to occur in the future, but not immediately—prudence may dictate that a longer period of time be allowed. The 1992 Horizontal Merger Guidelines imply that, at least in the merger context, two years is generally an appropriate period to wait for new products to enter the market.[15] But I wonder whether that period is sufficient, especially where, as in some industries, there are circumstances that may make the time to entry or innovation harder to pin down.

A second question we face in evaluating the proper deference to innovation claims is determining what evidence should guide our analysis and how concrete that evidence should be. It seems to me that, at the very least, we need to closely examine the empirical evidence regarding what's happened in the past. That evidence may take many forms. It may, for example, consist of evidence of prior entry or innovation. Or, it may consist of the stability (or lack thereof) of market shares over time. Or, it may consist of the extent to which venture capital is flowing to certain firms in the industry. In short, there are numerous clues about whether a market's structure is really dynamic, and about whether efficiencies are indeed likely to flow from a transaction or practice, and we should examine them all (within a reasonable period of time of course).

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[15] U.S. Dep't of Justice and Federal Trade Comm'n,

A third issue is whether certain practices involving intellectual property should be characterized as per se legal. This subject is usually debated where a party with a patent refuses to license intellectual property to a competitor. Section 271(d) of the Patent Act declares that refusing to license a patent cannot be patent misuse, even when the refusal is by a firm with monopoly power.[16] Likewise, a number of courts have held that a refusal to license intellectual property, standing alone, cannot be an antitrust violation.[17] Indeed, that was the context in which Justice Scalia made the comments in *Trinko* that I've already described. There he was observing that a rule that imposed a duty to license a

[16] 35 U.S.C. § 271(d) ("No patent ow

patent to rivals would reduce the incentives for innovation both by the original inventor, as well as by rivals seeking their own alternatives to the patents or the inventor.[18]

Although the lower courts that have addressed the issue of refusal to deal have generally found that, so long as their patents were lawfully acquired, patent owners have no duty to deal with competitors, the federal appellate courts have divided on what standard should apply to analyze refusals to deal.[19] In the *Kodak* case, for example, the Ninth Circuit held that a unilateral refusal to license intellectual property by a firm with monopoly power could violate Section 2 of the Sherman Act, if the firm's conduct was not supported by a valid business justification.[20] In what may have been the first time a federal court imposed antitrust liability for the refusal to license a patent, the court found that Kodak's reliance on the fact that intellectual property rights were involved as a justification for refusing to license was largely pretextual.

Three years later, however, the Federal Circuit rejected the Ninth Circuit's approach in the Xerox/ISO case, when it held that a patent holder's unilateral refusal to license or sell patented goods was an absolute right, subject to a few narrowly drawn exceptions for illegal tying, fraud, or sham litigation.[21]

anticompetitive effect, so long as that anticompetitive effect is not illegally extended beyond the statutory patent grant."[22] In a 2006 decision, the Seventh Circuit joined the Federal Circuit's rejection of the Ninth Circuit's analysis.[23]

Nevertheless, a circuit split remains. *Trinko* didn't resolve this split because, as I've already noted elsewhere,[24] the one and only question before the Court in that case was whether that defendant's refusal to license constituted monopolization, given the regulatory "safety net" that existed. To the extent that Justice Scalia, joined by five other members of the Court, chose to address the *per se* issue of whethe

benchmark for determining whether a party is engaged in anticompetitive pricing, but you have an industry (like pharmaceuticals) where the fixed costs are very high but the variable costs are not, then a firm's market price will always exceed its average variable cost. As a result, under such a rule, it will never be the case that a firm will engage in anticompetitive pricing because the firm will always price "above cost."

Second and relatedly, Judge Wilken observed that "[m]ore fundamentally, using average variable cost as a gauge of anticompetitive pricing leads to an exclusive concern with promoting manufacturing efficiency."[39] That concern, however, is beside the point in cases where the concern is not with the defendant excluding an equally efficient manufacturer *of the same drug*, but is instead with excluding manufacturers of *new equally efficient drugs* that would compete with a patented drug. Put differently, in Judge Wilken's words, "an antitrust doctrine that seeks exclusively to promote the efficient production of pills will not serve to promote the introduction of new medicines to compete with a patented drug."[40] Instead, she concluded, the appropriate rule "should have the effect of prohibiting Abbott's pricing practices if a hypothetical equally efficient developer of an equally effective [patented drug] would not be able to profit if it introduced that [patented drug] to the market" at the price of Abbott's patented drug. Thus, because the average variable cost rule did not accomplish that rule, she refused to apply it. Unfortunately, although Judge Wilken certified her decision to the Ninth Circuit for interlocutory appeal, subsequent events made the case moot.

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[39] *Id.*

[40] *Id.* at 1004.

The flip side of Judge Wilkins' analysis surfaced in the DOJ's challenge to Oracle's attempt to acquire Peoplesoft in 2004.[41] I was on the Oracle trial team at the time. In that case, the arguably central issue was what the market structure would be if the acquisition succeeded. The government argued tissu

incentives for other industries. In the context of innovation, it may mean that while a guideline says we only look 2 years out for new products, we should look at a shorter or longer period of time if there's concrete evidence that innovation in a particular industry is quicker or slower than we would normally expect. And in the context of predatory pricing, it may mean that as Judge Wilken so correctly discerned, before the courts or the Commission simply assumes that existing precedent should apply, we need to do the hard work to make sure that the application of a particular rule in any given case comports more generally with that rule's objectives. Such careful decision making inevitably requires some heavy analytical lifting by the courts and the Commission, but we're not doing our job of protecting competition and consumer choice if we don't test whether a particular rule or guideline's underlying assumptions hold up before we apply it.