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and
UNITED STATES DEPARTMENT OF JUSTICE

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Reported and transcribed by:
Susanne Bergling, RMR-CLR

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MODERATORS:

ROBERT POTTER
Chief, Legal Policy Section
Antitrust Division, Department of Justice
and
PATRICIA SCHULTHEISS
Attorney
Bureau of Competition, Federal Trade Commission

PANELISTS:

Morning Session:

Patrick Bolton
Kenneth G. Elzinga
A. Douglas Melamed
Janusz Ordover

Afternoon Session:

Tim Brennan
John Kirkwood
Janet L. McDavid
Steven C. Salop
Frederick R. Warren-Boulton
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MR. POTTER: Thank you for coming, everybody.

This is the first substantive hearing on predatory pricing from the Section 2 hearings. My name is Bob Potter. I'm the Chief, Legal Policy Section, Antitrust Division, Department of Justice, and I will be the lead moderator for this morning's session. Sitting to my left is Pat Schultheiss, an attorney with the Federal Trade Commission's Bureau of Competition's Office of Policy and Coordination. She will be the co-moderator for this morning and the lead moderator this afternoon on the buy-side predatory pricing.

Before we start, just a couple of housekeeping things that I need to say. One, for the courtesy of the audience and the panelists, please turn off any cell phones, Blackberries or other devices that may make noise during the hearing.

Second, the restrooms. The men's restroom is out the double doors to the left, on your left. The ladies restroom is out the double doors, past the elevator bank, to the left, and I saw this morning that neither of them had hot water, so, if you want hot water, you're out of luck.

MS. SCHULTHEISS: There is no place in the
building that has it right now.

MR. POTTER: Third, and perhaps most important, in the unlikely event that there is an emergency in the building, please calmly and quickly go out the doors to your right and down the stairs. The Federal Trade Commission has a policy of meeting in the Sculpture Garden, which is on Constitution Avenue. If you don't know where it is, just follow the line of people leaving the building, and I am sure you will get there.

This morning, we are very grateful for having a very distinguished panel to talk with us about predatory pricing and Section 2. Our panelists are Ken Elzinga, Professor Ken Elzinga of the University of Virginia; Professor Janusz Ordover of New York University; Professor Patrick Bolton of Columbia University; and Doug Melamed of the law firm Wilmer Hale and former Deputy Assistant Attorney General of the Antitrust Division and Acting Assistant Attorney General of the Antitrust Division.

The format for this morning is each of the panelists will give a 10 to 15-minute presentation, then we will have a short break, and then we will have sort of a moderated round table discussion for the rest of the time.

We want to thank the panelists. I'll introduce
them each before their speech as opposed to giving
everybody's introduction right now, and for the first
instance, I will tell you that although I'll give you a
short description, a much longer and better description
is contained in the biographical information that we
have.

Our first speaker this morning is Professor Ken
Elzinga of the University of Virginia. Professor
Elzinga is the Robert C. Taylor Professor of Economics
at UVA. He has a long and distinguished teaching career
at UVA, having been a faculty member there, although I'm
sure it doesn't look like it, for over 40 years.

Even more importantly for today's purposes,
Professor Elzinga is a creative and prolific academic
writer, having authored more than 70 economic articles,
a number of which have focused on predatory pricing.

In addition, perhaps even more importantly,
Professor Elzinga has been an expert witness in some of
the most important predatory pricing cases in the
history of antitrust, including Brooke Group,
Matsushita, and most recently, Spirit Airlines.

With that, please join me in welcoming Professor
Elzinga.

DR. ELZINGA: Thank you, Bob. I am going to
speak from the table here if that's all right, and I
have got 15 minutes, max, to talk about predatory
pricing. That's a big topic. So, hold on to your
seats.

As was mentioned, I was the economic expert for
the defendants in the last two Supreme Court cases on
predation, the first one being Matsushita -- that really
dates me for some people in this crowd -- and then
Brooke Group or what I still call Liggett v. Brown &
Williamson, and then also, as was mentioned, I was
involved more recently in a predatory pricing case,
Spirit Airlines v. Northwest. I did an economic
analysis for Spirit, a so-called low-cost carrier. This
case had a happy landing for Professor Ordover at the
district court level, it had a happy landing for me at
the circuit court level, and the final destination of
this case is still unknown, but I hope to make a few
remarks about it later.

When I first started speaking about this
subject, before a number of you in this room were even
born, there was not much economic analysis embedded in a
predatory pricing case. You basically answered two
questions. Were prices declining in the market -- not
necessarily below cost, mind you, just going down -- and
did the defendant generate documents with pugilistic or
militaristic metaphors? "We are going to cut off their

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air supply. We are going to squish them like a bug."

If I had to pick two events, I am just doing a
brief intellectual history here, if I had to pick two
events that changed all this, it would be the Court's
opinion in Matsushita with its famous line that
predatory pricing schemes are rarely tried and even more
rarely successful. That statement was based on the
Court's exegesis of research about predatory pricing in
the economics literature. Almost all of this research
suggested that predation would be a strategy that would
be difficult to pull off.

And the second event was the publication of an
article by Don Turner -- the first Assistant AG to
enlist an academic economist in the front office, that
should always be pointed out -- and Phil Areeda in the
Harvard Law Review. It's the most often cited article
in antitrust scholarship, led to the Areeda-Turner Test.

Now, for this audience, I don't need to review
that article or that test, but let me mention for the
record how powerful was the hidden economic logic in
this famous test by using an iconic product from
Matsushita, a 19-inch black and white portable TV set, a
consumer electronic products my students today cannot
even imagine.

Let's say -- and these numbers are not way
off -- that this set was sold by Toshiba, one of the
defendants, to Sears for $95, and the average total cost
was $100, but the average variable cost was $90. So, we
have ATC equals 100, P equals 95, AVC equals 90. Almost
everyone at the time believed Toshiba was selling below
cost. After all, how could Toshiba survive with that
type of price-cost relationship? And it took an
instinct for economic reasoning or a recollection of a
price theory course to realize that such a price was
above the shut-down point, it was cash flow positive,
and that Toshiba was better off making the sale to Sears
than not making that sale, and the Areeda-Turner article
convinced a lot of people, including a lot of people in
this building and a building nearby, of something that
economists have known since Alfred Marshall, and that
is, in economics, what happens at the margin really does
matter.

What was missing from Areeda-Turner was a way of
thinking about the period of recoupment. They set the
stage for a more sophisticated -- I did not say highly
sophisticated -- but a more sophisticated economic
analysis that the Court adopts in Brooke Group. The
Court in Brooke Group recognized that even if a firm
charged a price below cost, whatever was the cost
benchmark, if the firm couldn't recover its losses, it
was difficult to make a case for antitrust enforcement, because the aspiring predator would simply shoot itself in the foot if there was no recoupment, and this economic logic behind plausible recoupment entailed two analytical constructs.

The first one is real clear in Brooke Group and the second one is not transparent. The first is the recognition that predation is like a capital expenditure. In Brooke Group, the Court cites a paper by David Mills and me entitled "Investment in Predation." Economists have always recognized that a dollar invested today requires more than a dollar in future products because of the time value of money, and Brooke Group understood that and applied that logic to predatory pricing, that losses from predation need to be recouped and not just on dollar-for-dollar basis.

The second point follows from the first: Unless entry and exit conditions are symmetrical, the recoupment returns for the aspiring monopolist must be enjoyed for a longer time period than the time frame in which the aspiring monopolist shouldered the cost of the predation strategy, and I could just do a footnote here on Matsushita and how much the world has changed.

The plaintiffs in Matsushita thought they were making a good case for their side by arguing that the
Japanese charged prices below cost for years and years and years, over a decade, not recognizing that the longer is that time period, the more difficult it would be -- indeed, I think mathematically impossible given the power of compound interest -- to ever make up the gains.

For those of you who are attorneys, and that would be most of you in this room, I'll tell you what I find to be a fascinating war story from Matsushita. I did some back-of-the-envelope calculations as to what a 19-inch black and white TV set would have to sell for under the plaintiff's argument that predation had gone on for 15 years, that is, these sets had been sold below cost for 15 years. What would a 19-inch black and white TV set have to sell for? And I found it would be like $800 into infinity.

Now, I don't know if this is one of the things that economists talk about when we are not in the presence of antitrust lawyers. The antitrust lawyers thought, don't ever make that argument on the stand, because the plaintiffs will say, well, even the professor on the other side says the television sets will sell for $800 a year into infinity because of this case. And I said, no, that can't be. They can't sell for that much. They sell for $100 now. They are not

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going to go up to 800, trust me.

But my point is, the predator wants the period of recoupment to be long, not the period of predation to be long. The financial rewards that a successful predator is going to enjoy is the present value of the sum of each period's future return once the target has conceded the battle.

Now, remember, a business firm has some hurdle rate or internal rate of return before it signs onto any investment project. Signing on for a predatory pricing strategy to an economist is no different. The higher is the hurdle rate, the bigger and longer the monthly returns have to be during the period of recoupment.

And Grant, if you could show my first slide, please.

In my experience, if one plays with the math that I have at the top, which shows the monthly sacrifice and the hurdle rate and the time period versus the monthly return, it's hard to look at past episodes of predation and come up with examples where recoupment is mathematically possible. To my mind, when I try to teach my students just the basic economics of the elementary price theory level class, the important asymmetry for predation is the one in the little box at the bottom, if you can see it on the slide, slow entry...
but quick exits by target firms.

Putting the math aside, putting even the
diagrams aside, if there is slow entry but quick exits
by target firms, then there's a possibility that
predation can be successful. There's got to be, in
other words, an economic asymmetry between exit and
entry conditions in the market, and think about what
that means. In most markets where entry is easy, exit
is easy. So, predation simply won't work in those
markets. And in like fashion, in markets where entry is
difficult, that helps an aspiring predator, exit will be
slow, and that is bad news for an aspiring predator.
So, what the successful predator needs is a market
setting where exit is quick, but entry or supply
expansion is slow.

Now, in the Spirit-Northwest case, one of the
factors persuading me that predatory pricing was
plausible or rational for Northwest was because the exit
of Spirit, that was the target LCC, the target low-cost
carrier, took place quickly, but re-entry and supply
expansion was difficult. Spirit Airlines pulled
capacity out of Detroit quickly when Northwest cut its
fares in the two markets that Spirit served, but Spirit
could not enter and expand rapidly during Northwest's
recoupment period, because Spirit faced an entry barrier

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in the form of access to gates at the Detroit Airport.

Now, I went into the Spirit Airline case as someone from Missouri or Chicago, maybe either metaphor fits, but I ended up concluding that Spirit was a victim of predatory pricing by Northwest, and I'll just say as an aside, this is a case in which Fred Kahn should have testified and not myself. Professor Kahn knows more about the economics of airlines than most any group of economists combined, but he was unable to participate, though he was convinced that predation took place, as I slowly -- kicking and screaming -- came to conclude.

The pricing trends in the Spirit case are a textbook example of what predatory pricing would look like. If I could have the first slide, this shows the prices in the Philadelphia area -- I think the first one -- yes, in Philadelphia. There were two city pairs, Detroit, Boston and Philadelphia, and you will see that Northwest prices in both of these are high. Spirit enters; Northwest prices fall dramatically. Spirit exits; Northwest prices jump up. If you show the other slide, you will see basically the same scenario.

Now, these price trends -- I want to stress this -- they are merely suggestive. They are not dispositive of predatory pricing. Once a pricing scenario like this is observed, then there follows the
mind-numbing exercise of comparing revenues with some
measure of variable costs, and this is a difficult task
in the best of circumstances. It is by no means simple
in the airline passenger industry. In the Spirit case,
this was a battle between Professor Ordover, Janusz, for
Northwest, and Dr. Dan Kaplan was the economist for
Spirit. There was also a recoupment analysis done by my
colleague David Mills.

Briefly, from my perspective, going back to the
little box on the bottom of my first slide, one key to
the success for Northwest was simply how quickly Spirit
exited and the duration of the recoupment period, and
that's consistent with the first slide that I presented.

I was going to show one more slide, but in the
interests of time, I am going to pass on that.

Let me conclude this way: Antitrust always has
surprises. That is one of the reasons I have enjoyed
being an antitrust economist all these years. Let me
close by mentioning the surprise for me in the Spirit
case.

At the last minute, Spirit's attorneys suggested
that a price below average total cost but above average
variable cost could be predatory, and the Circuit Court,
at the tail end of its opinion, seems to suggest that at
least in the market circumstances of this case,
Northwest's conduct may have been predatory even if its fare structure exceeds, as the Circuit Court put it, and I'm quoting here, "an appropriate measure of average variable costs."

Now, Spirit's attorneys were pleased with this little present, I am sure. I can restrain my enthusiasm for the way the Circuit Court closed out its opinion. This might take us into a more European view of predation under Article 82, where prices greater than average variable costs might be construed as predatory and where, as I understand that in Europe, there is a continued interest in intent documents and there is no recoupment requirement, again, as I understand it.

Like most economists, I can restrain my enthusiasm for the misuse of intent documents. I hold the opposite view here of what had been the conventional view in antitrust. To me, pugilistic and militaristic metaphors are a welcome signal, not of predation, but of competition in a market that doesn't have a stodgy "live and let live" oligopoly setting, and where you see those documents, to me, the prima facie case is that consumers, albeit not rivals, but consumers are the beneficiaries of head-to-head competition and not predation.

MR. POTTER: Thank you.
MR. POTTER: Our second speaker today is Professor Janusz Ordover. Professor Ordover is a Professor of Economics and a former Director of the Masters in Economics Program at New York University, also Director of Competition Policy Associates in Washington, D.C. I first met him when he was the Deputy Assistant Attorney General for Economics in the Antitrust Division.

While at the Antitrust Division, Janusz was a member of the White House deregulation task force. He guided economic analysis of antitrust enforcement and acted as a major liaison between the Justice Department and various regulatory agencies.

Professor Ordover has written extensively about predatory pricing and has a great deal of experience as an expert witness in predatory pricing cases. He was an expert for the defendant in the Division's American Airlines case, and he is, as Professor Elzinga said, an expert in the Spirit versus Northwest case on Northwest's behalf.

Professor Ordover, welcome.

(DR. ORDOVER: Well, while we're getting set up,)

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thank you very much. It's always a pleasure to participate in these kinds of hearings.

Predation, of course, marks a lot of my antitrust life. The first time I unveiled my thinking on the subject of predation was about 1980 at the FTC hearings on predatory conduct, and at that time, I think I was attacked -- Professor Willig and I were attacked by Frank Easterbrook, David Scheffman and Mike Scherer, so essentially from left to right, everybody thought we were completely foolish, and Mike Scherer said it was the worst antitrust paper ever written, unlike the Areeda-Turner paper, obviously, has its own different reputation.

And then, just a few years ago, it was my misfortune to fly into Ken Elzinga, who has never seen predation other than the case that I was involved in. Something is wrong here. So, I don't know what's wrong, but I guess maybe I will switch careers in my waning years.

In any case, what I wanted to do today is to quickly run through some of the ideas that I have been toying with in the antitrust predation field for some past 20-some odd years and perhaps follow up on some of the comments that Ken made, although I will not try to relitigate Spirit versus Northwest. This will have to
await Northwest's exit out of bankruptcy. So, unless
they get into bankrupt predating, but you never know.
So, now we are in a holding pattern until somebody
coughs up some money and we can actually go back and
litigate the antitrust part of the airline life.

In any case, what I wanted to do was just go
through a few slides focusing essentially on some of the
issues that have been discussed over the years, and that
is how to analyze challenged conduct from
monopolization, particularly paying some attention to
predatory behavior.

I was going to simply jettison this whole talk
by simply saying one should have no price predation
cases, but I thought that would be too quick an exit, so
I have to torture you for a bit longer to convince you
maybe that we should think about it as a possible
solution to our woes in this antitrust patch, without,
at the same time, suggesting that we should throw out
all kinds of scrutiny of firms' conduct, which consists
of much more sophisticated pricing from other aspects of
what they do, behavior, what I would often call
competitive response package, which is I think a term I
coined for my testimony in U.S. V. American Airlines,
where actually American Airlines' behavior was not just
simply pricing but involved a lot of other things that
the Government alleged were designed to, in fact, retain
or maintain or defend American Airlines' position at its
hub, Dallas-Fort Worth.

So, I'm always thinking about competitive
response packages as strategies designed either to exit
the rival or to prevent the rival from coming in or
possibly designed to contain the rival, and I think it's
the last category of strategies which I believe is of
great interest and perhaps should be given a little bit
more time than we often do.

But in any case, the question becomes, how
should the decision-maker delineate conduct that does
not harm competition by harming scarce rivals from
standard, day-to-day market interactions? And
economists have been pulling their hairs out since
Areeda-Turner, 1975 paper, so we are now in 31 years, 30
years of thinking about it, and there is no solution as
evidenced by the articles in the latest Antitrust Law
Journal, where everybody is still fighting over
important things but without actually coming to any
particular conclusion.

I have been associated over the years with
something called the sacrifice test, but I always
thought of sacrifice test actually as a version of the
welfare test. In other words, what attracted me and
Professor Willig to thinking about the so-called profit
sacrifice approach to delineating procompetitive versus
anticompetitive conduct, or at least neutral from
anticompetitive conduct, was the notion that at least in
some well-defined range of circumstances, these two
tests ought to give a pretty close set of answers.

In other words, that one was not -- that is, the
sacrifice test -- was not somehow biased, setting aside
the difficulties of implementation, but it somehow was
not biased one way or the other against deterring what
would be anticompetitive conduct or what would not be
anticompetitive conduct, relating to too much conduct
that, in fact, would be harmful. We have been able to
show in a variety of circumstances -- in fact, these two
tests coincide for the very simple reason that a pursuit
of profit, which is the engine of market economies, in
fact, is a kind of behavior that generally or frequently
does, in fact, conduce to welfare maximization. Seeking
profit is a good thing, it is not a bad thing, and
therefore, it is not surprising that if you write down
your economic model correctly, or at least correctly for
the purposes at hand here, that in many circumstances,
these two tests will give you the same kind of answer.

So, there might be, however, a range of
circumstances in which these two tests fall apart by
virtue of the fact that the basic condition under which
they do coincide is potentially difficult to meet, and
that condition is incompassively stated as the third
bullet on this slide, but the basic idea here is that if
the incumbent firm can effectively, without creating
additional distortions, extract profits by its pricing
strategies and other strategies, then any strategy that
actually lowers the profits relative to that extraction
ought to signal, at least as a first step to the
analysis, ought to signal that a firm may have some
other aims in pursuing that strategy, something that I
think Bernheim and Whinston have now been calling over
the years as trying to create market power in what's
called a noncoincident market, okay?

So, the action takes place in market A, assuming
we have it well defined, but the goal essentially turns
out to be gaining incremental power or preventing
erosion of power in some other market, which Schullman
called a noncoincident market, let's say, which could
be, in Areeda-Turner world, it could be the same market
but in the future day, okay? So, what's the meaning of
noncoincident market is actually a little loose, but
that's the term that at least Berheim and Whinston in
their fine unpublished monograph on exclusionary
behavior utilized as a view for analyzing this kind of
situation.

So, it could be a setting in which the whole thing works beautifully. An example is an inferior source of supply, this is the second thing which I think is quite ubiquitous, in which the incumbent firm is faced with competition from another firm or a firm that constrains its ability to exercise pricing freedom, which provides an inferior product, and therefore, enables the incumbent firm to earn supra-competitive profits, at least profits higher than some rents, but getting rid of that firm would, in fact, lift the ceiling and therefore would enable the firm to raise the price even higher.

The problem turns out to be that maybe exiting that firm may be just very difficult; however, a circumstance that we have analyzed, Willig and I, under the rubric of systems competition, informs a view of the circumstance in which actually disabling a component that the other firm needs in order to be a full-fledged parcel, bundle and bundle competitor with the incumbent firm will, indeed, lift the ceiling and therefore enable the firm to exercise incremental market power. So, the idea that we have pursued, and the idea which I think is actually fruitful, is that in many circumstances, the goal of the competitive response package is not
necessarily to kill or to weaken or to disable the person that or the firm against whom this conduct is being perpetrated, but rather, to try to lessen or weaken some other kind of restraint which cooperates complimentarily with the firm whose market presence is being weakened.

I think if you look at these Microsoft cases, some of which were discussed along the same lines, this is a fruitful way of thinking about it, but you can immediately see that the economics of the situation is much more difficult than the one instance in the Areeda-Turner case, which is drop the price below some level of cost, you go perhaps profit-negative, assuming you know how to calculate profits, you know how to calculate revenues maybe, you know how to calculate costs maybe, and you can compare the two and see what happens, you are losing money, and as a result of which, it is anticompetitive.

But in the situation like this, you don't have to be losing money on anything unless you try to look at the situation in a somewhat different way, which is where the efficient component pricing rule tells you how to look at that situation that I have just described. The efficient component pricing rule for those of you who are not regulatory freaks like myself is a rule that
tells you what the price of a scarce bottleneck should be if it does not involve any kind of profit sacrifice, okay? So, ECPR is a way of thinking about pricing access, pricing access to the component that is needed in order for the firm to be a viable component system or system competitor.

Another example along the same lines, which again focuses on a complicated pricing strategy, not simply dropping price below some measure of cost, was discussed in Ortho v. Abbott. Actually, I worked for Ortho in that case, and there the situation was, again, packaged pricing of a very interesting kind, in part interesting because the buyer insisted on firms offering not only unbundled pricing, but also bundled pricing with a different number of components put in. The buyer needed to buy five tests. There was a regulatory presence out there that required that every blood screening used five tests at that time, I think now it's six, and Abbott was the one that could offer five of them, Ortho could only offer three.

Then the question was, could Ortho compete against Abbott if it did not get the access to the remaining two, either because the buyer could create the bundle or because Ortho could buy the necessary input and then resell the bundle? Again, in this case, it
turns out that there is some discussion that potentially
Abbott was pricing the incremental two tests at levels
that were unprofitable, that violated some version of
what we called a second ago the efficient component
pricing rule.

What was very complicated in that case was, A,
that Ortho did not give me any cost data. So, I
couldn't say anything, whether it was true or not, but I
did derive the test on a napkin, so other than the
Laffer Curve that also was derived on a napkin, this is
probably the second most famous napkin in the history of
economics. But in any case, the point I'm making is
that in this case at least we had a way of dealing with
an issue, but we had no reason to explain why this was
going on, and I think that's a very important aspect of
any predation case, which is that the plaintiff makes a
clear connection between the conduct that is at issue
and the anticompetitive impact that is being challenged
as leading to this anticompetitive outcome down the
road.

Virgin versus BA, another complicated case that
pitted Bernheim against Schmalensee, actually a
beautiful battle -- I think it was Schmalensee -- of
battle in IO, in which, again, there was no simple
pricing strategy, but rather, a complex pricing strategy
that Bernheim showed leads to an equilibrium in which
there's relatively cheap exclusion but in which no price
is technically below marginal cost, simply understood,
yet as we know, all of these tests that we have in front
of us do have some flavor of comparing something to
cost, and again, what Bernheim tried to demonstrate in
that case, that a simple comparison of price to
something like marginal cost may be a flawed way to go
if you put that pricing in a strategy that British
Airways allegedly developed in a broader context.

Quantity-forcing contracts, I think we will skip
that, only because we have to, A, rush, and B, we will
talk about it in the fall, so I am going to skip that
unless it comes up in questions.

Just because I don't believe that true price
predation is an antitrust offense that is of great
interest, it does not mean that we as economists and you
as enforcers do not have plenty to focus on. I believe
that business strategies, these competitive response
packages, that have a strong commitment value, are
actually a more relevant focus than just simply pure
price predation, which creates all types of problems as
these papers in ALJ demonstrate.

Commitment to discount, which is Virgin versus
BA, commitment to product design, commitment to defend
lucrative markets, which I call the "new era" tying
models, network economies, commitments to effectively
raising rival's cost of competing, are the types of
strategies that we are now slowly beginning to
understand with the help of very fancy economic models
and beautiful game theory.

The question that I think we will have to leave
for Patrick to help us answer is whether or not we can
actually fashion workable tests that will take into
account these kinds of complications that economists
have been focusing on.

Thank you.

(Applause.)

MR. POTTER: Thank you, Janusz.

Our next speaker is Professor Patrick Bolton.

Professor Bolton is the David Zalaznick Professor of
Business. He began as Assistant Professor at U-Cal
Berkeley, then moved to Harvard. Then he was the John
H. Scully Professor of Finance and Economics at
Princeton University.

Professor Bolton's research and areas of
interest are in contract theory and contracting issues
in corporate finance and industrial organization. One
of his particular areas of research is the impact of
strategic economic game models on predatory pricing
theory.

Professor Bolton, welcome.

DR. BOLTON: Thank you, Bob. It's a pleasure and an honor to be on this panel.

Unlike Professors Elzinga and Ordover, I have no experience as an expert, haven't had that pleasure, and if you want, I'm a new entrant. We will see whether this will elicit predatory response from the economists.

So, my interest, as Robert just alluded to, my interest in this topic came from reading the original McGee article, which claimed that predation couldn't be a rational economic strategy, and, you know, I read this article again and again, and I just was not convinced, and this led me later on to write a theory piece with David Scharfstein where we outlined how predation could be a rational strategy if it took the form of financial predation, and I will say a little bit more about that in my presentation.

And then later, I had the good fortune of meeting with Joe Brodley, who introduced me to the new developments in policy under Brooke Group and highlighted some of the problems with the new policy and also some of the new opportunities and challenges, and that then led to our, in my view, very fruitful collaboration on our article, which I will make the
centerpiece of my brief presentation today.

So, I thought I would start by saying first, you know, where are potential areas of agreement among economists and legal scholars and where there are still areas of disagreement. I would argue that this is relatively easy, that we are all in agreement on the general definition on predatory pricing. Namely, it's a price reduction that is only profitable because of the added market power the predator gains from eliminating, disciplining or inhibiting the competitive conduct, and to summarize what both Professors Elzinga and Ordover said earlier, you can distinguish two phases in any predatory pricing episode, a sacrifice phase and a recoupment phase. As Professor Elzinga wrote elsewhere, you can think of predation as an investment in market power. So, I would say that there is general agreement on this characterization.

Where there is more disagreement is on policy, and, well, there had been long disagreements on basic economic premise, whether predation is an economically rational strategy and how prevalent predatory pricing episodes are. My sense is that this is an area of convergence, at least on the first bullet point. I think nowadays it is more and more widely accepted that predation can be an economically rational strategy.
On the second bullet point, I think there are still some areas of disagreement, but I would argue that over time, things have moved in the direction of thinking of predatory pricing as being more prevalent than we thought before and also more likely to succeed than we thought before, in part because our initial beliefs were built on writing, McGee's writing, suggesting that it couldn't be rational, and those writings, I would argue, are now obsolete.

There are, however, still very sharp disagreements on the legal standard. Some people argue that we should have simple rules. Others have argued that we should always err on the side of under-deterrence to reduce the risk of false positives, and the policy under Brooke Group is characterized as both being simple and under-deterring. I would argue against this.

Now, let me skip the description of Brooke Group, because I imagine most of you are familiar with it, so it involves both a cost test and a recoupment test, and let me emphasize potential problems first with the new policy, and namely, when we look at the facts on what happened post-Brooke, what we find is that since Brooke, plaintiffs have not prevailed in a single case, and almost all cases have been decided by summary
judgment, and it is only very recently that we are
seeing some action on predatory pricing, particularly in
the case of Spirit versus Northwest.

So, what are the problems with the present
policy? Well, first of all, and I think we will discuss
this later on in the question time, I would argue that
the basic problem with the present policy is that the
cost test is highly unreliable. Professor Elzinga
earlier qualified proving a cost test as a mind-numbing
exercise. I would fully agree with that. I would say
that when you go into the details of trying to prove a
cost test, you will lose track of the economics of the
problem and of the case, and in particular, a very
narrow interpretation of the cost test, price being
below average variable cost, is a very poor proxy for
measuring profit sacrifice, which is what we are trying
to go after.

Another problem with current policy, we have
never gone to a point where we had to ask about a
possible efficiency defense on the part of the
defendant. There has never been any talk of applying
the same rigorous recoupment criteria that the plaintiff
has to fulfill on the defendant in proving an efficiency
defense. I would argue we should go in that direction.

But just to emphasize, I think that the major
problem with present policy is its failure to focus on
the main issues, and those are what is the predatory
strategy, what strategy drives alleged predation, first
of all, and second, what are the possible dynamic
efficiencies and how do you balance procompetitive and
predatory effects? And this is where our article takes
off and proposes an alternative approach, which I would
summarize as taking away some weight off the cost test
and emphasizing instead intent, bringing back intent,
but intent as structured by an economic analysis, and so
this is what in my short time I want to briefly go into.

So, specifically, we are thinking that any
approach based on intent should be based on strategic
analysis of predatory pricing, and in our article, we
emphasize at least two well-proven strategies, which are
financial market predation and reputation effect
predation. We also discuss test market predation. Of
course, as Professor Ordover highlighted, predation can
take many different and complex forms, and one should
not necessarily reduce one's self to just those few
strategies, and one should allow for any
well-articulated and rational strategy that might be
used. I might comment on that later on.

Anyway, so what we argue in our paper is that
this approach has two advantages. One is that it can
reduce the risk of false positives, and second, that it 
puts the spotlight back on what we are really trying to 
determine, which is discriminate between procompetitive 
and anticompetitive effects, and there we can use intent 
as our guide, evidence of intent as a guide to possible 
defense, and what I mean by intent is not what Professor 
Elzinga has referred to as militaristic and pugilistic 
language, but evidence of a deliberate effort to exclude 
and evidence of pursuit of a predatory strategy.

So, in our article, we outline five legal 
elements to a predatory pricing test. Let me enumerate 
them first, and then I will go into some of them in more 
detail. The first element, which is straightforward, is 
there should be a facilitating market structure. The 
second element is the scheme of predation and supporting 
evidence. Third, probable recoupment. Fourth, price 
below cost. And those four elements would constitute a 
prima facie case of predatory pricing.

I have put the fourth element in brackets here 
to emphasize the fact that we try to de-emphasize the 
cost test, and we would agree with the appeals court 
opinion in the Spirit Airlines case that predatory 
pricing which is above some measure of average variable 
cost but below average total cost, that kind of pricing 
could be predatory. Then, however, we add, if you
de-emphasize the cost test, we want to add as a safe
harbor the -- allow for an efficiency defense.

So, how do we prove those elements? Well, some
of them are straightforward, and I will not go into --
so, facilitating market structure is any evidence of
market power. The scheme of predation and supporting
evidence, I want to give you an example of how you go
about doing this. So, I will in particular take out of
our article the example we have on financial market
predation, and so under this element, what is important
is to establish that the conditions to implement a given
strategy are present and to provide direct or
circumstantial evidence showing that this strategy is
being implemented.

Recoupment, again, this is relatively
straightforward. You would want to show evidence of
exclusion and disciplining of rivals, and we stressed
the idea that second, that you should emphasize probable
recoupment instead of actual recoupment, because what
matters is whether at the time when this strategy was
being chosen, whether at that time, at the time of the
information the incumbent had at that time, whether it
made sense to implement such a strategy, and we know, as
in our own investments in finance, we know that at the
time when we make a decision of investment, we make an
analysis using this kind of cash flows that suggests that we have a positive net present value investment, but that is no guarantee that when we actually undertake the investment, it will end up being profitable. So, we would emphasize probable recoupment, and in particular, put a lot of weight on market structure that makes recoupment likely in the future.

Let me also emphasize here the "or related" in brackets, and this is a point that Professor Ordover emphasized, that recoupment shouldn't just be seen in the narrow market where predation takes place. It could be obtained in a related -- I forget the term you used --

DR. ORDOVER: Noncoincident.

DR. BOLTON: -- noncoincident market.

On price below cost, I do not have much to add to what I have said already except that in the paper we emphasize that a better measure than average variable cost would be average avoidable cost, and a better measure for long-run average cost would be long-run average incremental cost. I do not want to go further into this, because making fine distinctions about these definitions could end up being a mind-numbing exercise, and it just highlights the difficulty with applying the cost test.
So, what I would like to emphasize, though, is that we would argue that failure to meet the cost test, in particular, failure to establish pricing below average variable cost, should not be grounds for a dismissal on summary judgment and that, in fact, the way to go would be to balance the cost test with an efficiency defense. So, I would argue that if you are able to show that there was pricing below average total cost but above average variable cost but that there was absolutely no efficiency defense, plausible efficiency defense provided, that that would then make a strong case for predatory pricing.

So, the efficiency defense, we spent a lot of time in the paper on that, because one of the weaknesses of the policy under Brooke Group and the Areeda-Turner Test is that it really neglects looking at efficiencies, and so we would argue that an efficiency defense does provide safe harbor in itself for price competition that benefits consumers, and we distinguish between defensive defenses and market-expanding defenses and provide in the paper an approach to proving those defenses. So, defensive defenses, we mean by unilateral best response mainly and minimizing losses from unexpected market developments, and as for market-expanding defenses, we really mean here promotional pricing, learning-by-doing,
and network externalities.

So, let me move on perhaps in the few minutes that I have left with an illustrative example. How do you prove financial market predation in a particular case? So, very briefly, the theory here, you know, what is financial market predation, why does it work?

Well, the reason why it works is because in corporate finance, there are imperfections -- and there is enormous literature on this -- there are imperfections in capital markets due to agency problems in lending, and as I have argued and have written in my paper with David Scharfstein, a predator can take advantage of those imperfections and drive out an entrant by basically drying up financing.

So, how do you go about proving financial market predation? So, we distinguish five essential preconditions. One, the prey's dependent on outside financing. The prey's outside funding depends on its cash flow. Three, predation will reduce the prey's cash flow sufficient to threaten its continued viability. All these are fairly straightforward. Four, the predator knows of the prey's dependence on outside funding or can be assumed to know based on easily accessible facts or rational conjecture. And five, the predator can finance predation internally or has...
substantially better access to external credit than the prey.

I think in the Spirit Airlines case, I quickly looked at it, most of these elements you would be able to establish.

So, the example we have in the paper is about entry into the cable TV market in Sacramento. This is a case that predates Brooke, and here are the facts. So, this is an entrant with outside financing amounting to $6 million, entered in a small district in the Sacramento area, the Arden District, serving 5000 homes, and the entrant's intention was, of course, to reach a bigger market share and expand gradually in the Sacramento area. The incumbent Sacramento TV company responded to this entrant with drastic price-cutting, and after eight months, the entrant exited. So, how would we prove a scheme of financial predation here?

Well, first of all, the dependence on outside funding, what do we know? What are the facts here? Well, first of all, the prey obtained funds through a loan, and the entrant's owners were unwilling to commit more capital than they had initially. Secondly, outside financing depends on cash flow. Well, the incumbent targeted its price reductions on the entrant's customers and potential customers, and that obviously had the

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effect of reducing cash flow. Predation will reduce
cash flow and threaten viability. Again, that is easy
to establish in this case.

The predator knows of the prey's dependence on
outside funding. Well, here it turns out there is
evidence, intent evidence, memorandum from the
incumbent's files that speaks of sending a message to
the entrant's bankers. Well, that's relatively easy to
establish here. And then finally, the predator has
better access to credit than the prey. Again, that is
an easy proof in this particular case.

So, let me -- sorry for having stepped over my
time -- so, let me just quickly conclude with
highlighting one potential concern with our approach,
and that is something that Posner mentions in his second
edition of his antitrust book, and he argues that one
concern one might have with evidence of intent is that
it's really "a function of luck and of defendant's legal
sophistication." So, we would argue that this concern
is reduced if the plaintiff is also required to prove,
as we articulate in our article, all the other elements,
and if what you are required to establish is the
implementability of a rational predatory strategy.

So, let me end with that.

MR. POTTER: Thank you very much.
(Applause.)

MR. POTTER: Our final speaker today is also the only lawyer on the panel, although Doug is very used to dealing with economists, so I am sure it will not be a problem for him to follow them.

Doug is a partner at Wilmer Hale, and he is the co-chair of the firm's Antitrust and Competition Department. He has significant experience in a number of government investigations, both government and private litigation, substantial antitrust counseling, and some of that counseling in investigatory work, in litigation work, has involved predatory pricing.

From 1996 to 2001, Mr. Melamed served as the Principal Deputy Assistant Attorney General in the Antitrust Division and then as the Acting Assistant Attorney General in the Antitrust Division. He's a prolific writer, a frequent speaker, always has interesting viewpoints that are well thought out. His most recent --

MR. MELAMED: Don't raise the bar, please.

MR. POTTER: -- his most recent article, which appears in the summer 2006 Antitrust Law Journal provides a thought-provoking commentary on whether there are unifying principles under Section 2.

Mr. Melamed, welcome.
MR. MELAMED: Thank you.

Well, I am a lawyer, and much though I enjoy
listening to economists and talking to them, I am going
to be talking as a lawyer now and giving a lawyer's
perspective on some aspects of the predatory pricing
issue.

Let me start by saying, I think Brooke Group was
correctly decided, an important decision, it brought
needed rigor and order to predatory pricing law, but I
am concerned about what has happened to it in the life
of the law. There is a kind of -- I do not know if this
is the right word -- a kind of rarefaction of Brooke
Group that I think has done some mischief, and let me
tell you what I mean.

As everyone knows, Brooke Group has proven to be
a defendant friendly standard. As Professor Bolton
noted, no plaintiff has won a predatory pricing case
post-Brooke Group. Not surprisingly, therefore, when
price is an element of the allegedly unlawful strategy,
the defendant argues that the standard to be applied by
the Court should be Brooke Group, and, of course, they
are entitled to do that, because if that's the law, they
ought to make that argument, and certainly I have done
that myself.

But if it is not a straightforward price-cutting
case, if it is a little complicated, the plaintiff says, "No, no, no, this was different, bundled discounts, aggressive buying, low prices conditioned on exclusivity or other preferential treatment and so on." So, you have a legal dispute. Does Brooke Group apply? Is this the right category, predatory pricing, in which Brooke Group applies, or does the conduct at issue belong in a different category?

And there is a kind of a notion that there is an apparent precision of Brooke Group, the price-cost test and the recoupment test, that is uniquely valuable but uniquely applicable to predatory pricing, and one consequence of this is that when the Court decides in this kind of stovepipe analysis that the conduct before it really should not be considered predatory pricing, too often, courts seem to find themselves in a kind of "deer in the headlights, what do I do now" posture, and the result is incoherent decisions like LePage's or courts affirming nonsensical and meaningless jury instructions like Weyerhaeuser and basically a casting about in the way that Professor Elhauge had spoke of Section 2 as a kind of incoherent mess.

I think this stovepipe or essentialist way of looking at predatory pricing has created these kinds of dichotomies as categorization, and it has inhibited the

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development of a more robust antitrust jurisprudence, one that can help courts make reasoned decisions about conduct that they do not think falls into a precise, well-established category, whether it be exclusive dealing or predatory pricing or whatever.

Put differently, instead of inducing from Brooke Group principles of broader application in the kind of common law tradition which antitrust has in other contexts involved, the process seems to have separated predatory pricing from other forms of exclusionary conduct, and it's done so because there has been in what I call this rarefaction a number of propositions about predatory pricing that are taken for granted or thought to be true or thought to be unique to predatory pricing, and I want to express some skepticism about that. There is a lot of these propositions I have in mind, four or maybe three depending on my time, and I want to express skepticism either that they are true or that they are unique to predatory pricing or perhaps both.

So, proposition one, to apply the price-cost test, we need to select some term of art from the economists as our measure of cost, average variable cost or something like that. Now, this is a big topic. I will make just a couple observations.

Almost everyone seems to agree that some kind of
incremental cost is the right measure, because we want
to know whether the allegedly predatory sales cost so
much that either the defendant must have intended some
predatory scheme or, at the very least, that the cost of
the sales exceeded the amount consumers were willing to
pay for them and therefore resulted in a welfare loss.

Areeda and Turner say, "Well, marginal cost is
the right test, but it's hard to prove, so let's use
average variable cost as a proxy," and now we have this
debate for 30 years, "Well, average variable cost really
isn't a good proxy, we should use average long-run
incremental cost or average total cost, may depend on
the circumstances," and you all probably read the
article, too, the discussion paper which went through
this discussion at great length.

Why are we even having this conversation? Why
are we debating these categories about technical
economic jargon that might have made sense in the
Areeda-Turner world in 1975, a simple static price
series model, and you can draw the ABC curve, the
marginal cost curve, and you can talk about these
metaphors, what's going on in the real word, but that
doesn't make any sense in the real world as I have
experienced it as a lawyer.

Areeda talked about additional increments of
output. I have rarely had a client say to me, "I'm thinking of pushing more widgets off my production line. How low can I go in price?" That's not how the problem comes up in the real world, and if it looks like that, there's a lot more going on.

The kind of predatory pricing problems I've counseled clients on in recent years are things like this: Price offerings to early adopters in a de facto standards war; prices in two-sided markets; decisions to assign a plant or an airplane to one market or one segment rather than another. In these situations, I think these terms of art that economists have, they are very valuable in their models and their heuristic exercises, don't have much value, and even if they have value to the economists, they don't have much value to the lawyer and the client.

What I find is valuable is saying to the client, when I'm talking about costs, "What are the costs you are incurring to engage in the strategy at issue that you wouldn't otherwise have incurred?" Clients understand that question, and it's not always a trivial question, but I think it's one they can answer. So, I think avoidable costs -- and I don't mean that as some technical term, I mean simply as the but for costs of the allegedly unlawful conduct -- is the cost measure,
okay?

Proposition two, price-cutting is beneficial to consumers, so we should therefore have a standard that errs in favor of avoiding false positives. Then Judge Breyer, in the wonderful "bird in the hand" metaphor, I think most famously perhaps articulated that.

Here is my concern: Sure, price-cutting is good for consumers, no question about that. So are all sorts of other things that companies do for consumers. In fact, as I understand, from what the economists tell us, that innovation does a lot more for welfare than improving allocative efficiency by some price cuts and supra-competitive down toward competitive levels. So, why don't we -- and innovation, by the way, could be inventing the PC or it could be coming up with an improved method of distribution because of tying arrangements or because of exclusive dealing. It could be anything that improves the value of the product to consumers.

In fact, cost of sale reductions could be beneficial certainly to a total welfare sense and ultimately to consumers as well. So, why do we single out price-cutting, which I don't think has any unique benefits to consumers?

Now, there is one thing about price-cutting that
is different, and that is it's unambiguously in the
interests of consumers. A product improvement, you
know, the car with the air conditioner might look like
it's better, but maybe consumers would rather have
better mileage. So, there is some ambiguity about
whether other forms of conduct benefit consumers, but
why do we have a legal superstructure built on the
premise that pricing is unique?

At some point, if we do that simply because it's
easier to identify the consumer benefit, don't we begin
to look like the economists searching for the keys under
the light post? At the very least, when the defendant
is able to show that his conduct is benefiting
consumers, why treat predatory pricing any differently?

Proposition three, the recoupment requirement is
central to and a great contribution to predatory pricing
law. Let me be clear. I strongly believe there should
be something like a recoupment requirement at least in
the sense of a market power screen; that is to say, a
plaintiff ought to have to prove that the allegedly
predatory scheme will pay off for the defendant by
creating additional market power or preserving market
power that will guard against -- kind of belt and
suspenders -- a mistake in the application of the
price-cost test, and it will preserve antitrust
violations for those cases where there is competitive harm, and we won't worry about the others.

I think, in fact, there should be such a screen in all cases of exclusionary conduct. The problem is, I think in many quarters, including some of my predecessors this morning, the recoupment test is understood to mean that the plaintiff should prove, should quantify, the defendant's investment in the predatory strategy and then quantify his supracompetitive returns during the recoupment period, discount them by risk and uncertainty and time, and conclude that the recoupment exceeds the investment.

Now, I think evidence of that sort, on that issue, whether introduced by the plaintiff or the defendant, should be relevant in a predatory pricing case, because it certainly illuminates the likelihood that what is going on here is some exclusionary conduct, but I am very skeptical of the notion that that should be an element of the offense. It clearly complicates the proceedings, increases costs. It may be an impossible burden for the plaintiff in a multi-market reputation effect recoupment story.

If taken literally, you would have to go to a profit-maximizing standard to figure out the defendant's investment in the predatory strategy, because you
wouldn't be asking simply what did it cost him below
cost, you would be asking how much in profits did he
sacrifice. It's not necessary in order to identify
anticompetitive conduct, because if we think we got the
price-cost test right and the guy is selling below cost,
you can actually, it seems to me, infer that he expects
to recoup. It's not needed, because the market power
screen will identify the cases of competitive harm. And
finally -- and this is a point that I don't know that
it's original to me, but I haven't seen it before -- I
think it is an illusion that we're measuring something
about the welfare effects of the conduct when we use a
recoupment screen.

The welfare question in predatory pricing is
whether the welfare gains, consumer or total, during the
rivalry period, the competitive period, are greater than
or less than the welfare costs, consumer or total,
during the recoupment period, but the recoupment test
doesn't measure either of those. The recoupment test
measures producer surplus in the competitive period
versus producer surplus in the recoupment period, and it
doesn't take a whole lot of imagination to think of
situations where the results could be different, where
you could have, for example, recoupment but no welfare
loss from an allegedly predatory strategy.
So, proposition four, in applying the Brooke Group price-cost test, the price of the product at issue is the appropriate price to compare to cost. That in my view is only partially correct. Obviously you look at the price of or the revenues generated by the additional sales attributable to the predatory conduct. You don't look at the price of, of course, the inframarginal units, the units that would have been sold anyhow, because those units didn't exclude the rival or at least they didn't exclude them by reason of the anticompetitive conduct.

But that's not all there is to it. Suppose we're in a two-sided market. Suppose you're cutting price on circulation of the newspaper in order to generate more readers and therefore more advertising revenues. Surely you want to take into account the incremental advertising revenues.

Suppose you have complimentary revenues. You know, the Government didn't accuse Microsoft of predatory pricing because the browser was free when bundled with the operating system. Because it was a plausible story that it increased revenues, we didn't -- increased revenues for the operating system. What about revenues lost from inframarginal sales; that is to say, the sales that the defendant would have made anyhow even

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if he had not engaged in the predatory scheme, but he
would have made them at a higher price if he hadn't cut
prices?

To me, another way of putting that question is,
are we concerned with the incremental revenues or the
revenues from incremental sales? The law chooses wisely
in my view the latter. It ignores the loss of
inframarginal revenues, I think -- I know Professor
Bolton may disagree with this -- I think the law wisely
ignores that, because if you want to go into those lost
inframarginal revenues, you have to have a profit
maximization test, you know, what would have been the
profit-maximizing outcome of the strategy, and that is
in most cases going to be virtually impossible it seems
to me for the Court to figure out and surely impossible
for the firm to figure out in real time when it's trying
to comply with the law.

As implied by my discussion a minute ago with
the recoupment test, it's not going to correlate with
the welfare trade-offs you are looking at, although it
may illuminate a little bit, but most important, it
seems to me, is that price cuts on the inframarginal
purchases, price cuts until they are below some measure
of cost for the incremental units, enhance welfare, and
they enhance efficiency, and we all know that story,
right, going toward the competitive outcome, and you
reduce dead weight loss.

So, it seems to me that we ought to ignore
inframarginal revenues. I didn't mention this earlier,
I meant to say it, but costs ought to include
opportunity costs, ought to include the cost of moving
allocating assets to the predatory scheme rather than
somewhere else. That's part of the avoidable cost it
seems to me.

Forgoing inframarginal revenues in my view
shouldn't be treated as an opportunity cost, at least
not for this purpose, because they are not a cost. They
don't involve the consumption of any resources. They
are simply a transfer payment actually from producer to
consumer, and I don't see why we should take that into
account in the calculation.

Okay, so what does all this come down to? It
comes down to, I think, predatory pricing law ought to
be looked at in a common sense way. Predatory pricing
law ought to be looked at straightforwardly as pricing
that is not efficient, that is to say, pricing whose
avoidable costs exceeds the revenues generated by the
sales in question, and thus, pricing that reduces
welfare during the rivalry period.

If it's efficient pricing, if it increases
rivalry during the welfare period, the competitive period, because consumers value the marginal units, or the compliments that they generate, more than the avoidable costs of those units, it seems to me we ought to call this competition on the merits, and it ought to be lawful.

Now, looked at this way, it seems to me, predatory pricing isn't all that special. If we think of it in this common sense way and simply ask where the conduct is efficient in this sense, we have both in my view a sound approach to predatory pricing and the beginning of a more general theory of exclusionary conduct that can avoid the pitfalls of the stovepipe analysis to predatory pricing.

MR. POTTER: Thank you, Doug.

(Applause.)

MR. POTTER: Before we begin our round table discussion, we will take a short maybe ten-minute break to let people use the facilities and stretch, and if they have to call their offices, call their offices.

MS. SCHULTHEISS: And coffee upstairs if they need it, 7th floor, if you need coffee or water.

(A brief recess was taken.)

MR. POTTER: In deciding how to handle the round table discussion, I thought maybe one of the effective
ways of doing this would be to put up various
propositions on the screen and then ask for agreement or
disagreement among the panelists. If there's agreement,
fine, we have reached a consensus point, we can go on,
and we have solved the issue, and if there is
disagreement, we can debate the issue. The panelists
all have this in front of them, so they do not have to
turn around and look at the screen every three seconds.

Do you want to put the first one up?

MR. POTTER: I think Professor Bolton already
indicated there might be convergence around this point,
but there used to be economic literature saying that
predatory pricing was an irrational business strategy.
The proposition for the consideration of the panelists
is that predatory pricing can be a rational business
strategy. Is there anyone on the panel who disagrees
with this?

DR. ELZINGA: There is no disagreement. I would
like to correct one matter for the record, at least I
think this is a correction. Patrick indicated that his
reading of John McGee's classic article on predatory
pricing in the Standard Oil case or the lack thereof
indicated that predatory pricing was always irrational.
I think that's unfair to Professor McGee. That is not
my exegesis of the article.
I think the position of McGee and the Chicago School generally is that predatory pricing can be a rational business strategy, it's just it's a very unusual one, defined where it's successful, where it works.

DR. ORDOVER: Well, I certainly agree with the statement, with a couple of -- I don't know how many caveats, but first -- five caveats -- one, two, three -- the first caveat is we have got to define what predation means. Second, we have to figure out what the price is. Third, we have got to figure out how to engage rationality. Other than that, I think it's all fine. Other than that, how was the performance, right? So, this is exactly the way I see it.

I mean, this is surely a statement that has a meaning as long as we can agree on the meaning of the terms or words that go into the statement. None of these things are relatively or clearly defined. We already have different standards for predation. In the airline case that Ken and I are in, pricing to whom is an issue that -- average price on the aircraft? Is it the price to the business passengers, the leisure passengers? A huge amount of disagreement. Is it the price of the incremental unit? Is the price averaged out over the volume that is being sold?
Anyway, what's rational? I guess profit-maximizing, over what horizon, what discount rates we are going to use? All of these things enter into what we have been struggling with, which is to say that we have something -- we understand a basic core set of issues, but I think these remaining areas of disagreement are really needed to breathe light --

MR. POTTER: And with the later slides, we will get into those specific areas.

DR. ORDOVER: I haven't looked at them. Ex ante assessment, huh?

MR. MELAMED: Just a comment provoked by what Janusz said, there is always -- at least in my experience in cases I have dealt with, I am not involved in Spirit -- difficult questions about what are the products you're talking about, what prices are you talking about, is it the leisure passengers or whoever it may be. There is, if there is discipline in the overall case, however, some discipline on the parties on that issue, if the plaintiff wants to argue that the price is predatory because he found one passenger in seat 14B where the price was below cost, he is probably not going to be able to prove that he was driven out of the market on account of the predatory price, and so if the courts are rigorous in connecting the allegedly
predatory activity with the requirement of proving a
causal connection with the creation or maintenance of
market power, some of the sort intellectual concerns
that Janusz has may become less practically important.

DR. ORDOVER: Actually, it was 15C that's at
issue.

MR. POTTER: Patrick?

DR. BOLTON: So, you know, I may well have read
too much into McGee's article. Having said that, I
think it does -- the legacy that's left is tremendous
skepticism, and what I wanted to say was that there has
been new scholarship started in the 1980s, rigorous
economic scholarship based on rigorous game theory
analysis showing exactly how predatory pricing strategy
could be rational, and I think what I want to say is
that where things have changed is that slowly, this
literature is being brought in, is being acknowledged,
and is being recognized, and so what I wanted to say is
that, if anything, today, we should be less skeptical
about the rationale for predatory pricing than we have
been and that the Supreme Court has been in its Brooke
decision and its Matsushita decision, which was based on
older writing which couldn't be articulated using the
tools of the modern game theory.

MR. POTTER: Okay, subject to Janusz's caveats,
I will take that as agreement among the panel.

The second proposition, this is a quote from the Supreme Court in 1986, two decades old now. "Predatory pricing is 'rarely tried, and even more rarely successful,'" was repeated in Brooke Group in '93. Does the panel think that this is still a correct statement?

Doug?

MR. MELAMED: Well, I don't know. I will leave it to the economists. The question is whether it means anything. You know, murder may be rare, too, in some statistical sense.

But I wanted to say something about that, because I think in my own thinking, at least, until yesterday when I was preparing for this, there was some sloppiness, and maybe that's true of others, as well. In Matsushita, interestingly, when I looked at it, that was when the proposition was first set, it was used as a factual proposition to aid the Court's assessment of the evidence and to say is the predatory theory here sufficiently plausible that we should let it go to the jury?

It morphed into something else by the time of Brooke Group. It morphed into the rationale for defining predation a particular way. If it's used that way, we have to be very careful about what we mean. If
we mean pricing below cost is rarely tried and even more
rarely successful, it's rationally then used in
Matsushita, but it doesn't support Brooke Group, because
that would be like saying killing with an ice pick is
very rare, so let's define murder as consisting solely
of killing with an ice pick.

The question, if you want to justify or explore
the wisdom of defining predatory pricing as pricing
below cost, the question is, what about the conduct that
isn't deemed to be predatory pricing by that definition,
some kind of profit sacrifice at above cost levels, is
that rarely tried and rarely successful? And I'm just
not sure that there has been rigor in thinking about
what this statement means.

MR. POTTER: Building off of this slide, does
anybody have a view on whether predatory pricing is more
or less likely in certain industries because of the
characteristics of those industries?

DR. ELZINGA: Yes, I certainly do. I have a
belief that predatory pricing is more likely to occur
where the target firm will exit quickly and be unlike --
either the target firm or other capacity will be
unlikely to enter again, and just picking up on
something that Doug said, where you are trying to look
for some more simple benchmark, he suggested just
focusing on where avoidable costs exceed the revenues of
the practice, well, that's a very helpful way of
thinking about predation.

I think it's just as powerful, maybe even more
illuminating, to focus on entry and exit conditions as a
kind of filter, and I am a little surprised that Doug
never mentioned focusing on exit and entry. That is
kind of the mirror image of what he is getting at, but I
think it is clearer and analytically more robust.

MR. POTTER: Janusz?

DR. ORDOVER: Well, I think certainly by the
basic principle of self-selection, you at least observe
an attempt to induce an exit in the industry in which
exit is likely to be relatively quick or not too
costly -- it will be not too costly to engage in such a
strategy and in which, as Bobby and I said, re-entry is
very difficult entry or re-entry is very difficult. If
re-entry is trivial, as it generally could be in the
airline industry, setting aside the question of
signaling predation, setting aside gate constraints and
those kind of things -- which were not present in
Detroit, just by the way.

I think that obviously nobody in his right mind
is going to try to exit somebody who has invested
hundreds of millions of dollars of sunk capital that is
simply impossible to take out, but you can try very
aggressively and actively to prevent that person from
putting in another hundred million dollars of to-be-sunk
capital. So, you can try to accomplish something
different, but actually self-selection and rational
business behavior that we have all accepted as a premise
of what firms do, such as that you are not going to try
it when it is not likely to be successful, which is why
when we get to the recoupment phase of this whole thing,
we will probably have different views from what the
slides will ask us to say, but it is all part and parcel
of the same aspect of the analysis, which is to say, you
have to look at the entry and re-entry barriers and the
exit barriers or problems with trying to dislodge the
rival or problems with the ability to increase the entry
or impediment facing the incumbent. If you cannot
accomplish entry-enhancing creation of a barrier, then
you are not likely to go after that, because somebody is
going to come back sooner or later. How soon is
unpredictable.

DR. BOLTON: I have very little to add, just two
remarks. There used to be a time when economists
characterized the airline industry as a contestable
market. I just want to remark that we have come a long
way from that conclusion. Now we are I think defining
the airline industry as particularly prone to predatory pricing.

And on the rarely tried and even more rarely successful, I want to be even more outrageous by saying that, you know, nuclear bombs have been rarely tried, but they have been very successful. We have to look at the deterrent effect of episodic, very rare predatory pricing. So, you know, you look back at predatory pricing in the telecom industry at the beginning of the century or in the tobacco industry, it was followed by prolonged periods of lack of entry and oligopolistic pricing with very high returns to the firms, which is evidence that consumers were not getting the low prices that they deserved.

MR. POTTER: Proposition three, because lower prices immediately benefit consumers, we should be extremely careful not to adopt legal rules that can result in false positives; that is, condemn legitimate price-cutting. This seems to be a fundamental basis of Brooke Group, at least. Anybody have any agreement or disagreement with this? First say agreement.

DR. ELZINGA: Agreement certainly for me.

DR. BOLTON: I beg to disagree on the following grounds, not in principle, but on the basis of the evidence. How concerned should we be about false
positives today after a quarter century of systematic rejection of predatory pricing allegations? How worried should we be today that firms will be very cautious in their pricing and will refrain from aggressive pricing after this record?

I think in principle, we should be worried about this, but I am not sure that with the past history of predatory pricing enforcement that this is still a major concern.

MR. POTTER: Ken, I think you wanted to comment.

DR. ELZINGA: Yes, let me comment at two different levels.

First of all, there is no doubt, since Matsushita, that the economists have taught us things that we did not know at the time about models in which predatory pricing can be successful for the predator under conditions of certain financial asymmetries or information asymmetries or information effects, but if you look at some of the cases, the most recent, I think, or if I'm mistaken, the most recent predatory pricing case brought by the FTC, a long time ago, was the coffee case, General Foods Coffee case, and the staff was unsuccessful on that.

When we look at the record, did Maxwell House, which had all the things that would fit nicely into this...
model of reputation effects, signaling and so on, where you might think, boy, this looks like predatory pricing, the way the game theorists would structure the world, and people like Milgrom and Roberts have referred to that case as illustrative of applying their models to predatory pricing.

Well, that was a case in which Maxwell House was trying to keep Folgers from moving east. They were singularly unsuccessful. Folgers rolled out nationally, and if you walk around a bit, you just don't see Maxwell House of having visual evidence of being a monopolist in the coffee industry today. You are much more apt to see Starbucks than Maxwell House.

Matsushita, you think about the signaling effects or the reputation effects that the Japanese had and the popular culture at that time about being price-aggressive. You look at the television industry today -- now remember, this is a case the Japanese won -- they have less than 40 percent of the television business, total, all the companies combined. The largest television producer in the world is in China.

Brooke Group, the idea there was the majors, led by Brown & Williamson, would dial down the discount segment. That was a term used over and over again in Brooke Group. The discount segment would be dialed
down. Everybody would be left buying a full revenue cigarette if they were a smoker.

The discount segment continues to grow. It's about 40 percent of the industry now. So, if all of these cases had been decided differently using game theoretic approach or a concern that Patrick expresses, I think consumers would be worse off. I really do.

MR. POTTER: Janusz?

DR. ORDOVER: One comment. I think that there is an issue that we may want to talk about a little bit more, and that is to say, the rigor and the reviews of the galaxy of predation models that are based on really state-of-the-art game theory, and the question, what follows from those in terms of public policy? To me, that is the biggest problem that I have been totally incapable of resolving in my own head, but in the end, coming down on the proposition that while we cannot be as perhaps lackadaisical about anticompetitive exclusionary behavior as the Court in this famous quote was, we still need to take some kind of tools that the courts can use to say, yes, yes, I agree, things can happen, and Milgrom and Roberts and Kreps-Wilson, they all have shown all those things, and many others follow and, you know, your lovely paper with Scharfstein on -- what, signal jamming or -- it was, signal jamming paper,
which was the coffee case, and all those things are all true.

And then we come back to the question, what to do with that, how to translate it into something that a businessperson, who has to be counseled, will be able to understand in day-to-day operations, and how will the Court be able to take these principles of game theory, subgame perfect, Nash equilibria and all these things, and translate it into some simple rules that, you know, thou shall not do what? Thou shall not signal that you are going to be a tough guy? You can't say that. You have to be able to translate it into something. "Look, you can write any memos you want, you can do anything you want, but you cannot do X."

I think that it is absolutely essential that we take these models and we translate them into principles that are implementable by the business people, by the lawyers and by the courts. Otherwise, we are nowhere, and I think what we have been struggling with is trying to come to articulation of some principles that are actually understandable, and I think Doug went a long way in proposing that we actually take the learning of these models as implying we should not dismiss these cases, but we should take the learning of these models and figure out what they mean in terms of implementable
rules by all the stakeholders, and that includes, of course, consumers as well.

MR. POTTER: Doug, in your dealings with your clients, without a rule that is under-inclusive by protecting against false positives, is it your belief that monopolists wouldn't price close to the line?

MR. MELAMED: Ah, I'm not sure I understood the question. I think you are asking, should we worry about over-deterrence?

MR. POTTER: Well, if we don't protect against false positives, will the chilling effect of getting too close to the line lead people with monopoly power not to lower their prices to consumers because they're worried about false liability?

MR. MELAMED: Sometimes. I do not know whether the overall economy, with the relative magnitude, what its effects are. I particularly agree with how Janusz started. The signals you send to the business community are much more important frankly than whether the cases are right or wrong. If every case at the margin were wrongly decided but we were generally setting a useful set of standards, the law would be pretty good. So, the question is the false positives versus the false negatives.

Generally speaking, with the state of the law
today, you have a slide later on, is it hard to counsel
your client? No, I say not to worry about it, because
the -- but actually -- actually --

DR. ORDOVER: Can we go home now?

MR. MELAMED: But actually, I say more than
that. First I say you may lose the characterization
issue, you may not be able to prove predatory pricing,
but then I say, "Wait a minute, there are certain
settings in which you could get hurt. Is your target
likely not only to withdraw from this market but, for
example, to go out of business and become bankrupt and
his only asset may be a lawsuit? How litigious is he?
Is this a part of some broader commercial strategy?"
So, there are situations I think even with the
law today totally in favor of the weight of false
positives where it probably does deter some
procompetitive pricing. Whether on balance at this rule
or at some other rule that harm is greater than the harm
of false negatives I'll leave to the economists.

MR. POTTER: All right.

Next one, establishing a reasonable prospect of
recoupment should be essential in any analysis of
predatory pricing. Is there anyone who disagrees with
this statement?

MR. MELAMED: Only to the extent I already said
so.

MR. POTTER: Janusz?

DR. ORDOVER: Oh, I think the point I want to make is that from my perspective, this recoupment component is really part and parcel of a prior filter. Now, you can try to do it at the later stage. My preference is to ask the question whether the particular markets, market or markets, in which this anticompetitive conduct is alleged to be exclusionary, anti-consumer, whatever characterizations you want to attach, is acceptable to incremental exercise of market power, and if the answer is no because, you know, you get rid of this particular rival, but, you know, quick as a bunny, somebody else is going to show up who may be even more competitively advantaged rival, then there is no need to somehow construct this potentially complicated analytics.

As is clear from Ken Elzinga's net present value calculation, it is a very, very difficult step, possibly as difficult as the step of measuring revenues to costs, which costs which revenues and so on and so forth. So, I would say that as a filter, you certainly would want to implement a step during which the parties will slug it out, one saying, "Look, I get rid of you, there is ten more coming. I get rid of you, that will carry no
visible signal for the rest of the players that may be sitting out on the outskirts and waiting what to do."

Or it could be that the firm which you are trying to induce to exit or to restrain its expansion is what I called in the first slide a scarce competitor, and, in fact, there is something very special, very particular about that rival which cannot be replicated, and in that case, yes, you get to the point in which the assessment of this later recoupment or the implications of this strategy is critical, and if you cannot show -- you, the plaintiff -- that if you exit the marketplace or if you get cut back in the marketplace, economic welfare is going to be hurt in some way, then I think you have gone very far in challenging the conduct at issue.

MR. POTTER: Next slide -- oh, I'm sorry.

DR. ELZINGA: I was just going to say, I think I am saying just the same thing that Janusz said but perhaps in just a couple words. I do not think you need to do a recoupment analysis for many predation allegations, because entry conditions or prices and costs will tell you you needn't take that extra step.

DR. BOLTON: Can I just add --

MR. POTTER: Sure, go ahead.

DR. BOLTON: -- one comment? So, I agree with
Janusz that in principle, recoupment is important, it is the right question to ask, but in terms of how do you administer a recoupment test, I think the weight has to be on what you call the reasonable prospect, and I think a narrow reading of a recoupment test, as you criticized earlier, I would criticize as well.

MR. POTTER: Okay, fair enough.

Next slide. Prices above some measure of cost, and you can all pick your own measure of cost that you think is the best cost, whatever it is, should not be considered predatory. Is there anyone who disagrees with this?

Patrick, do you want to say anything?

DR. BOLTON: So, from the -- well, we know that a policy of -- after Brooke Group is that a price -- at least a price above average total cost should not be considered as predatory. I am happy to live with that, although I am not sure that it is always a wise policy.

MR. POTTER: When it is --

DR. BOLTON: I would disagree, though, with the statement that prices above average variable cost should not be considered as predatory.

MR. POTTER: You just mentioned that you might disagree in certain instances that even prices above average total cost should not be predatory.
DR. BOLTON: Could be predatory. In principle, in theory, there are situations where prices above --
even price above total cost can be predatory.

MR. POTTER: Can you give an example of those?

DR. BOLTON: Well, an example of a large incumbent with increasing returns, scaled technology,
facing a small entrant that has not been able to reach minimum cost capacity, you could exclude that entrant by pricing lower than monopoly price but still above your average total cost and exclude the entrant.

DR. ORDOVER: Maybe I could just ask you a question. Would you comment on the cost principles -- I have been puzzled by them myself -- that follow from these various game theory like models of, say, Kreps-Wilson? They do not seem to give clear cost benchmarks. Is that true? Is that your reading as well?

DR. BOLTON: Yes, that is correct. They do not give a clear reading on cost benchmarks, and I think there is a whole group of economists who have been working on predatory pricing who think that costs are a very poor way of discriminating between anticompetitive effects and procompetitive effects, that there are as likely to be false positives as there are to be false negatives. There are many situations where pricing is
below even average variable cost, and it is efficient.
It is not predatory. So, a lot of economists feel it is just a poor test.

MR. POTTER: Doug?

MR. MELAMED: Let me ask Patrick this question. I understand the theory, even if I cannot understand the game theory, of why an above cost, even above total cost, but below profit -- monopoly profit-maximizing test could be predatory in the sense that it could exclude a rival and in the long run we are all going to be worse off for it.

What I don't understand and I am interested in your reaction to is how one turns that into a legal rule that companies can comply with. I mean, how do you -- you know, if -- sure, if you imagine -- if you posit a stable market on day one and then the entrant comes and maybe you have a good historic benchmark and you can say, "Gee, he's changed his pricing," but even then you have to ask the question, "Well, what would the monopoly profit maximizing price be with the new entrant?" Is each company supposed to hire a game theorist and work out the game and figure out --

DR. ORDOVER: Yes.

MR. MELAMED: -- what the price is? In other words, how do we implement that test?
MR. POTTER: Patrick is looking for future employment.

DR. ORDOVER: We all are.

DR. BOLTON: Administerability is a serious concern, I take that. I'm happy with a rule that says -- I would not object to a rule that says price above average total cost is per se legal as a way of implementing an easily administrable rule.

As for determining whether it is procompetitive or anticompetitive conduct, I think there -- while business decisions are taken on average in a rational way, and you have to get justifications for the kind of policy you are implementing, these justifications often find their form in written documents in the company, whether it is emails or other board room records, and as I emphasized in my presentation, this is evidence of intent, which is extremely valuable. Intent here, that kind of intent evidence, is a very good guide to the kind of effects a policy can have, and there, I think we can be on pretty firm ground, and we do not have to do -- we do not have to hire a game theorist to do that kind of analysis.

MR. MELAMED: Sometimes companies adapt to the law, and if they are well counseled, they know how to write pieces of paper that perhaps articulate an
economic rationale rather than intent.

DR. ELZINGA: And in like fashion, Doug, I suspect you have encountered clients who just aren't aware that when they write things, they have to be written with an eye towards antitrust enforcement, and so you do find documents coming -- to have militaristic or powerful metaphors that have nothing to do with consumer welfare and may, in fact, represent exaggerated views of the company's prowess and stature in the marketplace.

MR. MELAMED: I find almost invariably they are written by lunatic middle managers, but --

MR. POTTER: That wasn't your position when you were Deputy Assistant Attorney General.

MR. MELAMED: Well, you know, you learn.

DR. ORDOVER: Or those documents are usually by investment bankers who are pedaling a particular deal or something like that, alleging that as a result of action X or Y, the firm would be able to leverage its market power from one market to another. If one were to take these arguments -- take these documents seriously, that would be the end of most of the Chicago Business School, presumably, investment banking, but also, the ability of business people to compete in the marketplace, because this is what these guys are selling. So, you have to
read their signal, which is the investment advice or
business advice which they proffer, as being an attempt
to market the product at above competitive price to the,
you know, willing or unwilling buyers, and I think that
that is why I am very worried about reading all kinds --
I mean, I have seen documents probably as good or as bad
as Doug or anyone, and I try to discount their value
because they are frequently misleading.

Now, this is not to say that people who run the
companies do not have an insight into the marketplaces
in which they are competing, but I think there are
limits of the kind of inferences you can really make
from those types of documents, especially when they are
also written by third parties with a very special agenda
of their own in my view.

MR. POTTER: Next slide, as long as we're on
costs, let's throw this out, a variety of cost tests.
The proposition for the panel is, average avoidable
cost, which for definition, cost per incremental unit
that does not have to be paid if the incremental units
are not produced, is the best cost measure to use if
forced to use the Brooke Group analysis. Is there any
disagreement with that?

Doug?

MR. MELAMED: Yes, I actually disagree with it
as phrased. I think it would be more useful to use
avoidable cost compared -- and then add up the revenues,
because when you say average avoidable cost compared to
price, you are limiting yourself to the revenues from
the product in question, and you can't take account by
that formula, at least, of two-sided markets and
everything else.

DR. ORDOVER: And networks. I think the issue,
just to pitch it to the folks if you want to raise it or
discuss it further, I think in the American Airlines
case, there was a lot of debate as to what the right
benchmark of cost was in my view, and at least the
Government had I think proposed four, if I am not
mistaken --

MR. POTTER: Correct.

DR. ORDOVER: -- that may be three too many,
but, you know, we have offered at least one or two
ourselves.

The same thing in Spirit, I think we have come
up with two different measures of cost, but they would
apply to different types of outputs, all passengers
rather than leisure versus business. So, there is a lot
of wiggle room as to what it is that this cost measure
is going to be applied to, and as Doug pointed out, it
is also key to figure out what is the measure of
revenues against which these costs are to be assessed.

So, I think that this is not a bad -- again, this is not a bad standard, but I think it is important to understand what is avoidability here that is at stake.

For example, in the American Airlines case, we thought, at least I thought quite strongly, that the right set of costs would be those that if -- the airline would avoid if it were to exit or substantially cut back on a particular route, and that actually includes a lot of costs that would be avoided, because it would include avoiding the aircraft costs which were at issue, those would be significant, much more than many other costs, and it could be cutting back at the hub, perhaps, cutting back at the stations from which the airline would exit.

So, these avoidable costs which we looked at at the route level are typically the kind of costs business people look at when they make business decisions in the airline business, and I thought there was a good measure of avoidable cost. It happens so that the increment of output over which we are looking at was that of the route as opposed to -- it could be a seat or it could be an aircraft or it could be a flight or something or an aircraft day, because these aircraft, they fly in
strange ways around the globe, but there is all these
things that can be taken into account that could confuse
or could illuminate the matter.

MR. POTTER: I wanted to follow up on this slide
for a couple other questions. One, Doug, I think you
talked about this in your presentation, but I was
wondering if anybody had a view of whether opportunity
costs should be considered in viewing the cost test.

MR. MELAMED: Yes.

MR. POTTER: Doug, I thought you were a yes,
Doug. Does anybody else on the panel have any views on
that?

DR. ORDOVER: Well, as I said, I think in
American Airlines, we had an internal discussion of
what's the meaning -- what to do about the aircraft. I
mean, there is no denial that American Airlines brought
in additional flights. You could say, well, is there an
opportunity cost of that aircraft, and if there is, how
are you going to measure it? And one measure, which I
thought was the most easy to implement, would be to look
at the lease rates as opposed to trying to understand
what is another route that this aircraft could have been
flying or was this aircraft sitting somewhere in the
desert in Arizona and doing nothing? Maybe American has
a lot of aircraft like that, they could fly them at very
low incremental capital cost, but I thought that the
most reasonable assumption would be to assume that the
airline uses its aircraft properly and it could actually
deploy an aircraft by leasing a new one, which is why an
18-month time horizon I thought would reflect the
leasing strategies and the fact that heavy and costly
equipment was deployed, and there is no way of avoiding
counting the assets that are not being used, which
aircraft were one of them, and there are others that I
thought were appropriately included as well. That was
not the view necessarily of all of my colleagues on that
case.

MR. POTTER: Ken?

DR. ELZINGA: I do not think you could trust any
economist who would say opportunity costs should not be
considered. I mean, opportunity cost is the main
analytical construct that we bring to the social
sciences, that the cost of something is the highest
valued opportunity forgone, but the problem is that in
antitrust, opportunity cost is a Promethean expression,
and it is very difficult to unpack it, and one of the
sobering things for me, who has worked in this area for
a while and tried to think about it, is how fragile some
of the cases are, some of them that I have been involved
in, some of them that I have studied, to the taxonomy of
cost.

The case that Janusz and I were involved in, what do you mean by the price of the product? Is it to all passengers, or is it to a group of passengers who are called leisure and price-sensitive and business and insensitive to price? The case can pivot upon that taxonomy.

In Brooke Group, after hundreds of hours of thought, one of the things that distressed me is that price above average variable cost pivoted upon -- it could pivot upon how you counted layers of tobacco. Tobacco is stored for years to age, and if you used a LIFO method, it looks like it violated Areeda-Turner. If you used LOFI, it looked like it was okay, and I don't like living in a world where it pivots upon what accounting standard you use.

One of the things economists supposedly also bring to the table is to get people out of using accounting data and to think in terms of opportunity costs, but even trying to apply that standard is problematic, and when you live in a world where there's a predatory pricing allegation, you probably are in a world where prices are close to costs, by whatever measure, and so then you start to figure out, well, how close and above or below, you inherently, if you are
going to use a cost-based standard, have to deal with
accounting data, but you try to always put it through
the filter of opportunity costs.

DR. ORDOVER: Just as an anecdote, in the
American Airlines case, I lived through like three days
of deposition and a number of questions related to the
question of how we treated these carts that people put
their luggage on when they pick it up at the station
that was going to be exited potentially, so I finally in
desperation said, "Look, if the whole goddamn case turns
on how we treat these carts, then the Government
shouldn't be bringing a case like that." There has to
be something more to it than that, right?

And I think somewhere -- I mean, tobacco is
probably more important to cigarettes than the carts are
to the airline, but again, this is really demonstrating
very well the kind of deep-level accounting issues and
cost treatment of issues that can go whichever way
somebody wants them to go, and therefore, to say that
something is average avoidable cost is, again, the same
thing. It is average, it is avoidable, it is a cost,
but other than that...

MR. POTTER: If you are going to require
opportunity costs to be considered, how does that differ
from requiring the defendant to maximize his profit?
Because one view of opportunity costs is he had an opportunity to get more profit. How do you distinguish the two, if at all?

Patrick?

DR. BOLTON: Yes, so, this is where Doug drew a very clear line that you should not count lost revenues and inframarginal sales as an opportunity cost. I would say as a matter of theory, you should count that as an opportunity cost. The real question is just one of administerability.

The other point I would make in this respect is that --

DR. ELZINGA: I am sorry, could you just explain for the benefit of at least me why, why you would count that, the inframarginal?

DR. BOLTON: Well, because the question we are trying to answer is, what is driving the price reduction? Is this a move by the incumbent that will raise profits irrespective of its anticompetitive effects or not? To be able to answer that question, we need to understand the nature of the profit sacrifice, the size of the profit sacrifice and what justifies it. Is there an efficiency rationale or is there an anticompetitive rationale? So, we cannot avoid it, and that is what I was going to say with respect to
Recoupment is the right question to ask. When you try and make a recoupment analysis, you are comparing profit sacrifice and return on investment. So, it is inescapable, you have to look at lost revenue and inframarginal sales when you do your recoupment analysis.

Now, if you do it for your recoupment analysis, I don't see why we should not take that into account for the cost test, but I will leave that for -- I think I see that as a practical problem and not a conceptual problem.

MR. POTTER: Doug, do you want any extra time or not?

MR. MELAMED: Well, the woman who is transcribing this said I spoke so fast that maybe my words were not caught before, but I will assume she got them.

MR. POTTER: Okay. What about, how do we distinguish in situations the appropriate costs when -- essentially price discrimination or nonlinear pricing? Does anybody have any views on that?

Doug? No, that is not on the slide.

MR. MELAMED: What are the avoidable costs?

MR. POTTER: Fine, let's go to the next slide.
Out-of-market reputation effects are so hard to assess they should not be considered in an analysis, and let me just give you another minute on this. I am thinking of a scenario whereby -- let's take the airline industry. An airline allegedly predates on, let's say, Dallas-Wichita. The airline has a bunch of other markets where it's in, and perhaps it's got monopoly power in a number of those markets. Maybe it doesn't know, maybe we don't know, who potential entrants will be in those other markets, but when the management team sits down to determine what they are going to do in Wichita-Dallas, they sit there and say, "Well, let's drive the guy out, because future people then won't challenge us in our other markets." How does that, if at all, get analyzed in determining recoupment?

Patrick?

DR. BOLTON: Yes. So, we elaborate on this point in our article. So, reputation effects do come into a recoupment analysis to the extent that reputation effects may raise the barriers to re-entry into the market, and they do raise them in the form of making other competitors aware that should they enter this market, the first thing they will be facing is a tough price war.

How do you prove reputation effects? That is
the harder question. But I do not think that that is
necessarily insurmountable. Again, there can be
analysis by the incumbent suggesting that this is a
profitable strategy, that reputation effects work, that
if we drive out this rival in this market, we will
benefit because there will not be other rivals or we
will be slowing down the growth of this rival.

So, this analysis is recognized by the
incumbent. If you find circumstantial evidence
suggesting that financiers think in those terms, that
they will raise the cost of funding of a new entrant
because they recognize that the market that the new
entrant is about to enter is one where there have been
past price war episodes, then I think this is all
evidence that this is a problem.

MR. POTTER: Ken?

DR. ELZINGA: This is a very strange statement,
and it could be easily misunderstood, but we have to
remember that the case for new entry and the enthusiasm
that we often have in antitrust for new entry can be
exaggerated. New entrants can inefficiently use
society's scarce resources. There are lots of
businesses that have no business entering an industry
because they use the resources inefficiently, and one of
the good things that keeps inefficient entrants out is
the reputation of incumbent firms for being tough, aggressive, low-cost competitors.

My concern -- and again, so much of the difference, perhaps, between Patrick and myself is one of administerability -- is once you start bringing in reputation effects as a potential hammer for antitrust plaintiffs, what is the consequence of that for all the good things that reputations do of incumbent firms to keep people, even for their own good, out of markets in which they have no business competing because they will not be efficient utilizers of society's scarce resources in those settings?

DR. ORDOVER: I think that the reputation effects are almost a cornerstone of the new game theoretic model of anticompetitive behavior of the sort that Patrick summarized in his talk and his paper, and there is no question that firms act in ways that try to convey signals to the outside world and to the inside world, and I think I would agree with Ken, not going so far as we should not find entrants to be all such great participants -- I like entrants. I think they should -- you know, let them slug it out.

Let's not create a presumption that some of them may be inefficient ones or some of them are efficient ones. Who the hell knows? It is the crucible of the
marketplace that ultimately will determine that.

But my issue is, again, I guess where we agree
is administratorability, and then to say, yes, indeed, it
is plausible to postulate the reputation effects. We
have the economic models. What we don't know in real
life is how many of these new entrants do you have to
kill in the airline business before somebody finally
realizes, hey, I'm not coming in, and empirical work
shows that no matter how many of them you squish, they
always come back, and so you say, am I still in the
reputation-building way or am I in the recoupment phase
or how am I going to account for that other than to say,
look, you go ahead and do what you want to do, compete
as hard as you want, but you should not break the
following simple rules, whatever they might be, because
I cannot account for all the other additional
considerations.

However, I think it is appropriate to say that
these reputational effects that we are encountering in
economic theoretical literature, but also in some
empirical stuff. In fact, there is some beautiful work
by Canadians on the supermarkets in Canada, indeed,
indicating that some reputational effects that have been
established. I just don't see how I can translate that
into an administrable test for the courts and for
counsel, because what can Doug say to somebody who says, "Look, I think I want to kill three guys because I think that will be enough," and he goes, "No, only kill two."
I mean, what? What do you say? I just don't know how to do it. I wouldn't know how to do it.

MR. MELAMED: Look, if the client comes to me and says, in effect, I want to cut my prices to below my avoidable costs, I might say, "Why are you doing that? You are going to run the risk of losing an antitrust case." And if he says to me, "I'll beat the rap because they will never hang me with the recoupment thing," because if my recoupment is going to be my reputation, I might say, "That ought to be illegal."

That is to say, as Patrick says, if you can prove a plausible recoupment story, a reputational story, that, in fact, you are gaining market power because you are gaining reputation and it is not just the lawyers -- the plaintiff's lawyer's fantasy, then I don't know why that's not enough to satisfy the market power screen. In the Microsoft case, for example, which I believe was rightly decided, the proof of competitive effects was, you know, rather conjectural, but you had conduct that unequivocally didn't do anybody any good and you had a plausible theory of a market power entry barrier story and the fact that Microsoft believed that.
Why wouldn't that be enough just because we have price here as opposed to the set of conduct that was at issue in Microsoft?

DR. ORDOVER: I think that there are substantial sunk costs of coming in, combined with the signaling, I think you have a plausible story to tell, say, look, you know, you are trying to convince these people that if they come in, there is going to be an aggressive price, and with the substantial sunk costs at issue, that might be something that will take you over the edge, and they say, I'll stay out of the relevant market, but it is the combination of the informational aspects of behavior coupled with the structural features, which is substantial up-front costs, which you require and that the market power screen really -- to say, ah, this market is susceptible to anticompetitive behavior, it's susceptible to recoupment or to price elevation if you protect it.

So, this acts as a part of the analytical story that is being told, but again -- and I am perfectly happy to accept it. What I am trying to say, it has to go hand in hand with another aspect of the proof, which is to say that the informational aspects are conjoined with the real exposure that the entrants will face if things go wrong, so that when he comes in, it loses a
lot of money if it stays, because it cannot exit, and therefore, it is not willing to try. If exit and entry are easy, then I don't believe there is much power to that informational signal.

MR. MELAMED: I agree completely with that.

MR. POTTER: Next slide. I know at least one of our panelists said in his presentation that he would disagree with this, so, Patrick, I believe that is you, but we will see what the others think. Meeting competition should not be a defense to predatory pricing. Is there anybody who agrees with that?

MR. MELAMED: Agrees that it should not be?

MR. POTTER: Should not be. Doug, one agreement. Patrick, you disagree. Okay, Doug, why --

DR. ORDOVER: Wait, should not be --

MR. POTTER: Should not be a defense. So, you have essentially a high-cost producer. A lower-cost producer comes in, more efficient, at lower price. The high-cost producer cuts his price, lowers cost to meet competition. Should that be protected or not in a predatory pricing case?

DR. BOLTON: So, on the meeting competition defense, if meeting the competition is a best response, then this should be a defense. So, in principle, this is an admissible defense. Administerability, again,
concerns are important here. For example, what do we mean by meeting the competition? Is matching the price of the entrant meeting the competition? Is that how we define it? I would argue that's dangerous, because the products may not be the same. If the incumbent's product is higher quality than the entrant's, then matching the price of the entrant is not meeting competition. It's --

Mr. Potter: So, a jury is going to decide what the quality-adjusted price is?

Dr. Bolton: (Nodding.)

Mr. Potter: Doug?

Mr. Melamed: I think Patrick and I might not actually disagree but just use different words. He said if this is the best response. If it's the best response, then it would seem to me that the revenues generated by the response are in excess of the avoidable costs, in which case it passes the price-cost test, but if that's not the case, if it fails that test, it's an inefficient response. The fact that he's meeting competition I don't think should make it a safe harbor.

Mr. Potter: On a more general basis, it's not one of the slides, but what role should efficiencies play as a defense to predatory pricing? I know, Patrick, you think they should play a central role. Any
of the other panelists have a view on that?

(No response.)

MR. POTTER: Seeing none, we will go on to the next slide.

It is extremely difficult to craft an effective injunctive remedy in predatory pricing cases, and I'm thinking of the -- I think there was at least one TRO in a case where the judge said for purposes of the TRO, the company couldn't price above the price that it had set on August 1st, you know --

DR. ORDOVER: Of any year?

MR. POTTER: Well, it was a particular year, you know, subject to changes in raw material costs. You know, is that the remedy that --

DR. ORDOVER: That was the Baumol Test, right, you can cut the price, but you can't raise it for five years?

MR. POTTER: What is the injunctive remedy? I understand what the damage remedy is if it's a private case. What is the effective injunctive remedy? Is there any?

Doug, have you given that some thought?

MR. MELAMED: Yes, that question I have. I think it is very difficult, very dicey. There may be a circumstance in which it makes sense for a court to
specify a price in that sense, I can't offhand think of
one, but I don't know why it's a terrible thing to
simply say, "I declare the conduct to be illegal, and I
order you to stop pricing below avoidable costs."

DR. ORDOVER: Having first defined it.

MR. MELAMED: Right, of course, assuming the law
has been decided so that we know what that means,
because I think the action in the government case, for
example, is to help the law evolve into sensible
principles, and then the deterrent effect might be
served by the damages rather than having government
regulate through injunctions.

MR. POTTER: Ken?

DR. ELZINGA: Well, probably like everybody on
around the table and everybody on the other side of the
table, I'm suspicious of having antitrust become a price
regulatory regime. It may be that in a genuine
predatory pricing case, as the Court has the authority,
that you could get at some other part of the structure
of the market that allows the predatory pricing to be a
viable marketing strategy. Patrick gives the example in
his article, which I found persuasive, of the Intel
Communications, whether the Court would have the
authority to get at the regulatory issue that allows the
financial asymmetries and the resource asymmetries to
make the predation successful.

I don't know, and I'm picking this not to pick a
dispute with Janusz, but let's say for point of argument
that -- I genuinely mean that -- but let's say that gate
constraints are the one variable that might make
predation successful in the airline industry, and if you
can get away from gate restraints, then new entrants
could always come in and unravel any successful
predation scheme. I would much prefer in the setting
like that for a court to say, "Well, instead of trying
to monitor and manipulate prices of airline tickets to
make sure they're above some measure of cost, that we do
away with that particular structural constraint that
keeps the new entrant from being viable at such and such
an airport because they can't get gates."

If that were the case, perhaps that would be the
way to get at it. That would be more appealing to me
than having the Court monitor prices over time.

DR. ORDOVER: I cannot disagree on the gate
issues. It has been recognized in the airline business
that gates and slots are one of these assets that the
contestability literature perhaps forgot about when it
was first deployed in the airline business, capital and
wings, but I think that is a very sound prescription. I
just have, again, one little caveat.
One of the reasons these gate problems often arise is because the airlines actually could finance a large part of the construction of the airport, and that becomes an issue, who is going to -- unless the airport is a public resource that is not paid for by the airlines or by one airline investing in a -- that's in a part of the airport, if it's actually paying for these gates, then I think it becomes potentially expropriation of what could be a costly investment, and I think we will have to worry about the remedy from the standpoint of investment incentives, in other words, opening up the scarce asset.

I don't have to worry about that so much perhaps in the airline industry, but other industries. Obviously Microsoft raised the question and said, "Wait a minute, we are investing -- the remedy is to open up the API. Hey, we are spending a huge amount of money innovating in this space, and now you are telling me to open up." So, this is again, you know, perhaps even more problematic than regulating price, to regulate access. It is an equally complex or even perhaps more complex issue.

MR. POTTER: Let's go to the last slide, and we are running a little bit out of time, but I definitely wanted to get this question in and get a response from
each of the panelists.

The final slide is, if there was one thing you could change with the current legal approach to predatory pricing, what would it be? And since we started with Ken, I think this time we will end with Ken, in reverse order. Doug, why don't you take this one first.

MR. MELAMED: I think I would just try to demystify it a little bit and think of it simply as part of a complicated set of strategies that companies use that under some set of circumstances can be anticompetitive.

MR. POTTER: Patrick?

DR. BOLTON: Yes, I would agree with that, and I would also vote for de-emphasis of the cost test and putting intent back as a possible way of proving predatory pricing, and here, I think it would be helpful to maybe articulate the guidelines on how one would -- what's a legitimate way of proving intent and perhaps, you know, move in that direction.

MR. POTTER: Janusz?

DR. ORDOVER: I don't think I have a favorite. I will just say that I will agree with Doug, that we need to get clarity on what are the public policy or economic principles that either underlie the tests that
are being proposed, where does the -- you know, the cost
tests, where do they come from? There has to be --
going back, I think at this point we have enough
learning to try to go back to first principles and try
to understand what it is that we are trying to
accomplish, taking full account of the administerability
of whatever provisions are going to ultimately be
developed, but I think it would be foolish for us -- for
me, anyway -- to vote for the least favorite aspect of
what is out there at this point.

MR. POTTER: Ken?

DR. ELZINGA: Well, I certainly can't argue
against Janusz's call for clarity, but I think we are in
a pretty congenial equilibrium right now.

MR. POTTER: Good. I just want to point out
that over on the side, we have some of this afternoon's
panelists that were kind enough to be here this morning.
They are John Kirkwood, Tim Brennan and Rick
Warren-Boulton, and just right before we leave, I will
give each of you 30 seconds to say anything you wanted
to say about this morning's panel, or if you just want
to wait until this afternoon, feel free. Anyone want to
take a go?

DR. WARREN-BOULTON: I think I will wait for
this afternoon, but --
MR. POTTER: You will all wait for this afternoon?

Well, if you could join me in thanking the panelists.

(Appause.)

MR. POTTER: That will end the morning session, and the afternoon session begins at 1:30. Thank you very much.

(Whereupon, at 11:56 a.m., a lunch recess was taken.)
AFTERNOON SESSION  
(1:28 p.m.)

MS. SCHULTHEISS: Everybody ready? Okay, good afternoon, and for those of you who were not here this morning, my name is Pat Schultheiss. I'm an attorney with the Federal Trade Commission's Bureau of Competition in the Office of Policy and Coordination, and I am the lead moderator for this afternoon. My co-moderator is Bob Potter, who is the Chief of the Legal Policy Section at the Federal -- at the Department of Justice's Antitrust Division. I was going to put you at the FTC again, sorry, Bob. I can't just get those words out.

Before we start, a few housekeeping matters. First, for everybody's benefit, please turn off your cell phones, Blackberries, any other device that might make noise during the session. We appreciate that.

Second, the restrooms are out to -- men's room right to the left, and the women's room, past the elevators and to your left. There are little signs out there to guide you as well.

Third, in the very rare event that the alarms happen to go off, please just calmly proceed down the staircase and follow the zillion FTC attorneys and staff that will be going towards 7th Street to the Sculpture
Garden. Those are the preliminaries.
This afternoon's topic is dealing with predatory
pricing but looking at it from the buying or bidding
side. We have assembled a very distinguished panel who
will discuss I think, among other things, just how
common buy-side predatory pricing is in the real world,
if at all, whether it's common at all, what Section 2 of
the Sherman Act can and should be doing about predatory
buying or bidding, and I'm sure there will be many other
things. I know we will have a little bit of raising
rivals' costs from Professor Salop and others. So, with
that, let me introduce very briefly the panel, and then
I will introduce with a little bit of greater detail
each panelist right before they speak.

Our panelists this afternoon, in the order they
will be speaking, are Professor Jack Kirkwood from the
University of Seattle; Professor Tim Brennan from the
University of Maryland, Baltimore County; Professor
Steve Salop from Georgetown University; Rick
Warren-Boulton, a consultant with Microeconomic
Consulting and Research Associates; and Janet McDavid, a
partner with Hogan & Hartson. Each of the panelists
will give a 10 to 15-minute presentation. After that,
we will take a brief break and then have a panel
discussion for the remainder of our time. I would like
to thank all the panelists for being here and for the
morning panelists who have decided to stay and enjoy the
rest of the discussion. We greatly appreciate the
willingness of all of the panelists to give their time,
not just here today, but also the time input into
preparing for this session.

Our first speaker today is going to be Jack
Kirkwood, as I said. Jack is a professor of law at the
Seattle University School of Law. Before joining the
Seattle University, Professor Kirkwood was an attorney
with the Federal Trade Commission. Before leaving the
rarified air of Washington, D.C., he was the director of
several policy offices here in the Premerger
Notification Program, but then decided to head out to
the Pacific Northwest, and he joined the Seattle
Regional Office, where he headed up numerous antitrust
investigations and cases.

Professor Kirkwood has edited two books and
published numerous articles, and he recently addressed
the topic of today's hearing in his article in the
Antitrust Law Journal, "Buyer Power and Exclusionary
Conduct: Should Brooke Group Set the Standards For
Buyer-Induced Price Discrimination and Predatory
Bidding?"

In addition, Jack Kirkwood is a consultant for

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the plaintiffs in the Weyerhaeuser appeal against
Ross-Simmons in the Ninth Circuit. I think we only have
one panelist who is not somehow or another involved in
the Weyerhaeuser case, but with that, Jack.

MR. KIRKWOOD: Thanks, Pat, and thank you to
both agencies for inviting me.

This panel's focus is especially significant.
It's not only an intellectual or antitrust policy
question, but it is a question of how should the Supreme
Court come out in a case that in my sense is they are
very likely to take, Ross-Simmons versus Weyerhaeuser,
and the central issue in that case, of course, will be
should Brooke Group apply. Should Brooke Group's
price-cost and recoupment tests apply to a practice that
has been called predatory overbuying or predatory
bidding.

This is, as I've conceived it and as Steve and
others have looked at it, is in major respects the
mirror image of predatory pricing on the sell-side.
With predatory bidding, a dominant buyer bids up the
price of a critical input, forcing up the market price,
and in certain circumstances, making it impossible for
rival buyers to continue to compete, causing either
their exit or their inability to constrain the dominant
buyer's future exercise of power, and hence, the
dominant buyer captures monopsony power that it wouldn't otherwise have, and in some circumstances, this may lead to a long-run harm to welfare, most directly to supplier welfare but also possibly to consumer welfare as well.

Given these similarities, all of the Supreme Court's stated rationales for applying Brooke Group apply to predatory bidding as well, at least to some degree. Furthermore, the only alternative test approved by the Ninth Circuit was an exceptionally vague jury instruction allowing the jury to find liability if it found that Weyerhaeuser bid more than "necessary" in order to prevent the plaintiff from buying at a "fair price." That strikes me as too vague and many others as well.

So, if that test is not acceptable, should we resort to Brooke Group or try something in the middle? And what I am going to suggest today is that a middle-of-the-road test is more appropriate, a test that has two parts. One, the plaintiff would have to show harm to welfare, I will explain what that means, but the defendant would get a complete defense if it can show that it would pass the no-economic-sense test.

Why a middle-of-the-road test, why not Brooke Group? In some significant respects, predatory bidding is different from predatory pricing. There is, of
course, one cosmetic difference. In predatory bidding, the first thing that happens is input prices go up, output prices to consumers do not go down, at least initially. So, there is this key difference in terms of what we normally think of as the central focus of antitrust on providing low prices to consumers, but that is essentially a cosmetic rather than an important difference, because when a buyer bids up input prices that benefit suppliers, it can be procompetitive, and through an output effect I will describe, it can benefit consumers as well. So, we should be concerned with chilling procompetitive bidding for inputs just as we are concerned about chilling procompetitive price cuts.

There is, though, a more significant difference. Compared to predatory pricing cases, predatory bidding cases have been brought less frequently, have been won less frequently, and arguably, there have been no false positives, no liability findings where it appeared that the defendant had not, indeed, harmed welfare. That is arguable, not hardly proven.

In the last two decades, since the mid-eighties, there have only been two cases in which the plaintiffs have won. Both have involved bidding up timber prices in the Pacific Northwest, and if the Supreme Court takes Weyerhaeuser, we are not even sure that the plaintiff

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will have won the second case. Why is it that these
cases seem to be rarer and that the proportion of
successful predation may be higher? Rick Warren-Boulton
will address that. I will defer to him on that. I have
suggestions, but he can cover it.

This track record suggests to me, at least, that
it is a little too early to apply a Brooke Group
price-cost safe harbor test to predatory bidding. To be
sure, the number of successful cases is too small to
produce a reliable conclusion that predatory bidding is
more dangerous than predatory pricing to welfare. We
are not there yet, yet the track record does suggest
that the danger of deterring procompetitive bidding is
less high than it is with predatory pricing, at least if
there were a stiff rule that applied to a plaintiff as I
will suggest.

This is consistent with my experience at the FTC
as head of the Planning Office, the Evaluation Office,
and then as a staff attorney in Seattle. I received
over the years many complaints about price-cutting but
never, ever, a complaint about bidding up input prices.

There are two other reasons to think we ought at
this point to choose a more flexible test rather than a
Brooke Group safe harbor. One is, there has been to
date much less scholarly or judicial analysis of the
practice, though thanks to the agencies and thanks to Steve, we are working on that. Even so, even so, the pile of articles on predatory bidding does not compare to the mountain on predatory pricing.

There is also a growing, though probably still minority, view that the Brooke Group average variable cost test, at least as interpreted that way, may not be the right standard even for predatory pricing where the concern with chilling procompetitive price competition is greater; that at least it counsels against extended Brooke Group predatory bidding.

What would an alternative test look like? My suggestion, just a proposal, is to put a stiff burden on the plaintiff and to give the defendant a complete defense. The plaintiff's burden would be to show harm to welfare. So, a plaintiff would have to prove the elements of a welfare-reducing instance of predatory bidding. So, they would have to show that, yes, the price was bid up; yes, at least some significant rivals were constrained in their ability to hold up, since we are talking about bidding, hold up the alleged predator's price; as a result, the predator got monopsony power it would not otherwise have; and most important of all, the plaintiff would have to show that the long-run impact on welfare was negative. So, to
pick up on one of Ken's key points this morning, the plaintiff would have to show that it was relatively easy to induce exit, but either re-entry or new entry would be more difficult.

How should we measure welfare? I have deliberately not put an adjective in front of it. It seems to me there are two principal possibilities: One, supplier welfare; two, consumer welfare. Steve is going to talk about either of those measures, particularly consumer welfare as opposed to total welfare. I will skip that debate.

Between supplier welfare and consumer welfare, it seems that both precedent and ease of measurement favor supplier welfare. The cases that have looked at monopsony abuses and at buyer cartels tend, on balance, to focus on the impact on suppliers rather than on consumers.

In addition, there can be instances of substantial harm with little or no measurable effect on consumers. So, if the plaintiff had to show some sort of significant, discernible, provable effect on consumers, that would be harder. So, I am tending to favor a supplier welfare test, but you could use a consumer welfare test at least for most cases. Why is that? Because successful monopsonization is likely to
harm consumers in two ways.

One, as many economists have pointed out, if the predatory bidding produces a net increase in long-run monopsony power, then there is likely to be a reduction in output. The dominant buyer is likely, on balance, over time, to buy less, and if it buys less, it is likely to produce less, and that means there is likely to be less final product on the market. And so, if the demand curve is neither totally vertical nor totally horizontal, if it is the normal downward sloping type, then less output is going to put some upward pressure on price.

So, the mere output effect will tend to harm consumers, again, maybe not noticeably, but there is that linkage, and that does not require market power. That is, the dominant buyer does not have to have market power in the final product market for this effect to occur. It occurs through the output reduction caused by the monopsonization.

There could be, though, a market power effect, as Rick may emphasize in his talk. Suppose the relevant market downstream was limited to the product whose input price was bid up. Then, if the dominant buyer eliminates its key rivals as buyers, it will also eliminate them as sellers. So, it may gain both
monopsony power upstream and monopoly power downstream, and so then that would magnify the potential consumer effect.

We could, therefore, use a consumer welfare test, as Steve may suggest. There might have to be exceptions, though, from such a test where predatory bidding leads to monopsonization but consumers are unaffected.

Whatever criterion is used for welfare, it seems to me that a welfare test would provide substantial protection to defendants. First, successful monopsonization appears to be rare and appears to be limited to certain markets, as Rick will suggest, markets where there is inelastic supply, and that is not commonly observed, typically in labor or natural resource markets.

The power buyers that we all know or suspect, the Wal-Marts, the Barnes & Nobles, the Costcos, they don't induce lower prices by monopsonization. That is, they do not go to their suppliers and say, "I am going to cut back my output a little bit, and I expect, because that will reduce your marginal cost, that you will give me a lower price." Rather, they engage in bargaining tactics, and at the risk of oversimplifying, the way they obtain a lower price is, in essence, saying
that I am going to increase my purchases over what they
would otherwise be if and only if you give me a lower
price. So, that is not monopsonization.

So, one, you have the limited set of cases, and
two, you have all of those elements that the plaintiff
has to prove. I will not repeat them again, but showing
net long run harm to welfare is not an easy task. This
is essentially a full rule of reason analysis, and as
you well know, private plaintiffs do not often prevail
in full rule of reason cases. That has been the record
under Section 1 and is likely to be the record under
Section 2 as well.

You might say, "Ah, but private plaintiffs
prevailed in LePage's and below in Weyerhaeuser," but
the difference is in neither of those cases did the
courts insist on a full rule of reason net welfare test.

Is such a test unworkable? It is certainly
reasonable to contend it is, but we do use it in
horizontal merger cases under Section 7 and in full rule
of reason cases under Section 1, and as Steve has
pointed out, we are not really balancing immeasurables
when we use this long-run welfare test. We are not
trying to decide what's more important, national
security or freedom of speech. We are asking whether
the long-run impact on our target group, let's say
suppliers, is positive or negative.

Still, still, the inquiry would not be easy for a defendant to predict its outcome, and the inquiry would stretch over a longer time period than in the case of a Section 7 matter certainly and probably the typical Section 1 matter, because we are talking about a long-run impact on welfare, and the key issue there, as Ken has stressed this morning, is entry barriers, and that is an uncertain and controversial topic. So, my sense is that we should not rely solely on a welfare test, that we should create an efficiency defense for the defendant, and for that, I have borrowed from the no-economic-sense test advocated by the Division.

It seems to me that if the defendant can show that bidding up input prices was profitable, without regard to any increase in monopsony power, that it should have a complete defense. This would put the burden on the party that best knows its own profitability and would give it an out if it could provide a good answer to the question, why did you do this?

So, to conclude, let me give you just a simple example. Suppose, as is my understanding of Weyerhaeuser's theory, suppose the dominant buyer improved its production process, lowering its marginal
cost. Then the new profit-maximizing price, without regard to monopsony power, might be an increase in output. That would entail buying more input, selling more of the final product, so there would be a margin reduction from paying more for the input and getting a little less for the final product, but if the lower marginal cost more than compensated for that, without figuring in any increase in margin due to monopsony power, then the defendant would be excused.

I am happy to talk more about that, but my time is up.

MS. SCHULTHEISS: Thank you, Jack.

Our next speaker is Tim Brennan, who is, as I indicated, a Professor of Public Policy and Economics at the University of Maryland, Baltimore County. Professor Brennan also has been serving as the 2006 T.D. MacDonald Chair in Industrial Economics at the Canadian Competition Bureau.

Before joining the University of Maryland, Professor Brennan held a number of positions focusing on economics and antitrust, including staff economist at the Antitrust Division, senior economist for industrial organization and regulatory policy on the staff of the White House Council of Economic Advisers, and a consultant to the Bureau of Economics here at the
Federal Trade Commission.

Professor Brennan's research areas related to antitrust include regulatory economics, monopolization law, exclusionary conduct, vertical integration, and the competition-regulation interface. His articles have appeared in numerous journals in economics, law, and other fields.

Tim, would you care to start?

DR. BRENNAN: Thank you.

I am grateful to the Department of Justice and to the FTC for the invitation to participate on this predatory buying panel. It is a great honor for me to be here. I am especially grateful because I have been thinking for longer than I care to remember about how to support Section 2 of the Sherman Act, and yet reconcile it with less controversial, more accepted frameworks for prosecuting cartels and horizontal mergers.

I will offer a suggestion along those lines today. Although I believe that my suggestion will make deserving exclusion cases easier to bring, some aspects may be significantly different from established jurisprudence. For that reason, I particularly recognize the privilege of having a place at this distinguished table.

Before proceeding, I need to say my statement...
today reflects solely my own opinions and does not
represent those of the Competition Bureau or any of its
staff.

For this complex topic, I offer a series of
recommendations.

Predation or exclusion? Pick one or the
other -- they are fundamentally different.

When first asked to participate in a panel on
"predatory buying," my response was to object to the
title. We should recognize that "monopolization"
entails two essentially different types of practices,
one that for shorthand could be called "predation," and
the other "exclusion." The most succinct distinction is
that predation cases involve doing too much of a good
thing to bring about a bad result later. There, the
understandable concern is with deterring energetic
competition -- not discouraging firms from charging low
prices, adding product features, and the like.

Exclusion cases, on the other hand, involve
doing a bad thing now. One way or another they come
down to acquiring control and effective market power
over a supplier or access to an input or service needed
to compete, what economists called complements. The
most explicit way to accomplish such control would be
through a series of exclusive contracts with the
complement's suppliers. It may involve overbuying inputs through explicit purchase or, as I'll suggest below, bundling, rebates, or other forms of "leaving money on the table." I call this practice "complement market monopolization," or CMM.

The major problem with single-firm conduct law is the failure to recognize the essential difference between these two types of conduct, leading to the counterproductive imposition of predation standards on exclusion cases. Perhaps the failure arises from a presumption that one statute -- Section 2 -- must imply one principle. Perhaps it follows from the persistent belief that Section 2 must be premised on harm to rivals. Since competition also harms rivals, Section 2 law is thus driven by fear of over-deterrence. Instead, exclusion cases should be recognized as different, where we can apply horizontal tools and not predation screens to the delineation and protection of complement markets.

Two, genuine predatory buying cases will be rare; when they occur, validate necessary assumptions.

I would have changed the title of this panel to "Exclusionary Buying," because the leading cases involve creating of market power over complements. The recent DOJ/FTC cert petition in Weyerhaeuser v. Ross-Simmons illustrates an exception that proves the rule. The
exception is unusual, in that the concern is not that a
timber processor would acquire so much control over a
relevant market in uncut trees to be able to raise their
effective price. Rather, according to the petition, the
allegation is that a mill would pay too much for trees
to drive out other buyers, with subsequent recoupment by
cutting prices paid for trees in the future.

I have little to say about which market power,
price-to-cost, and recoupment tests are appropriate for
preventing over-deterrence in these rare predatory
buying cases. I do suggest that courts demand not only
evidence appropriate for such tests. They should also
demand evidence that specific assumptions behind
strategic models are satisfied, i.e., that the alleged
predator either has a reputation for non-profit
maximizing behavior to protect, or benefits from
identified asymmetric failures in capital markets.
Theoretical possibility alone does not make a practice
harmful.

Three, for exclusion cases, the first and
crucial step is to delineate a complement market being
monopolized using the Horizontal Merger Guidelines
procedures.

Market power is often characterized not just as
the ability to raise price but also as "the ability to
This is a mistake of imprecision. Ability to raise the price of X depends upon entry barriers or other impediments to competition, but those do not depend upon the price of X. Higher X prices would, if anything, encourage entry. Rather, the ability to exclude depends upon control over the prices of Y, Z, W, or something else needed to enter and produce X.

Delineation of that relevant complement market should therefore be the first step in all exclusion cases. Taking Dentsply as an example, the case rested on the premise that the national distributors constitute what in merger contexts we would regard as a relevant market, in this case for the distribution of teeth to dental labs. The Merger Guidelines provide the useful framework for testing this premise. They ask whether teeth manufacturers would turn to other distributors, whether there would be entry into that distribution market in response to a "small but significant nontransitory increase in price" of using such dealers.

I do not know the facts of that case and thus the answers, but the Merger Guidelines ask exactly the right questions. Cases eventually turn to evidence of entry or substitution into the complement market, but they do not make such concerns central -- the best indicator being the continued identification of a
relevant market as that in which the alleged monopolizer
is already dominant, not that over inputs or services
competitors need to compete. Control over such a
complement market is not only sufficient to raise
competitive concerns; it is necessary for
anticompetitive exclusion.

Hence, plaintiffs should focus on identifying
that complement market and showing that the practices at
hand cover enough of it to raise the complement's price.
In effect, one should ask if one would be troubled if
the complement providers covered by the alleged
exclusionary practice merged. Unlike usual
characterizations of monopolization cases, this is one
we know how to answer -- use the Merger Guidelines. If
the answer is no, stop; if the answer is yes, go to the
next step.

Next, having delineated the relevant complement
market, the second step should be to establish the price
effect in that market.

Barriers to entry cannot be raised, and
competition impeded, by any more than the extent to
which the price of the complement can be raised.
Sometimes this higher price will be explicit, sometimes
it will be only an inferred higher price -- Professor
Carlton has usefully called it a "shadow price" -- if
the exclusionary practice so ties up the complement market that only higher priced substitutes, including self-provision, are available.

Explicit exclusive dealing contracts offer one such standard: Firms wanting to use those dealers would have to cover the cost of breaching the contract. Other alleged exclusionary practices, such as bundle discounts or royalty rebates, may create a significant price increase -- once one has established the first step.

Next, the standard for assessing the exclusionary effect of a bundle or rebate is not whether an incremental price is below incremental cost, but its effect on the price of the complement.

Following the last point, one could ask whether bundles, rebates, or other programs have to increase the effective price of the complement as much as it would explicit contracts. I have no reason to believe it should. Were we to follow the Merger Guidelines, as we should for complement market definition, we might only need ask if the practice leads to a small but significant nontransitory increase in price of the complement.

This tells us that whether a bundle is anticompetitive has nothing to do with a predation-like test. It does not depend on whether the incremental
price of adding a good to a bundle, or of supplying more
of a product given a discount, is less than some measure
of marginal or average variable cost. Rather, it
depends only on the extent to which such practices
create market power in order to raise the price others
must pay for the services provided by retailers,
distributors, or other complement providers getting the
discount.

Predation case screens -- profit sacrifice,
equally efficient competitor, and prior dominance -- do
not belong in exclusion cases.

Even for predation, we have heard today, some
commentators have noted that some or all of the screens
need not increase competition and consumer benefit.
Nevertheless, they may be appropriate to prevent
over-deterrence of competition through low prices or
added features. However, in exclusion cases,
controlling a monopoly share of complement markets is
not inherently procompetitive, and thus need not have
high bars for its protection.

The profit sacrifice or "no business sense"
test -- the two are equivalent if one assumes that
"business sense" means "maximize profits" -- substitutes
concern with intent and tactics for concern with
effects, as if whether someone had been murdered depends

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upon the price paid for the gun. Others have noted that it creates an absolute efficiencies defense, in that a penny of gain from a practice excuses untold anticompetitive harms. As Rick Warren-Boulton has said, the test is notably inappropriate when regulated monopolists do the excluding.

Although I have criticized "raising rivals' costs," mostly for its emphasis on "rivals," Steve deserves enormous credit for pointing out long ago that predatory sacrifice and recoupment is unnecessary to point out the tactics that raise those costs. My difference is that I would focus primarily on the complement market.

Ironically, the test also forgets that once upon a time, profit sacrifice implied previously unobserved efficiency, not anticompetitive harm. We learned that exclusive territories, exclusive dealing, tying, and even resale price maintenance must generate efficiencies because they reduce demand, making even monopolists worse off otherwise. That realization gradually reformed most vertical restraint law. Assuming now that a profit sacrifice must be anticompetitive forgets antitrust history and invites us to repeat mistakes that have not been fully undone after nearly a century.

On equally efficient competitors, I point out
what should be obvious: Inefficient competitors hold down price. Complement market monopolization leading to their exclusion can raise price and harm consumers.

Having gone after two sacred cows, I may as well finish off the herd: The Grinnell prior possession of monopoly test can also impede meritorious exclusion cases. It distracts attention away from the complement market, focusing instead on the characteristics of who monopolized it. Prior dominance could even be a defense, but once complement market monopolization is shown, it should be up to a defendant to claim that it has no consequence because of monopoly elsewhere in the production chain.

Moreover, this test is counterproductive. Proving the cost, demand, and entry barriers necessary to establish prior dominance undercuts the argument that the alleged exclusionary practice makes a difference. Using Richard Posner's phrase, the monopoly should be "fragile" at worst. An exclusion case will be strongest if the sector would be competitive, but for the practice under scrutiny.

Ask whether we would apply these standards to mergers. Should all mergers be legal unless one could show they would be unprofitable but for anticompetitive harm? Should any merger, including to monopoly, be
legal if a more efficient firm buys and eliminates a less efficient competitor? Of course not. Even prior dominance may make the incremental effect of a merger less troubling. If these tests would gut merger law, and if exclusion cases are akin to acquisitions in the complement market, they do not belong on this side of Section 2.

Consider share-based rather than "all or nothing" remedies.

Analogy to mergers opens the door to more creative remedies. Generally, either a practice is okay, or it is not and should be stopped. We should instead take a share-based approach. Exclusive dealing contracts, bundles, or other alleged monopolizing practices might have efficiency benefits. The problem is not the practices per se, but their scale -- that they pre-empt so much of the complement market to raise its price significantly. Rather, defendants should be allowed to retain the practice, but only over a nondominant share of the complement market, 35 percent, 50 percent or some appropriate number. If the practice is actually efficient, it will be kept. If it serves only to exclude, this remedy would lead to its discontinuance.

Last, focus on the creation of monopolies, not

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their maintenance.

About two years ago, I gave a talk at the FTC on these ideas, entitled "Saving Section 2." As I began, an economist there asked, "Why should anyone want to save Section 2?" My answer may not have satisfied him, but in short, it is that it can and should be saved. Were all Section 2, single-firm conduct cases about protecting a monopolist's rivals by drawing vague or impossible lines between competing just enough and too much, I might have agreed with the questioner. However, exclusion cases are not about maintaining monopolies but creating new ones. In focusing on complement market monopolization, such cases can and should be no more controversial than collusion and merger cases are today.

Thank you again for the privilege of allowing me to share these observations. I hope I can clarify them through responses to any questions you have here and as they arise in the future. Thanks very much.

(Applause.)

MS. SCHULTHEISS: Our next speaker will be Steve Salop, who is a Professor of Economics and Law at the Georgetown University Law Center where Steve teaches courses in antitrust law and economics and economic reasoning for lawyers. Dr. Salop also has a consulting practice at CRA International involving a variety of
antitrust issues.

Before joining the Georgetown faculty, Steve held positions at the Federal Trade Commission, and a while back, the Civil Aeronautics Board and the Federal Reserve Board. Professor Salop has written numerous articles in various areas of antitrust economics and law, many of which take a, quote unquote, "post-Chicago" approach. Professor Salop recently published two articles in the Antitrust Law Journal that concern exclusionary behavior and monopoly power.

Of particular importance for today's hearing is his article, "Anticompetitive Overbuying By Power Buyers." It contrasts predatory versus raising rivals' costs, overbuying behavior, and I will let him go further into that.

And in addition, Professor Salop has also consulted for Weyerhaeuser in its appeal and district court decision. Is that correct?

DR. SALOP: Yes, that's correct.

MS. SCHULTHEISS: So, with that, I will hand it over to you.

DR. SALOP: Okay, thank you.

I want to talk about these two types of overbuying, predatory overbuying, what Jack called predatory bidding, and raising rivals' costs overbuying,
but to just set it up, I think a key place to begin is a
notion that Tim Brennan touched on, the fact that in
Section 2, there are really two distinct paradigms, and
I believe that the way individual people think about
Section 2 has a lot to do with which paradigm they have
in mind, you know, which one animates them, and so I
want to stress the difference between these two
paradigms.

One paradigm is the predatory pricing paradigm,
seller-side predatory pricing, and the other is the
raising rivals' costs or non-price predation paradigm.
Now, in my view, and a key element in what I am going to
talk about today, and, indeed, much of my work, is that
conduct that fits into the raising rivals' cost paradigm
raises much greater concerns than conduct that fits
within or that people characterize as the predatory
pricing paradigm.

Now, we all know the claims about why predatory
pricing is seldom attempted and rarely succeeds. In the
short run, the predator loses more money than the
victim. Secondly, it only works if the victim exits.
Otherwise, there is no -- they will never be able to
recoup. And third, consumers benefit from the lower
prices, and the harm to consumers is mere speculative
impact in the future. So, for all those reasons, it is
argued that predatory pricing is unlikely to be tried, it is unlikely to succeed, and it is unlikely to harm consumers, and therefore, we should have a really light hand in predatory pricing.

Taken as a paradigm, conduct that raises rivals' costs raises much greater antitrust concerns; hence, let's say it is more likely to succeed, more likely to harm consumers. Why? Well, first, there is no need to induce competitors to exit. If you raise competitors' costs, variable costs, they will tend to raise price, and the excluding firm will gain even if the competitors do not exit. You would rather compete against a high-cost competitor than a low-cost competitor.

Secondly, there is no necessity for short-run profit sacrifice, chronological profit sacrifice, of the sort there is in predatory pricing. If the rivals' costs are increased, they will raise price immediately. The predator, the excluding firm, will gain immediately. So, there is no issue that the predator has to lose money for a while and then only gain later.

Similarly, there is no short-run consumer benefit, and this one I think is very important. In predatory pricing, the consumers inevitably benefit from that lower price in the short run. In raising rivals' costs, there is no inherent consumer benefit. You raise
rivals' costs, they raise price or contract, and the
defendant raises price, so consumers are harmed
immediately. There is no such thing as naked predatory
pricing, you know, just all bad, the way there is with
naked price-fixing, but there is naked raising rivals'
costs. One could conceive of that burning down the
factory, so on and so forth, and such conduct that
actually shows up in certain cases.

So, for all those reasons, I think that you have
these two paradigms that are distinct, and I think most
of the time you should be thinking in terms of the
raising rivals' costs paradigm. I think it is a better
paradigm for Section 2. I think that the predatory
pricing is the exceptional paradigm, not the norm.

Well, now let's apply this to anticompetitive
overbuying. Now, there are -- by overbuying, I mean
conduct where the defendant goes into the input market
and bids up the price of the input. Usually if you bid
up the price of the input, you are generally almost
surely going to buy more than you would have otherwise.
So, it is often called overbuying. Indeed, in the
literature, it was initially referred to as overbuying
cases, and I guess sort of the classic case that
economists studied initially was the bauxite aspect of
the Alcoa case, where Alcoa was alleged to have
overbought bauxite in order to raise the costs to its
aluminum rivals.

Well, there are two distinct overbuying
allegations that correspond analytically to the two
exclusion paradigms. There is predatory overbuying,
Jack talked about, and then there is raising rivals'
costs overbuying, and the difference between these two
paradigms is the goal of predatory bidding or predatory
overbuying is to gain monopsony power to the input
market, as Jack pointed out. The goal of raising
rivals' costs overbuying is to raise your rivals' costs
and then gain market power in the downstream output
market.

Okay, so if you think about Alcoa, they could
have overbought bauxite for -- one reason would be to
ultimately knock out the other purchasers of bauxite so
it could then be a bauxite monopsonist, and the
alternative would be that they did it in order to raise
the price of bauxite to its rivals so that they could
ultimately monopolize, raise the price, of aluminum. Of
course, in a given case, you could have both, but at the
same time, in a case, you could have one or the other.

Now, interestingly, in the Weyerhaeuser case and
the Ross-Simmons case, both allegations were made in the
complaint. It was alleged that Weyerhaeuser, by its
conduct, would ultimately gain monopsony power in the
timber market, in the purchase of timber, and secondly,
it was argued that Ross-Simmons would gain market power
in a downstream alder wood, alder hardwood market, and
Ross-Simmons did not carry its burden on the raising
rivals' costs piece, and so the part that has gone up is
just the predatory overbuying piece.

Okay, well, how do I think we should evaluate
these two types of conduct? I want to separate them.
So, first, the predatory overbuying, as I said, it's
market power in the upstream market that's the goal, and
in general, I have in mind a four-step legal standard,
very close, very, very close, to what Jack Kirkwood
called for, and I will talk about it and then stress the
differences.

So, the four steps would be, you have got to
show buyer power, monopsony power, and artificially
inflated input purchasing, and it's really the latter,
you have to show that they bought more and that the
price went up. You have to show exit or permanent
capacity reduction of the input market competitors, that
should be, and then there has got to be some kind of
recoupment through buyer-side monopsony power in the
input market, and finally, and this is very important,
you have to show net consumer harm.
Now, usually in these cases there will be a short-run consumer benefit during the predatory period, because when the defendant buys more of the input, it will produce more output, and so the price of output will go down, and then during a recoupment period, it goes in the other direction, so consumers benefit in the short run, harmed in the long run, and for that reason, in order to show -- in order to gain -- show liability, the plaintiff would have to show consumer harm on balance.

Okay, now, let me go through the steps in a little more detail. First of all, note, Jack Kirkwood said, well, I'm not sure you need consumer harm, maybe it's enough to have supplier harm, so that is one difference between our standards to date. Jack actually in his article had this last step, consumer harm. So, he has broadened his position today.

Now, the first step, the issue here is the question is, is the increased purchasing artificial or is it competitively driven? Now, you know, there are a lot of good reasons why a firm may increase its input purchases in this year versus last year. For example, maybe the demand for its output went up. It needs more inputs to produce more output. Maybe it is not so much its demand went up, maybe it decided to change its...
business strategy. Maybe it decided to decide to grow
its market share rather than go for a high price in the
output market. Or maybe it got a new production process
that is more efficient, and that leads it to want more
inputs in order to expand. Fourth, maybe something
happened in the input market. It used to have monopsony
power, and it finds it has lost that monopsony power or
has less of it, and so it wants to stop acting like a
monopsonist.

All four of those reasons would lead it to
increase its demand for inputs. As its demand for
inputs goes up, the price of the inputs would tend to
rise, and its purchases would tend to rise. So, for
these reasons, I mean, what would be most suspicious
would be if the defendant bought extra inputs and then
did not use them, just warehoused them, all right,
because that would suggest it was not buying more in
order to produce more output, but rather, did it in
order to raise price and drive its rivals out of
business. So, warehousing would be an issue.

Of course, the fact that it has inventories does
not necessarily mean it is warehousing. It could have
been an error. It could have just bought more thinking
it was going to need it and then it just did not need
it. So, one has to be careful there.
Because of the concern, you know, that there are all these legitimate reasons why you might want to purchase more output, and the fact that there is this inherent short-run consumer benefit, I am very worried that there could be false positives, and for that reason, I am willing to put on the Brooke Group style test of output priced below cost, where it's really sort of that marginal revenue product, or Rick went on to the value of marginal product, being less than the input price. Because here, like with predatory pricing, there is inherent consumer benefit in the short run that may or may not be offset by consumer harm in the long run, and because there is that balance, it is a lot like predatory pricing, and so the rule might be close to the predatory pricing rule.

I also think that in the end, this is why the Supreme Court will opt for a Brooke Group kind of test, because it is so close to the reasoning in Brooke Group that they are going to probably find it irresistible to change the rule.

Now, it is possible that there is no consumer benefit in the short run. If the demand for the output was perfectly elastic, demand for the input was perfectly elastic, in terms of price taker, then, when it increases its purchases, it will not reduce the price
that consumers pay for the outputs. There would be no
consumer benefit. But on the other hand, and under
those same circumstances, there would not be any
consumer harm. So, under those circumstances, the
plaintiff would lose anyway. So, I think the Brooke
Group, adding the price-cost test in Brooke Group, will
not cause any damage in this situation.

Now, when it comes to raising rivals' costs
overbuying, I feel a more interventional stance is
necessary. Again, I have got a four-step legal
standard. I do not have the Brooke Group piece, and, of
course, the analysis is somewhat different, because the
goal here is to gain market power in the downstream
market, not to gain market power in the upstream market.
So, you would still ask whether there were good reasons
for the firm to increase its demand for the input, but I
would not go so far as the Brooke Group test.

Here, you not only have warehousing could be a
concern, but also naked purchasing. Now, what I mean by
naked purchasing is suppose the firm does not even use
the input. It might buy up some of the input for the
sole purpose of making it more expensive for its rivals.
For example, in the Alcoa case, it was alleged that
Alcoa bought exclusive contracts to electricity from
utilities where it never had a plan. They just bought
the exclusive so that other aluminum companies could not
buy electricity in those regions. So, that would be an
eexample of naked buying, there where an exclusive wasn't
overbuying, it was simply buying the exclusive.

You would never have naked overbuying for
predatory overbuying, because you can't get a
monopsony -- why would you want a monopsony? Why would
you want to knock rivals out and get a monopsony over
some input that you don't even use? So, you know, it
just does not compute.

So, assuming that you can show inflated input
purchasing, then you go through the standard type of
raising rivals' costs analysis to show consumer harm.
You have to show that rivals' costs were raised
materially, but that's not enough. That's just harm to
competitors. We know in Section 2 that is not enough.
You also have to show harm to competition, as you have
to show downstream market power, some power over price
downstream. And then, as before, you need to show net
consumer harm, because the overpurchasing could have
efficiency benefits. Maybe the firm is producing more
output and, you know, competing harder, that is a
benefit. So, you want to have that consumer harm
standard. As I said, it is more interventionist.

Now, by consumer harm, I really mean it. I mean
true consumer harm. I do not mean supplier welfare, and
I do not mean what Robert Bork called the consumer
welfare standard, which was really a total welfare
standard. I think Bork was either deceiving people,
which is what Herb Hovenkamp has said, or maybe Bork was
just confused, and the reason I think it is possible he
was confused is that if you care about the total welfare
standard, then competitor injury is enough to carry the
day, because competitors are part of total welfare.

Indeed, it is easy to construct mainstream
simple examples in which conduct could harm competitors,
consumers could benefit with lower prices, but yet total
welfare could fall, and yet under the total welfare
standard, total welfare would go down, and so if you had
in mind a total welfare standard, that conduct would be
illegal. Now, I just cannot believe that Bork would
want to make such conduct illegal. So, I have chosen to
believe, out of respect, that he was confused rather
than attempting to create a consumer protection problem
or a court protection problem.

There are other reasons why I think the consumer
welfare standard is better. It is consistent with
precedent. It is what the agencies use. It is simple
to evaluate. Actually, the analysis I have done and
several other economists have done, it has shown that
actually, even if you care about total welfare, for
several reasons, the consumer welfare standard actually
could lead to higher total welfare, and I will go into
that if that comes up later on.

Finally, I think the consumer welfare standard
supports innovation better than does the total welfare
standard. Again, I will go into that if there is time
later on.

So, thank you very much.

(Applause.)

MS. SCHULTHEISS: Okay, our next speaker is
Dr. Rick Warren-Boulton, a principal of MiCRA,
Microeconomic Consulting and Research Associates, an
economics consulting firm and research firm specializing
in antitrust litigation and regulatory matters. Before
joining MiCRA --

DR. WARREN-BOULTON: We like to call that
"MiCRA."

MS. SCHULTHEISS: I like to call it "MiCRA."

Rick Warren-Boulton served in a number of positions
involving economics and antitrust law. He was an
Associate Professor of Economics at Washington
University in St. Louis. He was the Chief Economist for
the Antitrust Division at the Department of Justice. He
was also a resident scholar at the American Enterprise
Institute.

Rick has authored numerous publications -- you
lack --

MR. KIRKWOOD: Are you still welcome there?

DR. WARREN-BOULTON: Yes, for lunch.

MS. SCHULTHEISS: Old friends, huh, Rick?

He has authored numerous publications, primarily
in the application of industrial organization economics
to antitrust and regulation. He's served as an expert
witness in numerous cases, including the Department of
Justice, U.S. versus AT&T, and for the FTC in our FTC
versus Staples and Office Depot merger. He also was an
expert with the Department of Justice in the United
States versus Microsoft.

In addition, Dr. Warren-Boulton was recently a
consultant in support of the Ross-Simmons side in its
effort to convince the Supreme Court to reject
Weyerhaeuser's petition for certiorari. Rick is yet
another one of our panelists who has some connection to
the Weyerhaeuser case.

Rick, with that...

DR. WARREN-BOULTON: Thank you. You know you
are getting old when you start talking about when you
were an expert witness in the AT&T case.

MS. SCHULTHEISS: And now they have all
DR. WARREN-BOULTON: -- in 1981, and in terms of my connection with this case, obviously I was -- I tried to help Ross-Simmons in arguing to the DOJ and the FTC that they should not file what they did, so it was a complete failure, but I will just keep trying anyway, because I might as well.

You know, the issue that I would like to talk about here today is really a question as to whether or not we need a test, or at the extreme, even a safe harbor, and I think we need to distinguish between tests and a safe harbor for cases of strictly what I would call predatory overbidding to achieve monopsony power, and I think what we are doing is, in the order of the speakers here, we are going from general to specific.

You know, I think that the much more broader and frankly more interesting question is exclusion, and I think Tim is right when he says if you come away from this with anything, it is, for heaven's sake, do not get predatory pricing or predatory overbidding mixed up with exclusion, and then I think Steve would say, do not get it mixed up with raising rivals' costs, too, and I agree, very much so, that those are two very important questions.

I do not think that the analysis, nor the
implications for policy, are the same for the three of them, and I think what I am going to talk about today is, in fact, the least interesting and least important of the three, but that is what I thought my topic was, and so that is what I want to talk about.

You know, I want to begin by distinguishing between an economic definition of predation and a legal test for predation, because coming up with a definition for predation is extraordinarily easy. Any of us can define predation. I was thinking about it before. I think it is the reverse of pornography. We all know it. We don't know it when we see it, but we know how to define it.

You know, testing predation or coming up with a test for predation is very difficult, because a test for predation involves a balancing of the costs and probability of false positives against the costs and probability of a false negative, and so finding the right tests or the right safe harbors for each distinguishable situation is fundamentally an empirical question, and it's a different question for every situation that you can distinguish.

What I think for us at the moment to think about it is is a couple of implications of that for coming up with tests for predatory overbidding to achieve
monopsony power. The first is, there is absolutely no need to have the same rule for predatory pricing to achieve monopoly power as predatory overbidding to achieve monopsony power. You don't need to have the same rule unless you can't tell the two situations apart. But even a court, to be honest, it seems to me, is unlikely to confuse predatory pricing with predatory overbuying.

You know, when you have predatory pricing, you look at the final product price, and it goes down, and then it goes up, and when you look at predatory overbidding, the initial price goes up, and then it goes down. So, it seems to me that trying to order that you need consistency between monopsony and monopoly situations when what you are looking at is completely different behavior seems to me to be unnecessary and sort of pointless. It may not be the hobgoblin of little minds, but there is absolutely no reason to say that just because something is over here in the monopoly world, that we should apply the same rule in a monopsony world.

The second is, I think it is very easy to distinguish between predatory overbidding and what I think is going to be Janet's concern, which is between predatory overbidding and either the exercise of
monopsony power or, more importantly, the exercise of bargaining power by power buyers. When you have predatory overbuying, what happens is your input price goes up, and then it goes down. That is what we are looking at today. When you are looking at bargaining power, in my experience, input prices go down and then they stay down. You know, power buyers like Wal-Mart pay lower prices, you know, from the get-go. Wal-Mart, to my knowledge, has never been accused of paying too high a price, even temporarily.

Once more, of course, is you can distinguish the output effect, the classic monopsony problem, is you buy too little. You know, Wal-Mart buys a lot. So, it seems to me, you know, there should not be much concern here about false positives when we are facing allegations of predatory overbidding, and I hope that Janet will disagree strenuously, and I am sure she will, because otherwise, it will be no fun at all, but the result of this, I think just as a sort of preamble, is I find no urgent need for a safe harbor to deal with allegations of predatory overbidding to gain monopsony power. I do not think we should expect a flood of cases that might be false positives, that if we do not immediately nip this in the bud by allowing a Brooke Group safe harbor for predatory overbidding, and
I am certain Janet will disagree with that one.

The second point to me is there is no reason why we can't proceed inductively, decide Ross-Simmons and any of the other rare cases that arise on the merits, and then try to generalize them. There are two procedures here. Lawyers, in my experience, the idea is that you have a whole bunch of cases, you try them on the merits, and then you ask, "Gosh, is there some common principle that's going on here?" It is very much of an inductive reasoning process, and it works very well.

I think the economist approach is highly complementary. We go the reverse. We think deductively. We think what are the first principles, and we try to deduce, deductively, what the right principles are, and, you know, with any luck, it is like two people tunneling from opposite sides of the mountain, you know, the lawyers going inductively and the economists going deductively, and if all goes well, we meet in the middle, and if we don't, we just keep going until we get the other side, and we have two tunnels.

But, you know, this strikes me as a situation in which I think the lawyers -- I mean, look at how many years we have been trying deductively to figure out what
the right principle to use is on predatory pricing for,
you know, on the output side. We can't figure out the
damned thing. I mean, you know, look how far apart
those two gentlemen are, opposite sides of the table for
God's sake. They are never going to agree. So, I think
that the deductive approach really -- I mean, I think we
have plenty of time to get a few more Ross-Simmons cases
and then figure out how to go on.

But let us suppose -- you know, at this point, I
think I could sit down and say there is no need for me
to proceed further, but unfortunately, my panelists
won't let me do that, and anyway, I think I have another
six minutes. So, let's ask the question. Let's suppose
that you did do the unnecessary thing and you did ask,
well, let's ask, what kind of tests should we sort of
come up with for predatory overbidding to achieve
monopsony power? And the question I think you want to
ask is, what are the questions we want to ask?

And I think you really want to ask things like,
is monopsony different from monopoly? Are bidding
markets -- because remember, this was specifically a
bidding case -- are bidding markets different from, you
know, other markets? And I think that the first answer
is -- on both of them is yes. If you look at the
difference between monopsony and monopoly, I have a
paper, which I am not posting on the web site until I get a chance to sort of, you know, get all the information, getting digs at Janet, so I will post it later, but, you know, two of the main differences between monopoly and monopsony it seems to me is monopsony is much rarer, and it is easier to identify.

Monopsony is rarer for several reasons. Basically supply inelasticity is much rarer than demand elasticity. We all know this. Why is it? Well, producers can substitute easier than consumers in general, but most important, you know, in consumption, diminishing returns, you know, the demand curve slopes downwards, I mean, we all know that.

On the other hand, in production, the norm is constant returns to scale, and so what we tend to get is, you know, a situation in which -- I just -- you know, I don't like -- I don't have a blackboard or a white board, but if you were drawing a demand and supply curve, you would feel perfectly normal drawing a horizontal supply curve and a downward-sloping demand curve, something which would look like this, but most of you would think that what's somewhat less usual is to have a completely horizontal demand curve, supply -- you know, upward-sloping supply curve. I mean, fundamentally, demand curves slope downwards. Supply
curves usually are horizontal. So, the reason why we get that is I think because there's a real difference. There is diminishing returns of consumption and relatively constant returns on production.

The second thing is I think monopsony is much easier to identify, monopsony power, for several reasons. One is that supply inelasticity is really only observed in a few situations, and when I stop and I think about what they are, they are most importantly, in my experience, when a product is a by-product of some other product or when it is an exhaustible natural resource. Both of those are very unusual, and, you know, both of them actually apply in this particular -- in the Ross-Simmons case. Alder turns out to be a by-product or what they call a come-along product in the industry, and it is an exhaustible product. So, you can use the screen essentially of a by-product as a -- to limit the scope of any decision.

By the way, there is a second reason, which I always find kind of fun, which is why observing monopsony is so much rarer than observing monopoly. Monopsony is inefficient, and so nearly all monopsony situations or potential monopsony situations are solved by vertical integration, okay? If you are an aluminum plant and you are right next to an electricity dam and
you are the only buyer of electricity, you have monopsony power towards that supplier, say, of electricity, and exercising monopsony power can be profitable. It is even more profitable, though, if you buy the dam and get rid of the inefficiency.

So, vertical integration is profitable because it gets rid of the inefficiency of monopsony, okay? But vertical integration backwards is much, much easier than vertical integration downwards and to the consumer, and the nice test for this is if you ask where do we actually see monopsony being exercised, in most cases, it's situations where vertical integration is not possible, and the classic example of that, at least since the Civil War, is labor. You cannot buy people, okay? And that is why the other day, you know, if you were reading the New York Times, you would find that it said a class action case, you know, on monopsony, who is it? It is by a group of nurses who are being -- the assertion is that they are being monopsonized. Now, if the hospital could just buy the nurses, there would not be a monopsony problem, okay? So, most monopsony cases are in labor, because vertical integration does not solve the problem.

All right, the second main difference that I think we see between everything else we are talking
about is that these are, of the cases that we are
talking about here, Ross-Simmons, is it is a bidding
market, and the question is, just like monopoly is
different from monopsony, bidding markets are different
from markets in which there simply is single price. The
classic problem with predatory pricing has always been,
and I think it was Steve who introduced this, that it is
inherently implausible, because the cost to the predator
with a high market share is so much greater than the
harm to the victim.

If you have a 90 percent market share and you
engage in predatory pricing, you bear 90 percent of the
costs, and the guy with the 10 percent share bears 10
percent of the costs, and that is so stupid, you know,
that it is fundamentally implausible. The guy does not
believe you are going to keep shooting yourself in the
foot over and over and over again. So, it is sort of
hard.

But, you know, when you can price-discriminate,
if the potential competitor can price-discriminate, if
prices are individually negotiated, then the cost to the
predator is no longer linked to the market share. There
is no longer any connection between the relative cost of
the predator and the predatee, you know, and then market
shares, and so you have a fundamentally different
probability, you know, of a false positive here.

So, you know, my conclusion, looking at this, is
that if I am looking at the specific problem that we are
dealing with here, which is predatory overbidding to
achieve monopsony power, that if you have a combination
of three things, you have a very good probability of a
real case being there and a very low probability of
having a false positive. Those three things are a very,
very low supply elasticity of the input, which as I say
is almost always just when it is either a by-product or
a natural resource; secondly, the ability of the
predator to price-discriminate, particularly in bidding
markets; and third, very strong barriers to re-entry.

If you have those three things, then I think you
have basically passed sort of the structural criteria
that you need to pass. You don't pass -- you know, I
think you have to pass all of those three, but if you
pass those three, then I think you have a very good
argument here that the predatory overbidding to gain
monopsony power is, in fact, a realistic effort.

Recoupment, what I am basically saying, is very
likely, and then you do not need to get into the kind of
cost tests that are in Brooke Group that I think most of
us have looked at and said, the problem with these cost
tests is that they generate a very -- particularly if
you allow them as safe harbors, they allow a high rate
of false negatives. If you look at Ross-Simmons, it
fits all of those, alder is a by-product, prices are
individually negotiated, and the equipment that the
sawmills was using is actually specific to alder, okay?
If Ross-Simmons' equipment could have been used either
for alder or soft wood, then we would not be here. Then
basically, you know, Ross-Simmons could have been a
hit-and-run entrant. They could have come in, they
could have gone on, but the specificity of the equipment
means basically that there is a very high barrier to
re-entry.

If you look at those three criteria, I think it
merits what the Ninth Circuit sort of was saying. It
was saying that predatory overbidding for a resource
input in a highly inelastic supply, combined with a high
barrier to entry by the downstream firms, you know, that
is an extraordinarily narrow set of events, and if you
look at that and you combine that with a
no-economic-sense test, to understand the strategy and
say does it pass the economic sense, I do not think
there is any need for going into, you know, cost-based
tests. I think what we could basically do is accept the
Ninth Circuit decision, construe Ross-Simmons narrowly,
and we can all wait for the next 20 or 30 years to see

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if another case ever turns up.

You know, finally, in terms of the two gentlemen
over here, you know, I think we owe an enormous debt of
gratitude to what used to be called the Chicago School,
but I guess in this case more the University of Virginia
school, for 40 years of reducing false positives, and I
think that is yeoman's work at the academic level. I
would like to believe that the Reagan Administration and
Bill Baxter and the people who came in with him were at
least sort of implementing that, but I think one thing
we should realize is that getting rid of false negatives
is a complement to reducing false positives.

We all know on deterrence that optimal penalties
are a decreasing function of the probability of a false
positive, and for those of you who do not quite
immediately know what that means, what it means
basically is now that we have DNA testing, the case for
capital punishment is much stronger. That is the
easiest way to think of it.

So, what has happened is we have an accumulated
experience, we have many cases of alleged predation, we
have economists working on it, and I think we have
greatly reduced the level of false positives, and I
think the problem is, of course, is once you have
reduced the probability of false positives
significantly, then it becomes efficient and desirable
to turn to the question of can we reduce the number of
false negatives. So, I think what we are seeing over
here, and I know Professor Elzinga is going to shoot me
for this, but I would say Professor Elzinga has made
Professor Bolton possible. I leave the two of you to
duke it out.

(Applause.)

MS. SCHULTHEISS: Our final speaker is Janet
McDavid. Janet McDavid is a partner in the Washington,
D.C. office of the law firm Hogan & Hartson, where she
focuses on antitrust and trade regulation, litigation
and counseling. She is widely recognized as a leading
authority in antitrust law, has been included in many
guides to top antitrust lawyers, and an author of many
books and articles on antitrust law.

Ms. McDavid was previously the Chair of the
Section of Antitrust Law of the American Bar Association
and also a chair of its committee on Section 2 of the
Sherman Act. As a member of the Antitrust Council to
the U.S. Chamber of Commerce, Ms. McDavid also brings to
us a business perspective.

In addition, of particular relevance, again, to
today's hearing, Ms. McDavid was a co-author of the
brief for the Business Round Table and National
Association of Manufacturers in support of Weyerhaeuser's petition for certiorari, and Ms. McDavid was also the lead author of a recent article in the National Law Journal entitled "Predatory Purchasing?"

And at this, I give Janet the job of cleanup and responding to some of the comments that have been made thus far.

MS. McDAVID: I don't think my views will be quite as extreme as Rick may have suggested. My perspective here is that of a practicing lawyer who has to try to advise clients on where the line is between conduct that might be unlawful under the antitrust laws and conduct in which they can engage with relatively low risk, and Rick has suggested that greater clarity in this area really is not necessary, we should just allow the law to develop for a while and see whether inductively or deductively we can establish some rules, because the cases are rare.

I am not seeing dozens of these cases in my practice, but I am increasingly seeing a lot of monopsony questions coming up from my clients, and so I do not think these cases are likely to be as rare as perhaps has been hypothesized. I am hoping that these hearings or the Weyerhaeuser case in the Supreme Court, whichever comes out first, can provide an answer with

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respect to the predatory purchasing conundrum that can
reasonably be applied by businesspeople and their
lawyers.

Remember, the purchasing department of even a
Fortune 100 company does not include these guys. They
would not know a downward sloping demand curve if it hit
them in the face. And so the notion that that is a
standard that can be applied by a businessperson in a
purchasing department is just unrealistic.

It is actually quite funny, I think, that Rick
referred to Justice Stewart's definition of pornography,
because that is also the analogy that I had here. I
think the --

DR. WARREN-BOULTON: Like minds.

MS. McDAVID: -- Ninth Circuit standard in
Weyerhaeuser provides much less guidance than Justice
Stewart's standard with respect to pornography. There
is no basis here for advising a client, and this is a
serious mistake, because ultimately, businesspeople have
to understand the rules. Justice Breyer, when he was
still on the First Circuit, said that antitrust rules
must be clear enough for lawyers to explain them to
clients and be administratively workable, and that in
formulating antitrust liability standards, the courts
must consider what advice the lawyer is going to give.
Chairman Majoras made essentially the same point when she opened these hearings on Tuesday. The process of distinguishing between the permissible and the impermissible must be relatively consistent and transparent so firms can incorporate it into their decision-making.

So, where does that leave us with the Ninth Circuit? We have a standard of liability that allowed a jury, using 20/20 hindsight, to determine whether Weyerhaeuser paid a higher price than necessary to prevent Ross-Simmons from obtaining its inputs at a fair price and that Weyerhaeuser may have purchased more logs than necessary. How is a business person supposed to apply that standard? It is entirely vague, open-ended, and subjective. It gives us no way to draw the lines, and a jury exercising its 20/20 hindsight can come out in a completely different place than a perfectly rational businessperson did.

I think it is significant that Weyerhaeuser never lost any money on any of this. The division was operating profitably the whole time. I reread the Ninth Circuit decision this morning, and the Court talks about the need for recoupment in order to render the strategy profitable, but it does not actually impose that requirement as part of the test. So, the Court gave lip
service to recoupment without ever requiring it as part
of the standard.

So, one of the effects of all of this is to prop
up less efficient firms, such as Ross-Simmons, that are
unable to operate profitably at the same input prices
that a more efficient rival can afford to pay. Now,
firms compete for inputs just as they compete for sales,
especially if the inputs are scarce, and there is
language in the Ninth Circuit's decision that suggests
that the inputs were becoming more scarce. They
certainly were not more plentiful. So, we have a
circumstance in which firms are going to be deterred
from aggressive buying by the threat of liability for
treble damages as a consequence of a standard that they
cannot understand and cannot apply.

How is a firm supposed to know if a jury will
later determine whether it bought more than it needed,
whether it paid a price that was too high, whether it
paid a price that was not fair? If it buys too much,
there are lots of reasons that that could have happened,
as Steve was explaining earlier. It might have decided
to stockpile inventory to preclude future shortages or
to hedge against a future price increase. That happens.

We had it happen, for example, during the
Hurricane Katrina circumstance. Oil companies had
inventories. They were able to sell it off during a
time of shortage. They might have overestimated their
needs. Businesses make mistakes. They might have
assumed that demand was going to increase, and it did
not. Again, businesses make mistakes. They may have
planned that sales were going to grow and guessed wrong,
or they may have chosen to deal with the predictable
supplier who has a reliable source and paid a slight
premium to do so.

Any one of these could, in hindsight, become the
basis for liability by a jury that is exercising a
standard based on fairness. Under no other circumstance
in the antitrust laws, except perhaps the regrettable
Robinson-Patman Act, do we consider a fairness standard.
It is simply not administrable. So, people like me will
have a hard time telling our clients what they should
do, and the businesspeople on the ground will have a
very hard time knowing what they should do and what they
can do safely and fairly.

Now, I will recommend to my clients, as I do in
all circumstances, that they document the reasons they
are doing things if they face a risk. I always tell
them that I would prefer to create our own legislative
history, that in the event the inevitable happens, I
would like there to be evidence in their files that
explains, without us having to go back and explain it again, why they did what they did and that there was a rational business reason for what they are doing. I will also ask them, can you make money if you purchase at X price? Now, the unfortunate thing is, while I think that is a perfectly rational question to be asking, it is not relevant to the analysis in the Ninth Circuit, whether or not they were going to be able to make money if they paid X price for their inputs.

I do not understand why the Brooke Group standards should not be at least relevant to the analysis here. These are standards that businesspeople actually can understand. Very few of my clients have ever known what their average variable cost is, but they do know, if we talk about it in kind of gross terms, if you pay X or if you charge X, will you make money or will you be operating at a loss?

They also can understand the notion of whether or not it will be profitable in the longer term. These are standards businesspeople can understand, and the courts have got to give them some kind of guidance here, and if the courts fail to do so, I hope that these hearings will, because without it, the businesspeople are going to be left largely rudderless.

MS. SCHULTHEISS: Thank you, Janet.
(Applause.)

MS. SCHULTHEISS: I would like to thank all of our panelists, and we are going to take a brief ten-minute break, after which we will reconvene and have a directed discussion with some questions. Thank you.

(A brief recess was taken.)

MS. SCHULTHEISS: Okay, let's get started with the second part of our panel, which is the discussion period, and before I start asking some specific questions of the panelists, I would like to see if I can get some consensus from the panelists on some of the terms we are using and whether we are understanding them correctly.

As I am hearing the presentations, I hear that you are talking about two different things. You are talking about predatory conduct that affects the input suppliers and the price of the input supplies, and another area is the predation or predatory conduct that is directed at affecting your competitors in the output market. Is that correct?

Let's just start with Jack and let's just go through the panelists and see what you think. Is that a correct statement?

MR. KIRKWOOD: I am not sure I would put it exactly that way. I think that Steve's distinction is a
good one, that if you as the dominant firm could raise
the input costs of a rival, and the question is whether
your ultimate goal is monopsony power or, instead,
downstream market power, and the first I have called
predatory bidding, as did the Ninth Circuit, Steve has
called it predatory overbuying. The second category, it
could come from predatory bidding, as I explained, but
the second category is more typically described as
raising rivals' costs, or as Tim would say, exclusion,
and maybe Tim could address the question of to what
extent is exclusion different from raising rivals'
costs.

   MS. SCHULTHEISS: Tim?

   DR. BRENNAN: Well, I agree with what Jack said.
Again, I agree with the distinction as he put it or, you
know, that Steve made. I would not call both predatory,
because as soon as you do that, then you start using
predatory tests in both contexts, and I think for
reasons that I have argued and Steve has suggested as
well and others, that I think those are inappropriate.

The main reason I make the distinction, I mean,
I suppose there is a bit of a long story here, but just
to keep it short, the two are -- well, first, when you
say that the harm from something involves hurting
rivals, then I think you invite people to go back into
predation land, and I would rather call it something else, and the reason I would call it the something else, when I am calling it complement market monopolization, is that in order to exclude people, in order to raise their costs, whatever it is, you have to create and exercise market power over something that they need, and because antitrust authorities have ways of thinking about that sort of thing, that is what we do with mergers, that is what we do with cartels, you could in some sense take an enormous part of -- as Steve, I think, aptly put it -- the great lion's share of Section 2 cases and get them out from under the controversy that attaches to them because of the view that what Section 2 is about is in some sense about competing so hard that people get hurt too much.

MS. SCHULTHEISS: Steve, would you like to address that?

DR. SALOP: Yes, sure, I agree with Jack that I got it right.

DR. BRENNAN: I figured it was relatively safe.

DR. SALOP: I agree with the first two sentences of what Tim said. I think when you use the term "predatory," it is a loaded term. I never really liked the term "nonprice predation" for that reason. That is why I like calling it exclusion or raising rivals'

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costs.

Now, nonprice predation sometimes involves prices, like here, prices are involved, and when you call it predation, that tends to plug into Brooke Group, and as I said, I think there are two vastly different paradigms.

MS. SCHULTHEISS: So, in terms of what we are speaking about here today, Rick focused on the narrow with the predatory overbidding or overbuying that is in the Weyerhaeuser case, but then there is a separate area of conduct that involves some type of exclusionary conduct, what you call raising rivals' costs, what Tim might call exclusion, and looking at the complementary market.

DR. SALOP: I think what all three of us were taking issue with in your question was the word "predatory." Had you just said "conduct that gives market power in the input market" and "conduct that gives market power in the output market," we all would have --

MS. SCHULTHEISS: Do you all agree with that one?

DR. BRENNAN: More or less.

MS. SCHULTHEISS: What about you, Rick?

DR. WARREN-BOULTON: First of all, yes, I think
they are enormously different. I think that the first
is monopsony and the second is monopoly, and I think it
is incumbent upon a plaintiff to say which one -- which
world he's in. I agree that the false positive/false
negative trade-off is enormously different between the
two. I don't see how people can really -- or people
should not confuse them. I don't think they are
particularly relevant. I think all three of those
situations should be handled, you know, quite
separately, because they have different structure
requirements.

The final question, would I distinguish them in
terms of predation/nonpredation, no, I would distinguish
them I think in terms of, you know, simple pricing
versus, you know, more complex exclusion, you know,
price or nonprice. I mean, most of the really
interesting problems here really are exclusion done in
interesting and complicated and strategic ways and how
do we handle that. But again, I think at the very
beginning, it is really incumbent on people to say which
box they are in in any case.

MS. SCHULTHEISS: Janet?

MS. McDAVID: I think that Steve and Jack got it
right from my perspective.

MS. SCHULTHEISS: Okay. In terms of the
antitrust agencies, would you agree, then, that we
should be more concerned with the latter category, that
being, if you want to call it, either the exclusionary
conduct or raising rivals' costs, versus the pure
predatory buying towards, you know, monopsony over the
input market? And I would wonder -- I want to find out
if you agree with that.

MR. KIRKWOOD: I would be inclined to agree with
it, yes. I have not done the kind of research that
Steve has done into the frequency of raising rivals'
costs problems, but from what I have read of what he and
others have written, it seems to be a more common
problem. One of the key elements of the analysis of
predatory bidding we have done is that it seems to be
quite rare. So, yes, in terms of where you would target
your enforcement resources, sure, surely.

MS. SCHULTHEISS: Tim?

DR. BRENNAN: Yes, mostly for the reasons Steve
said before, that the predation parts of things, whether
it is buying or selling, are going to be rare for the
reasons he outlined and I do not need to repeat, and so
for that reason my expectation would be to worry about
things where people do not have to sacrifice a lot and
take a lot of risks in order to get some speculative
benefit down the road.
MS. SCHULTHEISS: Steve, I take it you agree.

DR. SALOP: Yes, I agree with what they said, but they didn't answer your question, which is, well, what the agency should not be doing, and frankly --

MS. SCHULTHEISS: I do not know if it is necessarily what we should or should not, but our primary focus. Should we be worried about one more than the other?

DR. SALOP: The way you phrased it is something that I think is all too apparent in this administration, which is you are spending an awful lot of time deciding what you should not do, and you are not doing a heck of a lot, and so I think that in the exclusionary conduct area, the agencies ought to get involved and start looking for exclusionary conduct cases rather than protecting monopolists.

MS. SCHULTHEISS: Okay.

DR. WARREN-BOULTON: I think I am probably agreeing with everybody. First of all, I agree that -- I mean, the whole point is that, you know, predatory overbidding to get monopsony power, as I said, is incredibly rare. So, the answer to the first question is yes, and oddly enough, I would agree with Steve that I think exclusion is a real problem, and so if you are going to spend more money on something, I would have you
spend it on exclusion.

MS. SCHULTHEISS: Janet?

MS. McDAVID: I would urge the agencies actually to play a role in the Section 2 enforcement area generally, because too often these cases arise in the context of disputes between business rivals, each of whom brings baggage, whereas the agencies are trying to do the right thing, and a case that an agency brings has been vetted carefully as opposed to just being the pissing contest between somebody who may have been forced out of business and thinks that, of course, it was unfair and something must have been wrong, it couldn't have been an inefficient firm, it couldn't have been incompetent. The agencies, I think, bring an important balancing rule to the enforcement in the Section 2 area generally and in this area as well.

MS. SCHULTHEISS: Let me ask you another question, Janet, because you were talking about in terms of counseling clients and what have you. Would you agree, then, with Rick and most of the other panelists, I think, that the overbidding or overbuying that we see in the Weyerhaeuser case is an unusual situation?

MS. McDAVID: I have not seen a lot of this. I think it probably is an unusual situation, but the plaintiff's bar is extremely entrepreneurial, and I do
not think we should assume that it will continue to be
an unusual circumstance.

MS. SCHULTHEISS: So, you --

MS. McDAVID: And virtually every major firm in
this country sues in the Ninth Circuit. So, unless the
law gets clarified, I think we will see these cases
because they will get syndicated.

MS. SCHULTHEISS: Steve, did you want to say
something in response to that?

DR. SALOP: Yes, I just wanted to -- I just
jotted down some overbuying cases before, and so I know
we see sort of the classic, you know, Ross-Simmons cases
being rare, but one, as I said before, Ross-Simmons
alleged raising rivals' costs as well as -- as well
as --

MS. SCHULTHEISS: Right.

DR. SALOP: -- predatory bidding, and in terms
of the history of antitrust, you know, among sort of the
cases I teach and run across, we have got not just the
timber cases, we have got the tobacco case was an
overbuying case, the beef case, the Monfort case that --
I mean, the beef case was a conspiracy in overbuying,
the Monfort case was about overbuying, went to the
Supreme Court, Socony-Vacuum was about overbuying, Alcoa
had a piece that was involved in overbuying, and in

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terms of what is going on right now, stuff the agency
has in its shop, all the stuff about shelf space is all
about overbuying, too, you know, could be thought of as
an overbuying issue. There could be overbuying of
patents. Alcoa, you know, allegedly tied up some
patents, so it made it harder for people in -- not sort
of classic predatory bidding, but, you know, you could
certainly have overbuying of patents, too.

So, I do not think it is a -- I think this idea
that it is just exhaustible resources that are
by-products, I know that covers the old molybdenum case,
one of my favorite cases when I was at the FTC, but I
think it is rather broader than that.

DR. WARREN-BOULTON: Can I just make a -- I
mean, I have not gone back and looked at the cases, but
I would question how many cases are there --

MS. SCHULTHEISS: Can you speak into the
microphone?

DR. WARREN-BOULTON: I'm sorry, how many cases
are there in overbidding to gain monopsony power. Steve
cites a tobacco case. I do not think that was to gain
monopsony power for tobacco growers. I thought that was
to exclude other, you know, cigarette producers. The
beef case, I do not think they ever managed to -- it was
ever shown that they ever managed to raise the price of
anything. The others I cannot remember, but, I mean, I
guess the question is, are there any cases other than
Reid, which was I don't know how long ago, and
Ross-Simmons that are predatory overbidding to achieve
monopsony power? I mean, I do not want to say sui
generis, because I do not know how to pronounce it
correctly, but it has got to be something like that.
Sui?

     MS. McDermott: Sui.

     DR. Warren-Boulton: Sue me, sue you.

     MS. Schulteiss: All right, Jack would like to
say something.

     MR. Kirkwood: Yes, Steve is certainly right
that there have been a number of overbuying allegations,
but if you look narrowly at how many of these cases are
predatory bidding cases, American Tobacco, as Rick and I
discussed last night, that seems fairly clearly a
raising rivals' costs case as opposed to a predatory
bidding case, because the kind of tobacco the major
producers bid up was a tobacco they did not use at all
and continued not to use it. So, they were not trying
to get monopsony power in it, because they were not
using it as an input.

     And in beef, though there was a predatory
bidding allegation, as Rick suggests, they were not able
to raise the price at all. And in Socony, that was
behavior designed to facilitate a cartel. Monfort had a
predatory bidding concern, but it was a concern raised
as part of an effort to enjoin a merger. So, there was
not any actual evidence of predatory bidding, and the
Court analyzed it as a predatory pricing case.

MS. SCHULTHEISS: Steve, and then I want to get
Janet's reaction.

DR. SALOP: Of course, the Supreme Court
misanalyzed Monfort, but putting that aside, I mean, I
agree, a lot of these are not predatory overbuying
cases, they are other things, but the Ross-Simmons jury
instruction does not require you to show anything other
than they paid more than necessary or bought more than
necessary or paid more than a fair price. So, all of
them would be swept in if we go inductively and just
allow the Ross-Simmons jury instruction to stand and
screw things up for another 15 years until Ken has to
get involved and clean up the area.

MS. McDAVID: That is precisely my concern, is
that if this is the law in the Ninth Circuit, virtually
anything can be brought as one of these cases, and they
probably will not be tried to judgment in the end,
because the defendants cannot take the risk of trying
those cases to judgment with the treble damages burden.
MS. SCHULTHEISS: I am going to let Tim have the last word on this particular point, and then I would like to move on.

DR. BRENNAN: I think that the reasons that Rick in particular elaborated on why these cases would be rare in terms of the circumstances of the market, exhaustible resources, the bidding market and stuff, I think those are all important to keep in mind. I do not think, though -- one should be careful about making the distinction, one, between buying and selling, because that can be just an arbitrary function on the nature of the market.

Let me give you an example, which is pipelines. I don't know as much -- I don't know as much now about how the pipeline sector works as I used to, but pipelines are kind of funny in the following sense: The way oil pipelines worked is that they sold oil pipeline delivery services to oil wells basically. The way the gas pipeline industry worked was that they bought gas from gas wells and then resold it at the end of the pipeline. If the oil pipeline was exercising market power against the oil wells, it would involve monopoly, that they were raising the price of pipeline services. If they were -- if the gas pipeline was exercising market power against the gas wells, it would be
monopsony. They would be driving down the price they
paid for the natural gas.

The triangles, the welfare losses, the dead
weight stuff, all that stuff would be exactly the same
in both cases, at least qualitatively it would be the
same, but one's monopoly and one's monopsony, and so
it's purely in some sense a -- I don't know, I won't say
it's arbitrary or artificial, but it is the way those
markets just happen to work. So, one needs to be
careful about making a distinction in that way, that one
can turn monopoly into monopsony in some sectors without
a great deal of difficulty.

DR. WARREN-BOULTON: Yes, I --

MS. SCHULTHEISS: Rick is going to have to get
the last word I see.

DR. WARREN-BOULTON: -- I very much agree. You
can be regarded as buying a service or selling, and it
can be based on form. I think one implication that I
think is kind of interesting is that in terms of a
welfare loss, you know, the idea that somehow welfare
losses are only important if they happen downstream
rather than upstream strikes me as kind of bizarre.

MS. SCHULTHEISS: Let's get to that in a second,
because I want to get to that issue.

DR. WARREN-BOULTON: But that is one of the
reasons why, because we can characterize it as upstream
or downstream sort of at will.

MS. SCHULTHEISS: Okay. Does everybody agree
that the jury instruction in Weyerhaeuser was just
wrong?

MS. McDAVID: Yes.

MS. SCHULTHEISS: Is there anybody that
disagrees with that?

DR. WARREN-BOULTON: You know, I am an
economist, I am not an attorney. If I was giving a set
of jury instructions to a group of economists, it would
be quite different from those instructions.

MS. McDAVID: How about if they were grocers and
guys who pump gas, because that is who your jury is made
up of.

DR. WARREN-BOULTON: So if I had a set of
instructions that said something like if you were a
group of economists and I wanted to have a recoupment,
how would I say that in a way that a group of grocers
would understand? You know, maybe this is the best way
the Court could think of to explain it to a group of
grocers. I'm not sure it would have been a better
result if we would have explained it in sort of
mathematical formulas.

MS. McDAVID: It probably would have been worse.
DR. WARREN-BOULTON: The question is, what does
the audience grasp?

DR. SALOP: You think saying they bought more
than necessary is a good proxy for recoupment? Is that
what you just said?

DR. WARREN-BOULTON: No, paying more than
necessary, it seems to me to be to a -- I don't know, an
ordinary person's idea of was there a profit sacrifice
here, all right, which is at least one element.

MS. SCHULTHEISS: But in terms of precedent, how
can that possibly -- you are just agreeing with the
statement I just said, then. You would not have that
kind of an objection to the standard that was set out in
the jury instruction.

DR. WARREN-BOULTON: You know, I am saying
anybody here, I think anybody here could probably today
come up with a better set of jury instructions than
that. How bad it is, I do not know.

MS. SCHULTHEISS: I do want --

DR. SALOP: Do you think a reasonable jury could
reach the right conclusion if they tried to apply that
jury instruction?

DR. WARREN-BOULTON: You know, actually, I have
been on a jury, and I have to tell you that my personal
experience is that what a jury decides has little, if
nothing, to do with the jury instructions. I was on a
cocaine bust jury in the District of Columbia, and we
convicted him of carrying a machete. We did that
because two people in the room said under no conditions
would I convict a male in the District of Columbia
carrying cocaine. We decided that he should go to jail
for three months, and we cast around to try to think of
what kind of thing would get him to jail for three
months. So, we convicted him of carrying a machete,
so...

MS. SCHULTHEISS: All right, I get the point.

There have been some different standards put
out, and I would like to get some input, because it
appears -- I mean, we have talked about consumer
welfare, we have talked about total welfare, no economic
sense, and they have come into play in different ways,
and I would like to start with you, Janet.

Which of the standards do you think makes most
sense in this type of a case, in the case where you are
dealing with either overbidding or some kind of
overbuying situation?

MS. McDAVID: Well, I am taken with Steve's
standard, which is effectively a rule of reason analysis
applied to the sort of circumstances we have here and
which incorporates as part of the analysis the Brooke
Group test, because I think it gives us some grounding.

MS. SCHULTHEISS: In dealing with the Brooke Group test, though, then, do you have to have power then in the output market in order to get that recoupment?

MS. McDAVID: You have to be able to make it up somewhere, and exactly where you are going to make it up might vary based on the particular circumstance and as to whether it's a raising rivals' cost case or a predation sort of case.

MS. SCHULTHEISS: But if you are recouping solely on the input side, on the supply-side, then you really do not necessarily have the consumer welfare harm.

MS. McDAVID: You may not.

MS. SCHULTHEISS: And in that case, would you find that there would not be a violation or there should not be an antitrust violation found?

MS. McDAVID: I am actually not terribly troubled by also applying the antitrust laws and allowing the victim to be the supplier, just as we do in the cases Gail used to investigate when she headed the health care shop where we looked at large insurance companies and whether they were going to acquire sufficient power over doctors and hospitals. I think it is a reasonable inquiry.
MS. SCHULTHEISS: So, the consumer welfare test should not necessarily be the end all and be all, okay.

MS. McDAVID: Not the exclusive. It should be the major concern, but it would not exclude entirely concern to suppliers.

MS. SCHULTHEISS: Okay, Rick?

DR. WARREN-BOULTON: Yes, I just categorically disagree strenuously. I mean, I just do not see any difference between a dollar in producer surplus that goes to some guy who is growing timber and a dollar to a guy who is buying a unit of lumber, nor do the Merger Guidelines. I mean, I think the economics literature is absolutely unambiguous on this. The welfare losses from monopsony are, you know, the same as the welfare losses from monopoly, consumer surplus.

I mean, I think Roger Noll wrote a very nice article right before everybody else's article that basically walked through that, you know, and as Tim points out, is that, you know, trying to find some distinction as to whether or not it is upstream versus downstream is completely arbitrary. It certainly cannot be a distinction that says, "Gosh, if it is a loss by producer, it does not count."

In that case, what you say is all input monopolies are legal? I mean, you do not care if it is
an input monopoly because, you know, the thing is bought
by a firm who does not necessarily pass it on? I mean,
the idea of restricting this to consumer surplus to me
is bizarre. I think basically you have got an
externality test, basically says I have got the bad guy
who is doing something, and the question is, is he
hurting the rest of society? And the rest of society
are the people he sells to and the people he buys from,
and those people stand, you know, on the same footing.

So, you know, I think what we used to call a
consumer welfare test when we were trying to read the
names back in the good old days is the sum of consumer
surplus and producer surplus. I think what most of us
say is you ignore the profits of the monopolist, but
that is it. Everybody else is in.

MS. SCHULTHEISS: Steve, is that what you mean
when you say consumer welfare or consumer harm?

DR. SALOP: No, I thought my slides were very
clear on that, and I have got actually a paper that I
submitted to the Antitrust Modernization Commission on
this issue. I think by consumer welfare I mean true
consumer welfare. I think that people who want to say
suppliers, losses to supplier welfare should be enough,
should consider whether they think harm to competitors
should be enough to carry an antitrust violation, and
the Supreme Court has made it very clear that harm to competitors is not enough, and I think the same thing should be true with harm to suppliers.

The tricky part of this -- and I am sorry, this is kind of a long answer -- the tricky part is that it is quite clear to make an agreement --

MS. SCHULTHEISS: Could you speak more into the mic? I'm sorry.

DR. SALOP: I'm sorry.

It's quite clear that naked agreements among competitors, buyer-side competitors, to fix prices that they make to inputs is illegal and should be per se illegal, and --

MS. SCHULTHEISS: Well, that is horizontal, though.

DR. SALOP: But that is where antitrust starts.

MS. SCHULTHEISS: Right.

DR. SALOP: So, I think it is worth thinking about that case, because a lot of people that I have talked to when I say it should be about consumer harm, not about supplier harm, they pretty quickly think about the buyer cartel cases, and the way I would distinguish is even in the buyer cartel side in the following way:

Suppose you have an agreement among competitors to jointly set -- I will not use the loaded term...
"fix" -- to jointly set the price that they pay for
inputs. I think if that is naked, it is quite clear
that is per se illegal and should be per se illegal, but
to the extent that they have a justification, a
procompetitive, i.e., pro-consumer welfare justification
for that, then it ought to -- and I think it does -- go
into the rule of reason, just like in VMI.

If a group of sellers jointly sets a price, it
goes into a rule of reason if they have a procompetitive
justification for their actions, and then when you get
into the rule of reason, I think it makes sense that
consumer welfare rules, that it is not enough -- once
they show that consumer benefit, then the burden would
go to the plaintiff to prove that consumers are harmed.
It is not enough to show suppliers are harmed, and it is
not, I do not think, a balancing between the losses to
the input suppliers versus the effect on consumers and
versus the gains to the buyers that engage in the joint
price setting.

So, you know, I think antitrust is a consumer
welfare prescription, it is about consumer welfare, and
we should stick with that. We should stick with that
here, particularly in a situation where -- you know,
with this overbuying, where in a standard case,
consumers gain in the short run from it, just as they
gain in the short run during the predatory period from predatory pricing.

MS. SCHULTHEISS: Okay, Tim?

DR. BRENNAN: A few very quick observations. First, I just happened to go to the AMC deliberations on mergers last week, and the only thing -- almost the only thing they argued about was the welfare standard, and the only arguments in favor of the consumer welfare standard that were given were essentially critical rhetoric, that the basis of public support for antitrust is if people believe it is about consumers rather than about the economy as a whole, but there was not a substantive argument offered in its favor. So, I do go with that.

As far as the harm to competitors being unduly counted goes, I suspect that in these cases, that is balanced out by profits to the perpetrator or gains to the consumers or someplace, that that is all going to be just a transfer, and you still end up with the assorted dead weight losses versus efficiencies that we are familiar with.

As far as what sort of tests to use, more specifically, on what I would call the exclusion cases, I basically view those as essentially horizontal, taking up an ever larger share of this complement market.
through exclusive dealing contracts or whatever it might be and that we have horizontal tools for looking at that. So, that is what I would use there.

On the predatory buying or predation cases generally, I do not know enough to know at what point one hits that balance between type I and type II error, but that to me is what it is about, I think rather than attempting to get each case exactly right, and I am just going to leave it at that.

MS. SCHULTHEISS: I am going to let Steve make a quick response and then Jack.

DR. SALOP: I am not surprised that the AMC was confused during the hearings on the welfare standard. Rick Rule testified that Bork used the Williamson Diagram, he called it consumer welfare, as Rick said, that was the old days when we were trying to confuse people. The Supreme Court cited the Bork book. Therefore, what the Supreme Court meant by consumer welfare is total welfare, and that is the law, you know, so I can certainly see why the AMC would get confused.

With respect to what the law ought to be, you know, I think it is a complicated argument, but to Tim I would say the following: It is not just a transfer. Suppose you have entry into an industry by a relatively high-cost entrant, enters the market, prices begin to
come down, benefiting consumers, and then the
monopolist, which has got much lower costs, kills the
entrant, prices go back up, suppose demand is relatively
inelastic? Well, in that situation, the killing of the
entrant would raise total welfare, and I thought you
said in your statement that standards like that were no
good, but regardless of what you said, it is quite clear
that that is conduct that I think ought to be illegal.

MS. SCHULTHEISS: I want to get to Jack now.

MR. KIRKWOOD: Sure, sure. We are looking at
various welfare standards now, which is inevitably a
somewhat complex topic. One choice is between total
welfare and what Rick called third-party welfare, so let
me just talk about total welfare versus consumer
welfare.

That is ultimately a value choice. You can
think of the famous Williamsonian case where the merger
lowers cost but raises price. My value judgment is that
antitrust ought to stop that. There are arguments pro
and con, but the legislative history seems to reflect
that judgment, and every court that has ever faced that
issue has come out the same way.

On the more difficult and more judgmental choice
of supplier welfare versus consumer welfare, I agree
with much of what Steve said and originally wrote my
article using a consumer welfare test, even in monopsony cases, because generally there is a link between the adverse impact on suppliers and the adverse impact on consumers, but people raised two issues with me.

One, what about the case law? The case law generally favors supplier welfare in a monopsony or cartel case, and two, what about those instances, of which Steve has described, where there is an adverse impact on suppliers, suppliers are exploited, just like in that merger, prices to them are lower, but no impact whatsoever on consumers? Does that allow the practice? And it does not seem it should.

DR. WARREN-BOULTON: Can I just make an example, and I am responding really to Steve, to his statement that somehow once we start talking about producer welfare, we have to take into account the welfare of competitors, and I do not think that is true. Let me give you an example.

Suppose that I am a Kansas wheat farmer, and what I do is I burn down all my neighbor's fields in the county. Now, do we have a harm here? Yes. The question is, is it an antitrust harm?

Now, you know, it is unlikely to me that I am going to burn down all my neighbor's wheat farms because I think that as a result, you know, there will be a
shortage of wheat and I will be able to raise the price
of wheat. So, I do not have any consumer harm at all.
Let's suppose that there is no input problem at all.
Then I typically have harm. I do not have an antitrust
harm. I still presumably go to jail for arson, right?
So, I have harm, but it is not an antitrust harm.

Antitrust harm gets triggered when I have a
market impact, and it could be one of two things. It
could be that I really burn down enough wheat to
actually raise the Chicago price of wheat, unlikely, but
if somebody came to me and said, you know, what the guy
did is he burned down all his neighbor's wheat farms,
and why did he do it? He said because there is a local
labor market for workers, and if I burn down and put out
of business all my local -- you know, who are with me in
the local labor market, I will be able to reduce the
prices I have to pay my workers.

Now, that is monopsony. Now, do I think that is
an antitrust violation? Yes, I would say that that is
an antitrust violation. I do not care whether it is
raising the price of wheat or reducing the wage rate of
farmers, nor do I think, in particular, that somehow
that one, you know, on some ethical standard, they are
any different. In fact, wheat bread consumers are
probably richer than farm laborers. So, there is some
distinction. I do not think you have to say that somehow by bringing in producer surplus, we are somehow worrying about competitors.

DR. SALOP: Well, you said something very different. You said you would be willing to find an antitrust violation where there is no consumer harm. That is different from saying that you are adopting the total welfare standard as the overarching standard to govern antitrust cases, because if you were adopting the total welfare standard to govern antitrust cases, then the simple business tort of burning down your neighbor's fields would lower total welfare, and it could support an antitrust violation.

Certainly if you and your neighbor burned down everybody else's fields, so you would not get into all this complexity --

MS. SCHULTHEISS: Let's deal with a single firm, which is what we are really focusing on.

DR. SALOP: Actually, we are not. We are focusing on what the welfare standard should be.

MS. SCHULTHEISS: Right, but in connection with Section 2.

DR. SALOP: Well, why would you have a different welfare standard for Section 1 and Section 2? Why would you want to make -- why would you want to gerrymander
antitrust and make it incoherent? You know, Tim pointed out this notion of the pipeline, you know, if you have different rules governing how -- if the rules are very different according to whether the pipeline does a tolling agreement where they sell services or whether they buy the gas and resell it at the other end, you are going to have incoherent antitrust. If you are going to have dramatically different rules for tying, exclusive dealing, vertical mergers, where one's per se illegal, one's rule of reason, and one's virtually per se legal, well, since lawyers can characterize conduct pretty easily as any one of those three boxes, you are going to end up with very incoherent antitrust, which we did until the eighties. So, I think saying this is Section 2, not Section 1, that is a recipe for disaster.

MS. SCHULTHEISS: Janet, did you want to respond to that?

MS. McDaviD: No.

MS. SCHULTHEISS: Okay. Rick?

DR. WARREN-BOULTON: Well, the broad question is, gee, do we have to have the same rules in every situation? My answer is no. If you can distinguish between situations, then you can have the same rules -- you can have different rules. There is no --

MS. SCHULTHEISS: But would the test be the
same?

DR. WARREN-BOULTON: Sure. I mean, I think the test for naked price-fixing is different than the test -- you know, for the safe harbor for naked price-fixing is very small. I think the safe harbor for, you know, predatory pricing should be quite large.

MS. SCHULTHEISS: No, I mean in terms of the consumer welfare versus total welfare, that test should be the same across all of the violations or different? Steve is arguing I think that it should be the same welfare test regardless of the violation.

DR. WARREN-BOULTON: Oh, I see, yes. You can argue what is the best welfare, but somehow suppliers are upstream or downstream, welfare does not change depending on --

MS. SCHULTHEISS: So, you agree with Steve, then, that whatever welfare test -- whatever welfare test is chosen should apply across all of the various violations you're looking at?

DR. WARREN-BOULTON: As long as he chooses my welfare test, then --

MS. SCHULTHEISS: Janet, would you agree with that? Yes, no?

MS. McDAVID: I think we should probably move on.
MS. SCHULTHEISS: Well, I think the test is important, though, and I think whether you apply the same test or not is an important issue.

DR. WARREN-BOULTON: It has a huge effect on the case in question.

MS. SCHULTHEISS: And I really would want to know whether you think we should be using a consumer welfare test or a total welfare test regardless of the type of violation you are looking at.

MS. McDAVID: Well, I think I started by saying much as Rick did, that the suppliers are entitled to a competitive market just as buyers are, and so I would not exclude a remedy for suppliers by using a test that focused entirely on consumers.

MS. SCHULTHEISS: Exclusively.

DR. SALOP: Suppose two firms get together and exchange a technology, a labor-saving technology, that enables them to produce the same amount of output with less labor, and as a result of that agreement, the firms demand less labor and the wage rate goes down or some other input, if you will, and suppliers -- here the suppliers of labor are harmed. Do they have standing to bring an antitrust case against that agreement?

DR. BRENNAN: No, because total welfare went up.

MS. SCHULTHEISS: Jack?
DR. WARREN-BOULTON: Total welfare -- I mean --

MS. SCHULTHEISS: Let's do this in order. Jack

looked like he wanted to respond. Let me let Jack

respond first.

MR. KIRKWOOD: Yes, that was a point I didn't

comment on before, but I do agree with Steve there. If

you do have a case in which there is supplier harm but

customer benefit, then I would go with the consumer

welfare standard. I think that does make antitrust more

coherent.

DR. BRENNAN: Total welfare went up in that

standard, so I would stick with it.

DR. SALOP: Yes. Now, how do you know that

total welfare went up? Did you do that calculation?

DR. BRENNAN: It is a -- I guess it is a

presumption for me, kind of 101, yes.

MS. SCHULTHEISS: I mean, I am going to give

Rick and Janet one more chance, and then we will get off

this.

DR. WARREN-BOULTON: How about we get a group of

consumers that get together a group of monopsonized

customers, is this somehow a good thing? I don't think

so.

DR. SALOP: That is the cartel case decided by

Judge Breyer at the time, and he said it was okay.
DR. WARREN-BOULTON: Well --

MS. McDAVID: I think in this -- in the circumstance that Steve has posited, we have got an integrated joint venture that will be evaluated under the rule of reason, there is an efficiency and a business rationale, and under the rule of reason, you probably do not conclude it is illegal.

MS. SCHULTHEISS: Well, I want to get to something else that is completely off of this topic for a few minutes, because I want to make sure we have time for it, and that is related to relief and remedies.

How do you deal with relief and remedies and in particular in the overbidding situation? Should a court enjoin the defendant's pricing? How do you deal with that issue in the context of this type of conduct?

MS. McDAVID: Well, in the private party litigation, it is going to be damages.

MS. SCHULTHEISS: I mean in a government case.

MS. McDAVID: In a government case, probably -- well, then you need to have a standard, and a standard of fairness does not allow a remedy.

MS. SCHULTHEISS: But even if you have the Brooke Group standard, what is the Government's remedy in that situation on the predatory bidding, you know, raise your prices or lower your prices? I mean --
MS. McDAVID: It is pretty unlikely to me that
this is going to be a government case, although I think
there is a role for the Government to play in Section 2
effort, an important role. These cases are going
to come up in disputes among rivals.

MS. SCHULTHEISS: So, you are thinking the
overbidding context, it is not the type of case that the
Government should be getting into?

MS. McDAVID: It is the type of case that I
doubt the Government will get into. It is the type --
the Government typically intervenes in cases where there
is kind of a broader principle to be generated. This is
typically an intrafirm dispute or interfirm dispute, and
they rarely get into those circumstances.

MS. SCHULTHEISS: Well, when we are looking at
what test to apply, though, you know, for example, you
know, we did file an amicus brief in this case,
obviously concerned with the test and the jury
instructions from the Ninth Circuit, if it had been a
government case, and I mean this sincerely, what kind of
relief could the Government get in any kind of an
overbuying monopsony type case like this? Does anybody
have any --

DR. WARREN-BOULTON: I am about to agree with
Janet. I think there are situations in which we rely
primarily on deterrents -- there are situations in which
deterrents, ex post penalties, are simply much, much
less expensive than ex ante penalties. I mean, you
think of how would you have hypothetically solved
Weyerhaeuser. Well, I suppose to me the answer is you
deter basically through either private litigation or a
fine. How could you prevent this situation? Would you
have to divest? You would have to sort of break up
Weyerhaeuser.

It seems to me that facing an alternative,
looking at the costs of preventing bad behavior through
structural means, that is to say, you know, forcing
Weyerhaeuser to sell off sawmills versus simply having
an ex post, you know, you will face damages if you, you
know, behave badly. A behavioral remedy is probably
better than a structural remedy, and if it is
behavioral, it seems to me I agree with Janet, it is
really something -- it is for private litigation.

MS. SCHULTHEISS: Would you agree with that,
Steve?

DR. SALOP: No, I thought -- I think there is an
answer. First of all, what the Government usually does
is it gets an injunction. You tell them not to violate
the standard anymore, and once you know what your
standard is --
MS. SCHULTHEISS: We have to have a standard, yes.

DR. SALOP: -- which hopefully you will know once you bring the case, then you tell them, don't violate the standard.

Secondly, I am not sure why Rick was so negative with respect to structural relief. If what Weyerhaeuser did was it knocked its rivals out of business and thereby got a monopsony, then the way to jump-start buy-side competition is to make Weyerhaeuser divest some of its mills to re-establish that competition, or perhaps if Weyerhaeuser simply has one big mill, you would make Weyerhaeuser subsidize the entry of the small sawmills that it knocked out of business. So, there is a potential structural remedy there, or, of course, maybe this would be one of the places where the FTC should seek disgorgement.

MS. McDAVID: You see, that is precisely the remedy for private damages. That's what private damages are designed to achieve, is what Steve has just described.

DR. WARREN-BOULTON: I agree.

DR. BRENNAN: I agree with Steve, and I think Ken said it earlier today, about if you have a structural remedy, that that would be a better thing to
do. I think the instance was slots, you know, making
that more competitive or something for airports.

The one thing that came up in the morning
discussion and also here that I honestly do not
understand is that somehow that seeking damages is
different and that this question only comes up with the
Government seeking injunctive relief, because if you
have a world where damages are collectible, then people
out there have to know what to do to avoid having to pay
damages, and the threat of damages in predation cases
is, I think, going to involve some kind of, in effect,
price regulation that says, you know, if you are bidding
now, if you set your price -- if you pay -- and that's
in essence the whole problem with the jury instruction,
right, that if you pay this much, it's okay, but if you
go beyond that, then you are paying too much, and then
you are liable to damages, and it is the threat of
damages that basically you are going to force people to
say, how high a price can I pay and I can't go above
that.

So, there is something I think inevitable about
this kind of law apart from the Government's specific
remedies that says that some prices are okay and some
prices aren't okay.

DR. SALOP: But that is not a lot different than
saying you can have exclusive dealing arrangements with six supermarkets but not eight. You talked earlier about the share remedy, so why is one less administrable than the other?

DR. BRENNAN: I mean, I think that is a good question. I mean, it's -- you know, we are more comfortable with merger law than we are with price regulation, and maybe we shouldn't be.

MS. SCHULTHEISS: Jack?

MR. KIRKWOOD: Yes, Pat, your question is excellent, because it forces all of us who are thinking about what standards should be ideal to think about them in the concrete situation where a court might enter an injunction that incorporates the standard, and so if I think a particular standard is appropriate, that would incline me to believe that an injunction that wrote it down would be appropriate, too.

I am a little reluctant, for the reason Ken suggested, antitrust normally does not get into direct price regulation, and you would think in the kind of structured rule of reason that Steve and I have been advocating, though with some differences, that there would be more flexibility in the way a court would interpret such a standard in an actual case than the way a court might interpret an order that was written down.
where someone was seeking contempt sanctions. So, I
would be a little reluctant to enter an order here and
would want to pay attention to the possibility of
structural relief.
Weyerhaeuser had six different mills in the
area, so it is not inconceivable, and it acquired those
mills rather than building them internally.
MS. SCHULTHEISS: So, you would envision that it
would be possible for the Government to seek relief
other than just an injunction?
MR. KIRKWOOD: Yes.
MS. SCHULTHEISS: Putting aside damages, you
know, the DOJ going for treble damages?
MR. KIRKWOOD: I mean, the preference, as Janet
suggested and Rick, is for --
MS. SCHULTHEISS: Deterrence.
MR. KIRKWOOD: -- private action.
MS. SCHULTHEISS: Rick?
DR. WARREN-BOULTON: One little problem, and I
think it was echoed by somebody this morning, who said
that, you know, the harm to competitors may correlate
but is not a very good measure of the harm to either
consumers or to producers. In the Ross-Simmons case,
the person who is suing for damages is Ross-Simmons,
another sawmill. I mean, the whole theory of this is
the person who should be suing for damages is the timber
owner. I mean, they are the guys who supposedly have
been harmed by this, who are being monopsonized.

MS. McDAVID: They weren't sure, they were
getting a little extra.

DR. WARREN-BOULTON: The question is, why do we
have the competitor suing rather than the timberer, and
the answer is because the competitor gets hurt first,
right? Now, we could, of course, simply have said
forget it, let's wait, right? But having the competitor
sued is a sort of an ex ante, prophylactic way to
prevent presumably the monopsony harm to the person you
are really worried about, you know, who probably never
turned up in this litigation, which was the people who
were actually sawing the timber. They are the guys who
were supposedly monopsonized.

MS. SCHULTHEISS: I am going to ask Ken and
Patrick, since they have spent the afternoon with us and
have clearly given a lot of thought to these issues, and
we talked about it extensively this morning on the
sell-side, whether you have any response to the remedies
on this side of it, of the issue.

DR. ELZINGA: I just have a couple reactions.

First of all, I must confess --

MS. SCHULTHEISS: Is there a mic near you?
MS. McDAVID: First of all, you notice they are sitting closer together.

MR. KIRKWOOD: And further away from us.

DR. ELZINGA: But you will notice it is I who moved, and I did that as a symbolic gesture in response to what Rick said, and also I moved to my left, which is uncharacteristic for me, as my students would know.

Two things: First of all, this has been extremely helpful to me. I didn't realize this whole topic on the buy-side was such a big issue, and that is a reflection perhaps of my being out of a particular loop, but this was a great way to learn about it.

I also have rarely seen a group of antitrust experts basically in as much agreement as this group has had. I mean, you can talk about, well, is it consumer welfare or total welfare, and everybody can get into snipping about that, but I thought there was remarkable consensus among the panelists on the topic. So, thanks.

Patrick, you are going to have to move down here.

MS. SCHULTHEISS: Patrick?

DR. WARREN-BOULTON: And now for something completely different.

DR. BOLTON: Ken pretty much stole my thunder.

I am very much in agreement. Just on the last point...
about damages, it occurred to me, some of the issues
were brought up similar to the case, the
Sotheby's-Christie's --

MS. SCHULTHEISS: The auction case?

DR. BOLTON: -- cartel, yes, where there was an
issue who was harmed and how do you -- was it the -- was
it the buyers of art or was it the sellers and who
should be the recipient of the damages, and in that
case, I forget how it was decided in the end, but there
was reason to believe that the wrong party was
collecting the damages. Maybe someone else will --

DR. WARREN-BOULTON: I agree.

MS. SCHULTHEISS: Does anybody know?

MS. McDAVID: I don't remember who got them.

DR. WARREN-BOULTON: Yes.

MS. SCHULTHEISS: But it was a damages issue.

DR. WARREN-BOULTON: Well, the question was, is
if you read the auction -- it is pretty much like the
Social Security question, you know, if you pose --
Social Security taxes, who pays it, is it labor or is it
the firm? If you ask anybody on the street, they say,
oh, I pay half of it and my employer pays half of it.
If you ask an economist, and he will say 95 percent is
paid for by the workers, but the incidence of a tax
bears very little resemblance to the accounting and
collection of that tax, and I think in the same way, it is extraordinarily difficult to find out who actually pays for antitrust violations by simply looking at the accounting incidence.

DR. SALOP: Yes, I --

MS. SCHULTHEISS: We have two minutes.

DR. SALOP: Okay, so I will just make a law professor remark. There is Illinois Brick and there is Hanover Shoe, and that says the direct purchasers get to sue the direct purchasers or sellers of the art. They get the money. There is no pass-on defense by the cartel, and the -- you know, the Supreme Court had a reason for that, and so the -- I would think the proper people to get the money under the current law are the sellers of the art, not the buyers.

MS. SCHULTHEISS: Okay. Well, I think with that --

DR. ELZINGA: I worked for the judge on that case. Most of it went to the lawyers.

MS. SCHULTHEISS: Well, on that note --

MS. McD AVI D: The entrepreneurial plaintiff's bar.

DR. WARREN-BOULTON: Well, at least some of it went to you.

MS. SCHULTHEISS: On that note, we will wrap
this session up, and I ask you to join me in giving a
hand to our panelists. Thank you very much.

(Applause.)

(Whereupon, at 3:58 p.m., the hearing was
concluded.)
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DATED: 7/9/06

SUSANNE BERGLING, RMR-CLR

CERTIFICATION OF PROOFREADER

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