Cheap Exclusion

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Remarks Before:
Charles River Associates 9th Annual Conference
Current Topics in Antitrust Economics and Competition Policy
Washington, DC
February 8, 2005

I. Introduction

Thank you for inviting me to address this Ninth Annual Conference. In a short time, this has become one of the premier events on the antitrust calendar, and I look forward to participating in it. Needless to say, the views expressed are mine alone and are not necessarily the views of the Commission or any individual Commissioner.

A central question for any law enforcement program is where to focus resources to best achieve the program's objectives. Now, the search for good merger cases is comparatively easy. Most problematic mergers walk right in the door, and they bring their documents with them. The Hart-Scott-Rodino Act[1] makes the first step in identifying anticompetitive mergers a reactive one and reduces initial search costs to close to zero.[2]

Nonmerger enforcement obviously requires a different approach. The size of the American economy and the range of conduct contained within it would make any notification program impossible. Under such circumstances, it becomes important to be able to identify particular patterns of behavior that are likely to result in the illegitimate acquisition or maintenance of market power. If we can identify such patterns, we can more efficiently allocate resources to target that conduct.

To identify such patterns, let me begin by distinguishing between two different types of potentially anticompetitive conduct. One type involves efforts by competitors jointly to raise price by reducing their *own* output – what I will here call "collusion." The other involves conduct by which firms exclude competitors from the market and effectively prevent those

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[1]Clayton Act § 7A, 45 U.S.C. § 18a.

[2]Of course, mergers that fall below HSR thresholds can also be anticompetitive, and the Commission allocates non-trivial resources searching for those acquisitions. Additionally, once the HSR filings are made, there are significant search costs in identifying the minority of acquisitions that are potentially anticompetitive.

excluded firms from expanding output, so that overall market output is reduced. Hereafter I will refer to such efforts as "exclusion." I would note that this distinction between "collusion" and "exclusion" does not quite match the distinction between Section 1 and Section 2,[3] because exclusionary conduct to reduce *others'* output may be undertaken either unilaterally or through agreement among rivals.

With respect to "collusive" conduct, the antitrust community long ago reached a consensus that certain types of agreements – to set prices, allocate customers, or divide sales territories – are inherently problematic. They are therefore an easy and obvious focus for antitrust enforcement efforts.

With respect to exclusionary conduct, however, no similar consensus has developed that there exists some set of "core" conduct that can be viewed as inherently problematic and to which enforcement resources should be directed. One possible explanation for this lack of any consensus is that there simply *is* no such conduct – that is, no forms of exclusionary conduct can be readily identified as anticompetitive without elaborate analysis. But another possible explanation is that our analysis of alleged exclusionary conduct typically has focused elsewhere – for example, on developing standards, such as the "profit sacrifice" test, that attempt to establish a single standard for separating anticompetitive exclusionary conduct from legitimate business behavior.

What I would like to do this morning is to suggest that it may be worthwhile attempting to consider whether it is possible as an aid to targeting good cases to identify some types of conduct as "naked" exclusion. If we could isolate conduct that is likely (assuming all other elements of an antitrust violation are made out) to have only anticompetitive effects, it would be an important step in helping prioritize our enforcement efforts.

Some additional benefits also might follow from reaching agreement regarding types of "naked" exclusionary conduct. To begin with, it may be an easier, albeit more modest, task than reaching agreement regarding the broader question of whether there is a single proper mode of analysis that should be used to distinguish exclusionary from legitimate business behavior. At least, that is one possible lesson that might be drawn from our collective experience with collusion. In that area, even decades after a consensus developed regarding forms of collusion that might be rejected *per se*, the lively commentary surrounding some of the Commission's recent decisions in cases such as *Schering*[4] and *Polygram*,[5] reflect the fact that the proper

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[3]Sherman Act §§ 1-2, 15 U.S.C. §§ 1-2.

[4]*Schering-Plough Corp. v. F.T.C.,* 402 F.3d 1056 (2005), *rev'g In re Schering-Plough Corp.,* Dkt. No. 9297, 2003 WL 22989651 (F.T.C. Dec 08, 2003) (Opinion), *available at* http://www.ftc.gov/os/adjpro/d9297/031218commissionopinion.pdf.

[5]*In re PolyGram Holding, Inc*., Dkt. No. 9298, 2003 WL 21770765 (F.T.C. Jul. 24, 2003) (Opinion), *available at* http://www.ftc.gov/os/2003/07/polygramopinion.pdf, *appeal docketed,*

analytic framework for more complex forms of cooperation between rivals remains a subject of heated debate.

Moreover, if it proves possible to identify certain core types of exclusion, that exercise might in turn help us to assess the utility of particular standards that have been advanced for distinguishing legitimate business conduct from exclusionary behavior. And identifying "core" forms of exclusionary conduct also may bring other antitrust issues into focus.

How, then, should antitrust enforcers go about identifying types of "naked" exclusion? I would like to spend the balance of my remarks this morning focusing on what I and my co-authors in a forthcoming paper have called "cheap predation" or "cheap exclusion." Most if not all of the exclusion cases that the FTC has brought in recent years involve "cheap predation." And, I would submit, these cases also provide examples of what should properly be recognized as "naked" exclusion.

In describing the FTC's cases as "cheap" predation, we mean exclusionary conduct that is "cheap" in two distinct ways. First, by "cheap," we mean conduct that costs or risks little to the firm engaging in it, both in absolute terms and when compared to the gains (or potential for gains) it brings, and which is therefore attractive for an aspiring monopolist. Firms may choose to engage in "expensive" predation (predatory pricing being the archetypal example), but it seems plausible to suppose that firms will opt for a cheaper form of exclusion if one is available. Because market (or monopoly) power is a desirable goal for a rational firm, and because rational firms are likely to prefer low-cost strategies to achieve their goals, our view has been that "cheap" predation can be expected to be relatively common compared to other forms of exclusionary conduct, all else equal.

Second, when talking about "cheap predation," we mean a particular kind of low-cost exclusionary strategy, namely, one that does not raise any cognizable efficiency claims – that is, it is "cheap" in that it has little positive value.[6] When considering collusive arrangements, what distinguishes conduct that can be quickly condemned (such as price fixing) is that it lacks any cognizable efficiency. In our view, the same distinction can be drawn with respect to different forms of exclusionary conduct.

For example, exclusive dealing arrangements may sometimes (for example, in some monopoly maintenance cases) be profitable for a firm even in the short term, and therefore in some circumstances might be viewed as "cheap" in the first meaning of the term. Because exclusive dealing arrangements generally have legitimate, efficiency-enhancing justifications, however, exclusive dealing is not "cheap" in the second sense, because a detailed factual analysis is necessary in a particular case to determine whether the arrangement in fact is

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Dkt. No. 03-1293 (D.C. Cir).

[6] *See* Merriam-Webster's Collegiate Dictionary (3d ed.) at 194.

anticompetitive.

By comparison, I believe that there are many varieties of inexpensive exclusionary conduct that do not even arguably raise cognizable efficiency justifications. In other words, they are cheap in both senses, inexpensive to implement and "lacking any redeeming qualities." The allegations stated in the FTC's administrative complaints in *Unocal*,[7] the Orange Book cases,[8] *South Carolina Dentists*,[9] and *Rambus,*[10] all in my view are cheap in that second sense – that is, the defendant's conduct cannot be explained in terms of the defendant's effort to increase output or improve product quality, innovation, or service. As with *per se* collusive arrangements, proof that the alleged conduct actually occurred might be strongly contested as a matter of fact. Once established, however, and assuming all other elements are satisfied (such as proof of monopoly power in a Section 2 case and the absence of any antitrust immunities), the antitrust analysis is at an end.

Let me use the *Unocal* case to illustrate. The trial in this case just ended. I am going to discuss the allegations in the complaint. Fairness to Unocal requires that I acknowledge that Unocal denied some of those allegations and that I realize it is our burden to prove them at trial – as I believe we have done. The complaint in that case alleges that Unocal made false representations to the California Air Resources Board ("CARB") and to other refiners in connection with CARB's adoption of regulations relating to reformulated gasoline. According to the complaint, Unocal falsely represented that certain technology was non-proprietary and in the public domain. After CARB incorporated the technology into its regulations and the other refiners configured their operations to comply with those regulations, Unocal announced that in fact it held patents on the technology at issue and sued the refiners for patent infringement. Unocal's infringement actions sought royalties of approximately 5 cents a gallon for virtually all

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[7]*In re Union Oil Company of California,* Dkt. No. 9305 (March 4, 2003) (Complaint), *available at* http://www.ftc.gov/os/2003/03/unocalcmp.htm. My comments are limited to the allegations of the complaint since the case is in litigation.

[8]*In re Bristol-Myers Squibb Co.*, Dkt. No. C-4076, 2003 WL 21008622 (F.T.C. Apr. 14, 2003) (consent order), *available at* http://www.ftc.gov/os/2003/03/bristolmyersconsent.pdf; *In re Biovail Corp.,* Dkt. No. C-4060, 2002 WL 31233020 (F.T.C. Oct. 2, 2002) (consent order), *available at* http://www.ftc.gov/os/2002/06/biovailelanagreement.pdf.

[9]*In re South Carolina State Board of Dentistry,* Dkt. No. 9311 (Sept. 12, 2003) (Complaint), *available at* http://www.ftc.gov/os/2003/09/socodentistcomp.pdf, *appeal docketed,* No. 04-2006 (4th Cir.) (petition for review of Commission order denying motion to dismiss on state action grounds).

[10]*In re Rambus Inc.,* Dkt. No. 9302 (F.T.C. Feb. 23, 2004) (Initial Decision dismissing complaint), *available at* http://www.ftc.gov/os/adjpro/d9302/040223initialdecision.pdf, *appeal docketed before Commission.* I am recused in *Rambus*, and so I take no position on the merits of the case.

gasoline sold in California during the summertime. The complaint alleges that Unocal, by deceiving CARB and the other refiners into adopting Unocal's patented technology into a binding standard, acquired monopoly power – the power to raise market prices for a sustained period of time – in a well-defined antitrust market.

The allegations made in the *Unocal* complaint illustrate a number of common themes underlying cheap predation. First, the conduct was "cheap" in the sense of low-cost. Indeed, in *Unocal* the cost may have been particularly low, since Unocal would have had other incentives to participate in CARB's processes and in the refiners' organizations and would have therefore already incurred whatever costs that participation entailed.

Moreover, as is often the case in instances of cheap predation, the costs were highly asymmetric. According to the complaint, undoing the effects of Unocal's deception of CARB and the refiners, even if possible short of an antitrust suit, would require regulatory change and a vast expenditure of resources in reconfiguring refineries designed to produce CARB-compliant summertime gasoline. Thus, a small expense by the alleged predator required much larger expenditures by victims seeking to avoid exclusion (or to avoid paying monopoly rents).

In addition, the conduct at issue is not "competition on the merits." It is therefore "cheap" in the sense of lacking redeeming value. Deceiving a governmental regulatory agency and private standards-setting and trade organizations – the conduct alleged in *Unocal* – plainly is not efficiency-enhancing. Indeed, the conduct alleged in *Unocal* appears to match the definition of "opportunistic behavior," as that term is used in the literature.[11] Although I am no expert, it is my understanding that, very generally speaking, opportunistic behavior occurs when a party to a relationship (such as a contract) engages in behavior designed simply to transfer wealth from the other participants in the relationship, and where the behavior is contrary to the other parties' legitimate expectations, although it may not necessarily violate the explicit rules governing the arrangement.

Unocal involved misrepresentations to a public agency as well as to private organizations, and involved unilateral rather than joint conduct. Neither of these features, however, is necessary to constitute "cheap" predation. For example, consider the Supreme Court's decision in *Allied Tube*.[12] In that case, Allied Tube, together with certain other steel interests, collectively packed a meeting of a private standard-setting organization in order to defeat a proposal to include plastic conduit in industry standards. That activity, strictly speaking, did not violate the organization's code of conduct, and the regulation adopted by the vote was held to be duly promulgated. But the virtual dictation by a handful of firms of an exclusionary standard was completely inconsistent with the legitimate expectations of the parties to the

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[11] *See, e.g.,* Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts,* 65 Minn. L. Rev. 521 (1981), and the literature discussed therein.

[12] *Allied Tube & Conduit Corp. v. Indian Head, Inc.,* 486 U.S. 492 (1988).

arrangement, and with the terms that made the organization efficient for all its members and for the public.

As in *Unocal*, the conduct in Allied Tube also was "cheap" in the sense that it cost little, especially relative to the size of the profits that would accrue from acquiring market power. It cost Allied Tube only about $100,000 to recruit 155 new members, while other steel interests recruited and paid for the expenses of another 75 new votes. By contrast, the jury awarded $3.8 million in damages (before trebling). This high upside resulted in large part because the opportunism occurred in a setting where a handy source of durable market power already existed. Respected private standard-setting organizations often have the power to confer market power by choosing one party's processes, or by excluding another's – for example, as happened in *Allied Tube*, when the standard they set are routinely embodied in local building codes. In this setting, opportunistic behavior not only may be cheap to the excluding firms and inefficient in the marketplace, but may have great ability to inflict real harm to consumer welfare.

Just as standard-setting can provide a promising setting for the creation of durable market power, so too can misuse of government processes. The Commission's Orange Book cases, involving alleged unilateral conduct, and its *South Carolina Dentists* case, involving alleged collective action, both illustrate this point. Orange Book listings exclude by the force of law once a relatively low additional investment (the filing of a patent infringement lawsuit) is made. *South Carolina Dentists* was an even better bargain from the point of view of the excluding firms. Not only did the Dentistry Board's "emergency" regulation excluding hygienists have the force of law, but the State of South Carolina bore the cost of enforcement against hygienists violating the regulation.

That said, as much as the manipulation of government processes provides a promising vehicle for cheaply acquiring durable market power, "cheap" exclusion can take place entirely in the private sphere, between individual firms. Business torts, for example, provide a useful illustration. Consider, for example, the allegations regarding Java in the government's *Microsoft* case.[13] The court found that Microsoft sought to limit Java's threat to its operating system monopoly by engaging in deception to damage Java's ability to function across different platforms. Microsoft deceived Java developers by representing that the Java programming tools provided by Microsoft would allow the programmers to develop Java programs that were compatible with multiple platforms. In fact, however, those tools were Windows-specific and could not create such "cross-platform" compatible programs.

Another example to consider might be facts similar to those alleged in the *Conwood* case.[14] Suppose that a competitor has its agents destroy its competitor's product displays at the point of sale. Or the hoary hypothetical of the dominant firm that blows up its competitor's

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[13]*United States v. Microsoft Corp.*, 253 F.3d 34, 76-77 (D.C. Cir. 2001).

[14]*Conwood Co. v. U.S. Tobacco Co.,* 290 F.3d 768 (6th Cir. 2002).

factory.

None of these acts can be explained in terms of the defendant's effort to increase output or improve product quality, innovation, or service. As intentional business torts, the behavior already has been recognized by societal consensus to be such that we want to discourage, not encourage. It is therefore "cheap" in the sense of "lacking any redeeming qualities." All of these acts also are "cheap" in the sense that they cost the firm engaging in them little in the way of expenditure. Tearing down a competitor's display rack may take less than a minute of an employee's time; lying to software developers costs even less. Indeed, we know from the fact that firms often engage in intentional torts against their competitors, that the conduct often will be viewed as profitable to the firm engaging in it, even when there is no prospect of gaining durable market power.

The fact that most intentional business torts do not contribute to monopoly power of course means that we should exercise extreme caution when claims of monopolization are raised. The antitrust plaintiff must prove that the alleged predator has acquired monopoly power and that the effect of the conduct is anticompetitive exclusion, not simply the imposition of costs on a competitor. That a competitor has been harmed may justify a tort suit by that competitor, if the other relevant elements of the tort are established, but to show an antitrust violation one must prove harm to competition. After all, firms are supposed to compete hard against their rivals, and antitrust must facilitate that, not deter it. But the point remains that when all the elements of monopolization, including injury to competition, are present, tortious conduct – rarely if ever an efficiency-enhancing form of "competition on the merits" – can be a cheap form of exclusion.

Because misuse of government processes, opportunism in standard-setting, and intentional torts lack any cognizable efficiency benefit, I would submit that they properly should be considered to constitute "naked" exclusionary conduct. And because they are also "cheap" in the sense of inexpensive to undertake, I submit that they are also likely to be – and the FTC's experience has shown them to be – relatively common. And that means our enforcement program should be especially tuned to them. The alternative hypothesis that I advanced at the beginning of these remarks, therefore, that we may not have previously labeled conduct as "naked" exclusion because there simply is no such type of conduct, is belied by the exclusion cases that the Commission has brought in recent years.

If "cheap" exclusion properly should be considered to be an important focus of enforcement efforts, let me conclude with three implications that might follow from that conclusion. First, examples of cheap predation suggest that there might be limits to the application of the "profit sacrifice" test as a necessary (rather than sufficient) standard for all forms of predation.

In determining whether conduct should be deemed exclusionary, it is often helpful to try to ascertain whether conduct should be deemed "economically irrational" but for its exclusionary effect – or, more narrowly, whether the conduct appears unprofitable (except for the profits gained by exclusion) . But profitability, economic rationality, or cost may not be very useful

metrics for cheap exclusion, either because costs are low, zero, or indeterminate, or because the "profits" involved may not result from efficient conduct. Indeed, the well-worn phrase "legitimate business reason or justification" used to describe appropriate forms of conduct, implies that not all business reasons or justifications are legitimate.

Second, if cheap predation properly can be considered as "naked" exclusionary conduct, and if it plausibly can be viewed as a relatively common form of exclusion, it highlights the importance of defenses and immunities – most notably, *Noerr*[15] and state action[16] – that impinge on antitrust enforcement against such conduct. Although the Commission's efforts in these areas have been widely discussed, their importance to antitrust enforcement may not be well understood. Firms seeking cheap exclusion strategies are likely to focus on areas in which conditions are ripe for inexpensive, high-benefit gaming. As I have already described, governmental activities designed to advance entirely different policy goals may create such conditions. And market power obtained by exploiting inadvertently-created flaws in governmental systems is by that very fact often stubbornly resistant to market correction and is, therefore, likely to be durable.

Thus, limiting *Noerr* and state action to the core articulated by the Supreme Court is central to an effective strategy for antitrust enforcement directed against cheap exclusion. If, as I believe, cheap exclusion should be a central part of a proper enforcement agenda, the undue expansion of these defenses and immunities is not simply an issue at the periphery of antitrust, but rather goes to the heart of the effectiveness of the agency's enforcement efforts.

Finally, a question I sometimes get with respect to cheap exclusion is: why antitrust? Why not leave the matter to tort or contract law, or the affected government agencies, or the standard-setting bodies? Instead, I would say that it is not surprising that conduct that "lacks any redeeming qualities" might also be problematic under other laws, but that fact provides no basis for concluding that antitrust should step aside. Indeed, by that same logic, criminal antitrust claims should be viewed with particular skepticism, because the conduct also often constitutes mail or wire fraud. It seems backwards to say that conduct is *less* of an antitrust concern *because* it lacks any plausible efficiency claim. Put differently, just because conduct lacks any efficiency benefit does not mean that it cannot violate the antitrust laws. I might add that purely private remedies, such as tort or breach of contract causes of action, are aimed at obtaining recoveries for harm to individual competitors – antitrust remedies, by contrast, are aimed at protecting consumer interests. Business cost-benefit considerations may militate against the bringing of tort or contract suits against conduct that imposed consumer harm. And even when such suits are brought, the remedies sought may not align ideally with long-term consumer interests. Those considerations weigh heavily in favor of government antitrust intervention in

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[15]*See Eastern R.R. Presidents Conf. v. Noerr Motor Freight, Inc*., 365 U.S. 127 (1961); *United Mine Workers of America v. Pennington*, 381 U.S. 657 (1965).

[16]*See Parker v. Brown,* 317 U.S. 341 (1943).

appropriate cases.

In conclusion, in our forthcoming article on cheap exclusion, which is co-authored by Bruce Hoffman, Tom Krattenmaker, and Ernie Nagata, we analogize our enforcement program to fishing. When fishing for exclusion, our notion has been that the best place to fish is where the fish are plentiful, and the things you catch are likely to be fish. Because we believe cheap exclusionary efforts are likely to be relatively plentiful, and are likely to lack any plausible efficiency justification, we have found it a useful part of the lake in which to dip in the line.