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Roundtable: Recent Developments in Section 2

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R O U N D T A B L E D I S C U S S I O N

Roundtable: Recent Developments in Section 2

Editor's Note: Recent Section 2 activity in the courts prompted ANTITRUST to convene a group of experts to discuss what the cases add to our understanding of what constitutes unlawful conduct by a monopolist. We asked Professors Aaron Edlin and Joe Kalt, former Acting AAG Doug Melamed, and economist Gary Roberts to talk about *U.S. v. AMR Corp.*, *LePage's v. 3M*, and *Verizon Communications v. Trinko*. In an overview preceding the Roundtable, Associate Editor Dennis Cross sets the stage for the discussion by reviewing the issues raised in those cases and others, including *Dentsply*, *Air Canada*, *Conwood*, and *Concord Boat*. In his commentary following the Roundtable, Associate Editor Gregory Wrobel synthesizes the participants' discussion, pointing out areas of agreement and disagreement, and what the practical implications may be for counseling and litigation.

The Roundtable discussion was moderated by ANTITRUST magazine Articles Editor and Howard University School of Law Professor Andrew Gavil.

P A R T I C I P A N T S



Aaron Edlin

Law professor and economics professor at UC Berkeley; formerly a Senior Economist at the Council of Economic Advisers in the Clinton White House. He is the author of *Stopping Above-Cost Predatory Pricing*, 111 *Yale L.J.* 941 (2002), and co-author with Joseph Farrell of *The American Airlines Case: A Chance to Clarify Predation Policy*, in *THE ANTITRUST REVOLUTION* (John Kwoka and Lawrence White eds., 2003).



A. Douglas Melamed

Partner in the Washington, D.C. office of Wilmer, Cutler & Pickering, and co-chair of the firm's Antitrust and Competition Practice Group; formerly Acting Assistant Attorney, Antitrust Division, U.S. Department of Justice. Melamed participated in the AMR case while he was at the Justice Department and, in private practice since then, has represented Verizon in connection with the *Trinko* case and has filed an amicus brief supporting, and has otherwise assisted, 3M in the *LePage's* case.



Joseph P. Kalt

Ford Foundation Professor of International Political Economy at the School of Government at Harvard University, and a senior economist with Lexecon Inc., in the Cambridge, Massachusetts office. Kalt was an economic expert for American Airlines in *U.S. v. AMR Corp.*



Gary L. Roberts

Vice President in the Washington, D.C. office of Charles River Associates Inc.; formerly Associate Director for Antitrust in the Bureau of Economics at the Federal Trade Commission. Roberts provided economic expert testimony on behalf of 3M in *LePage's v. 3M*.

ANTITRUST: In this Roundtable discussion, we want to take a look at three cases, all recent developments under Section 2 of the Sherman Act dealing with monopolization: *U.S. v. AMR Corporation*, *LePage's v. 3M*, and *Verizon Communications Inc. v. Trinko*. In addition to discussing the cases individually, we will be looking at connections among the cases.

Let's start with *AMR*, which has generated a great deal of interest and attention. Did the court of appeals get it right, or do you believe the Department of Justice had a valid case?

DOUGLAS MELAMED: I think the answer to both questions might be yes. As I understood it, the government's case was premised on two basic ideas. The first concerned the likelihood of predation. The early learning that predation is rarely tried and even more rarely successful leads toward a legal regime that puts a high priority on avoiding false positives. The government relied on more recent learning to the effect that predation is a more serious problem that should be taken seriously. In that respect, the court of appeals seemed to agree

with the government. The second premise concerned the proper measure of costs. The government argued that the old models based on the Areeda-Turner analysis—the static price theory and homogeneous single product models that lead to the conclusion that average variable cost is a suitable proxy for incremental cost—do not apply in a lot of situations, such as commercial aviation. The government argued that, in those situations, the court should try to assess avoidable or incremental costs directly, and should not use the average variable cost proxy. The court of appeals agreed with the government in that respect as well.

In those two basic respects, I think both the government and the court got it right. Where the court of appeals parted company with the government is on the facts. There, I'm not sure the court got it right. The government's test four was a pretty good proxy, as I understood it, for avoidable costs. The court of appeals said it was not a good enough proxy. The lesson may be that the court of appeals paid lip service to the new learning but, when it came to assessing the facts, showed little willingness to run the risk of a false positive.

AARON EDLIN: My view is that the court of appeals got the law wrong. Part of the reason was that the government wasn't as clear as it could have been about the central legal issue in the appeal. The court of appeals was struggling with the problem of defining what is an appropriate measure of cost in a predatory pricing case. The Supreme Court has repeatedly and explicitly ducked this problem. What the government wanted to contend in comparing incremental revenue with incremental cost was that, if additional flights didn't increase revenue by as much as they increased cost, then adding these flights involved a sacrifice. If the most likely explanation for that sacrifice was that American Airlines was trying to reduce competition in the future, then that should be seen as predation.

The court got tangled up in a logical error. The court begins by saying that one should compare marginal cost to price to find out if a firm has sacrificed profits. The Department of Justice didn't challenge that idea, which gets it into trouble later. The court of appeals says that a firm that is selling at a price that exceeds marginal cost is necessarily reducing its losses or increasing its profits and, therefore, is not sacrificing, quoting *Advo, Inc. v. Philadelphia Newspapers, Inc.* Both the *Advo* court and this court are simply wrong about this. That principle is only true for a competitive firm. To make that principle hold true for a firm with market power—the type of firm one sees in these cases—one must interpret marginal cost broadly so that the additional cost of selling one more unit includes not just the production cost for that unit, but also the cost of lowering the price charged on other units in order to sell this additional unit.

A firm like American Airlines that has downward sloping demand may be decreasing profits quite substantially even though it is selling at a price above its marginal costs. It has to lower its price on the first units it sells in order to sell more,

so it may be sacrificing a great deal by expanding capacity, even when price exceeds marginal cost. That's what the government's test picks up, because when it compares incremental revenue with incremental costs, incremental revenue is a lot less than the average price of seats times the number of seats sold on the additional flights. The court says that's the problem with the government's test. In particular, the court complains that the government's test could label as predatory, conduct in which an airline adds flights to a profitable route, where the passengers on the new flights pay more for their tickets than the new flights cost, just because the additional flights cause profits on the original flights to fall by so much that the addition is in net a losing proposition. But this is not some perverse side effect of the government's test, instead that's exactly what's *right* about the government's test. The government didn't make sufficiently clear that, in fact, its test challenges the very idea that one should compare price with marginal cost and that marginal cost is the appropriate cost to compare with price. One has to take into account lost revenues and forgone profits if one is going to make a comparison with price. That's a cost of expanding output. Courts that fail to account for lost revenues are making a mistake.

MELAMED: Aaron is right that you can sacrifice profits without having a price below marginal cost, avoidable cost, or incremental costs—whichever you want to call it. That was at the very least what was going on with American Airlines. On the other hand, the cases that have asked the question whether predation law ought to turn on the sacrifice of supra-competitive profits, rather than on below-cost pricing, have chosen the below-cost approach for a number of policy reasons. I'm not sure those cases are all wrong, the way Aaron thinks they are wrong. One of the reasons is that it does not follow, from the fact that a company is sacrificing profits and then recouping in the long run, that long-run welfare is diminished. It is a more complicated trade-off. If, on the other hand, the company is selling at a price that is less than its incremental costs, then one can confidently predict that long-run total welfare will be diminished.

GARY ROBERTS: I'd like to add one thing from my perspective as an outside observer of *AMR*. The potentially anti-competitive activity in a predation case generally must be evaluated in light of and jointly with the theory of anti-competitive effects. The court of appeals in *AMR* focused on profitability evidence without directly considering the evidence regarding the ultimate effects on competition and consumer welfare. This type of decoupling may lead to incorrect conclusions. This is in part what Doug was talking about a moment ago. If a firm sacrifices profits today by charging low prices, producing innovative new products, or doing anything else that reduces its short-run profits in the hope of earning greater profits in the future—perhaps even by charging higher prices—it is not necessarily or generally appropriate to view the strategy as anticompetitive. To the

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contrary, the incentive to gain advantage in the marketplace by establishing and maintaining a reputation for low-cost pricing or aggressive innovation is a desirable characteristic of competition.

JOSEPH KALT: Gary said he was adding comments from an outsider's perspective. My perspective is more that of an insider, having testified for American Airlines in this case. Doug began his remarks by harkening back to Areeda and Turner and the kind of judicial caution that comes out of that tradition. Having lived through the litigation wars as an expert witness in *AMR*, I have become more supportive of the Areeda and Turner tradition of caution. Because of the multitude of false positives under the government's theories, I've come away a real advocate of having not only an economically defensible, but also a judicially workable, standard.

The issues of price versus cost, the measurement of cost, and so forth arose extensively in *AMR* with respect both to measuring opportunity costs—giving up profits—and to measuring marginal or incremental cost within a multi-market firm. The problems in this regard are very, very real. This pushed me back toward the Areeda-Turner tradition.

EDLIN: Of course, there is an evident paradox with regard to all predatory pricing claims. The plaintiff is asserting in a predatory pricing claim that lower prices are bad for consumers. Yet giving benefits to consumers in the short run *can* be anticompetitive and *can* hurt them in the long run. The trick is to figure out when they are hurt. Doug is definitely right that one can't be sure from the mere fact that a firm has sacrificed profits—i.e., priced below an appropriate measure of cost—that this is going to lower overall welfare or consumer welfare. Profit sacrifice does not by itself prove lower welfare.

I want to observe, though, that the welfare ambiguity which Doug astutely points to exists whether the firm is pricing below marginal cost, sacrificing short-run profits because its incremental revenues are less than its incremental costs, or because pricing is below marginal costs, taking into account forgone revenues. Regardless of which of these standards you use, as Gary observed, such pricing doesn't by itself prove that consumers have been harmed. One may therefore want to have some alternative showing of exclusion and competitive harm. My point was just that what the court says, when it quotes *Advo*, is simply a false premise from which to begin the argument. That is, pricing above marginal cost only ensures that sales are profitable

if the marginal cost of selling one extra unit includes the lessened profits on other sales.

ROBERTS: I have always thought of the cost test, however defined, as a safe harbor, and thus the beginning rather than the end of the discussion. If there is a sense in which the government's case in *AMR* was a bit adventurous, it is in trying to pare back that presumption in its claim that *AMR*'s prices were too low in the short run. Of course, there is some risk of error in establishing a standard no matter what cost measure is used. Nonetheless, I think the tendency of the courts to be careful in allowing predatory pricing claims is likely appropriate.

MELAMED: Let me try to defend these cost-based tests. With predatory pricing—as well as with other types of conduct challenged under Section 2—you're dealing with conduct that in the short run benefits consumers. But you're worried that in the long run, if it leads to an increase in market power, there's going to be a harm that outweighs the short-run benefit. And, of course, you're afraid of getting the trade-off wrong and condemning aggressive competition when it wasn't necessary to do so. I agree that, in general, you want to use caution in these cases.

An avoidable cost, or incremental or marginal cost, rule is a pretty good place to draw the line. One reason is this: If the sacrifice is simply one of supracompetitive profits that could have been earned from higher prices, and not an actual loss in the sense of a price below cost, then you cannot confidently say that, in the long run, recoupment is going to harm either consumer welfare or total welfare more than the benefits from the short-run price reduction. On the other hand, if the defendant is selling below cost, then during the period of rivalry, while consumers are benefited, total welfare at the margin is diminished by the extent to which sales are below cost. When you add that welfare loss together with the total welfare loss during the recoupment period, you can unambiguously say that, if the conduct entailed below cost sales during the period of rivalry, and you can predict recoupment for a rational defendant engaging in the conduct, then the conduct will reduce total welfare in the aggregate. As long as we have sufficient confidence that the factfinder will get it right, it is perfectly appropriate for the antitrust laws to say that, when you make deliberate sales below cost, we can predict a long-run reduction in total welfare.

EDLIN: Doug makes an extremely good point. If a firm prices

below marginal cost, total welfare is lower than it would be in a perfectly competitive world, but that world is probably not a relevant alternative in a predation case. If American adds several flights and lowers fares from what are originally very high prices, then this action could increase total welfare in the short-run by bringing prices closer to competitive levels, even if American has actually lowered price somewhat below competitive levels. These welfare gains might exceed whatever long run harms are done by the allegedly predatory behavior. This potential exists whether you compare price with marginal costs or compare marginal revenue with marginal cost. Regardless, one may be vexed by the antitrust paradox.

As I see it, the problem with the *AMR* decision is that in comparing price, which is average revenue, with marginal cost—or the cost of the last unit—you’re comparing apples and oranges. Now, Gary can defend that by saying this comparison creates a safe harbor. But it is a curious safe harbor. The safe harbor is very large when there is a lot of market or monopoly power, so that the firm’s demand is very inelastic, and marginal revenue is far below price. In contrast, the safe harbor is very small when price is close to marginal revenue because the firm has very little market power. That’s a peculiar kind of safe harbor. It is the opposite of what one would expect to avoid false positives. There may be a reason for a safe harbor, but it’s strange to put it in by comparing a marginal concept like marginal cost with an average concept like price.

KALT: In response to what Gary said about long-run recoupment, we have to emphasize that recoupment would have to be attributable to the creation or enhancement of market power. That is the standard. The benchmark isn’t one of perfect competition or some textbook standard, but it’s relative to a world in which misconduct does not occur. Second, purported “recoupment” might arise for perfectly good reasons of having introduced new products and gotten the consumer’s attention.

ANTITRUST: Let’s turn to a slightly different focus. It seems that all of the panelists have been accepting *AMR* as a case about predatory pricing. Is that the right characterization? If it is, is the state of the law adequate to assess a case like *AMR* as a case of predatory pricing? If it’s not, would the DOJ have done better in *AMR* if it had never argued that American Airlines engaged in predatory pricing?

MELAMED: DOJ tried to argue that *AMR* was a case about capacity expansion, not predatory pricing. But I don’t think the courts were persuaded. My own view is that the distinction is an empty formalism. This is a case about output expansion, and whether you call it pricing or some other form of output expansion, it seems to me that the analysis ought to be the same.

EDLIN: Doug is absolutely right. The DOJ tried hard to argue

that this was not a case about predatory pricing. In fact, when I wrote an article featuring *AMR* as a predatory pricing case, I got a call from the DOJ saying it was not a predatory pricing case and that this was a terrible mistake on my part. Part of the problem with the DOJ arguing the case that way was that they did not take on, in a direct fashion, the issue that I continue to harp on about, which is that the price versus marginal cost comparison is not the right standard by which to measure sacrifice, unless of course marginal cost includes the forgone revenue from lowering price in order to sell an extra unit. DOJ said that the price-marginal cost comparison might be inappropriate because *AMR* was a capacity case, not a pricing case, but this tactic made it easy for the court of appeals to say that output is just the flip side of price, so that comparing price with marginal cost is appropriate. The DOJ tried to slide into the four tests they had developed without explaining that the reason the tests didn’t look like a comparison of price with marginal cost is because the price-marginal cost comparison is not a sensible notion of sacrifice. The court said the correct standard is to compare price with marginal cost, and that the DOJ was not doing so with the four tests.

The Department of Justice ended up losing so badly because it tried to make *AMR* a non-predatory pricing case and adopted the assumption that comparing price with marginal cost is the law for predatory pricing cases, even though the Supreme Court has never said it is. DOJ might have lost anyway if it had started out by pointing out the fallacy of comparing price and marginal cost to get at sacrifice, but at least it would have had more logically coherent arguments and would have made it more difficult for the court to find against the government.

KALT: Watching it evolve from the inside, I think Aaron is right. *AMR* essentially evolved *toward* a predatory pricing case. The initial briefs and arguments had much more of a flavor of a capacity flooding, or capacity expansion, case. That distinction, however, is more of words than of substance. I think DOJ found itself in a situation in which it faced obvious difficulties—or at least a long uphill battle—in arguing some foundation for a broader kind of exclusionary case, perhaps based on something like essential facilities. The case evolved, as the DOJ found itself being drawn down into these categories of predatory pricing. So, it ends up being styled as a predatory pricing case.

ANTITRUST: What accounts for the evolution of *AMR* toward predatory pricing? Were there different philosophies at work with respect to this evolution that might be attributed to the change of administration during the case?

KALT: Having lived through *AMR* as an expert, I certainly didn’t perceive any changes in the flavor of the case as a result of a change in the administration. It seems much more like the case got honed, in finer and finer detail. The way it had

been argued, it didn't have anywhere else to go but into predatory pricing for the reasons I've touched on.

MELAMED: At least on the basis of one reading of the government's appeal briefs, I thought DOJ could have done more to emphasize the fit between the DOJ's test four and the incremental or avoidable cost measure supported by the case law. It didn't do that. Instead, it tended to group some of the tests together. That suggests to me that there was not any retrenchment toward more conservative or old-fashioned predatory pricing thinking in this administration.

ANTITRUST: What guidance can be gleaned from *AMR* with respect to the two components of a traditional predatory pricing case? What does it tell us, if anything, about the appropriate measure of cost in such cases? What does it tell us about recoupment? How will we advise our clients after *AMR*?

MELAMED: I don't think *AMR* says much about recoupment. On the cost measure, as I said at the outset, I think the court somewhat embraced what the government was trying to say. But the court clearly signaled that it was going to hold the plaintiff in these kinds of cases to a very high standard of proof. It was unwilling to use proxies for avoidable costs. It said, in effect, that the plaintiff really has to prove the avoidable costs, and that the government did not prove them there. I don't know if all courts will do that. But, if they do, it's going to continue to be very tough for predatory pricing plaintiffs.

EDLIN: It's clear that if you are coming before this court again, you are going to have to have some direct measure of either average variable cost or, perhaps, of incremental cost. In this court, you are not going to be able to compare incremental cost to incremental revenue. You are going to have to compare incremental cost to the sales revenue on the actual output increases. Perhaps you could point out before another court that there's a logical error in the *Advo* quote with which the *AMR* court begins. Once one realizes the *AMR* court is beginning with a logical fallacy, then maybe one *can* compare incremental cost with incremental revenue. However, you have to begin by knocking down the idea that the ideal test would compare price to marginal production cost.

KALT: We are all in basic agreement that the implication of this case is that, strictly speaking, that part of the predatory pricing standard remains quite tight. It implies that plaintiffs are going to be looking to move, where they can legitimately, into broader notions of exclusion, rather than just staying within a predatory pricing standard tied to some measure of average variable cost. That's more of a prediction than a piece of advice.

ANTITRUST: Let's turn now to a different court and an

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—Gary Roberts

arguably different set of facts. On their face, both *AMR* and *LePage's* involved below cost, strategic pricing by a dominant firm enjoying significant advantages over its rivals. Are *LePage's* and *AMR* in conflict? Are they distinguishable?

ROBERTS: Although there are potentially important factual distinctions between *AMR* and *LePage's*, both matters do involve strategic pricing by an arguably dominant firm. In fact, the most striking thing about the two cases is the significant differences in the way they were presented to and evaluated by the courts. Indeed, the troubling thing about the various decisions in *LePage's* and *AMR*, as well as *Concord Boat Corp. v. Brunswick Corp.*, is the apparent failure of the courts to apply a consistent set of standards to predatory pricing claims and more generic claims of exclusionary conduct. *LePage's*, unlike *AMR*, was not analyzed as a predatory pricing case and was decided without a clear standard of what would constitute illegal conduct.

MELAMED: I think that's right. *LePage's* was unreasoned, but it seemed that what drove it was an intuition that was not entirely crazy—that is, that the economics are different for bundled pricing versus single product pricing. The court failed to understand that more general but nonetheless rigorous antitrust principles regarding exclusionary conduct could be applied to the somewhat different sets of facts before it.

ROBERTS: You are right in principle that bundled pricing and predatory pricing *can* be different. But they are not necessarily different. For example, bundled pricing can, in some circumstances, result in de facto tying, and the economic analysis of such tying arrangements may be different from the analysis of predatory pricing. However, if there is no de facto tie, in the sense that there is an economically legitimate unbundled price, the bundled discount can be analyzed as exactly that—a discount. The relevant economic questions then focus on the number of products that are being discounted and the size of the discounts in relation to the purchases of those products.

EDLIN: It seems to me that the different treatment of *LePage's* and *AMR* suggests that the distinction between price and non-price predatory behavior is a strange and somewhat artificial one. You might recognize a reasonable distinction based

upon whether you are adding short-run surplus or value to consumers or instead taking away surplus with restrictions like in *U.S. v. United Shoe Machinery Corp.* or *Aspen Highlands Skiing Corp. v. Aspen Skiing Co.*, or polluting Java, like in *Sun Microsystems, Inc. v. Microsoft Corporation*. One might want to have a substantial safe harbor for conduct that adds surplus to consumers. We would expect to see a safe harbor in both *LePage's* and *AMR*. Yet *LePage's* does not have a large safe harbor.

I think Gary is exactly right that it is reasonable to start thinking about *LePage's* in a similar way to the way you think about predation, perhaps by comparing price with cost, if you think that that's a sensible thing to do with predation. However, if you're going to do that, you might view the price of the transparent tapes that 3M produces in competition with *LePage's* as the price that 3M charges, less the rebate, not on just that tape, but the rebate on all six lines of product. In that case, perhaps, you could actually win with the predatory pricing theory.

MELAMED: Interestingly, the petitioner in *LePage's* asserted that, even using that allocation, the price would still have been above cost. In its opposition to certiorari, the respondent did not dispute that assertion.

ROBERTS: It is also interesting to note that 3M's bundled discount program was not targeted at a small set of products or competing suppliers. To the contrary, the 3M program was a broad-based discount that covered a large number of different products. Given the ability of 3M customers to obtain discounts by purchasing more of any 3M product, it is somewhat arbitrary to attribute the discounts entirely to a particular product.

MELAMED: There is an additional implication of that fact. From the standpoint of a competitor in off-brand tapes, the breadth of the bundle actually made it less threatening because it meant that, in order to qualify for the discount, the customer had to do more than simply buy 3M's tape. It had to buy its Post-it® notes and everything else. So, in that sense, it was a more restricted kind of competitive action.

ROBERTS: That's exactly right. Not only could the customers earn discounts by purchasing a large number of items, but also no particular item necessarily had to be purchased in order to obtain the discounts.

EDLIN: I don't see this the same way Doug and Gary do. If the question concerns competition in tape, then it is reasonable to hold constant a consumer's purchase of all other 3M lines and attribute hypothetical variation in the discounts across all lines to corresponding variations in the customers' tape purchases. If even after subtracting those discounts from the price of the tape, price is still above cost as Doug suggests, then you don't have the kind of sacrifice that a court looks for

in a predation case. That strikes me as a very strong point in 3M's favor if 3M were tried in the *AMR* court. If the plaintiffs have nonetheless successfully argued that they should win even with those kinds of facts because it's not a case about price predation, then this case goes to show that the distinction between price and non-price predation is shaky.

ANTITRUST: Do all of our panelists agree that the distinction between price and non-price predation is shaky?

ROBERTS: We should make a distinction here. Price predation and non-price predation frequently refer to different types of conduct. I think Aaron made the distinction earlier between conduct that provides short-term value to consumers, such as low-cost pricing or the introduction of new products, and conduct that does not provide any immediate benefit to consumers, such as poisoning, in some way, a competitor's product. These are different kinds of conduct and may require different types of economic analysis. In the end, they both require a similar conclusion—that is, that competition is harmed by the conduct. However, because they may reflect different types of behavior with different economic implications, it is not necessarily appropriate to use the same type of analysis to address what is ultimately a common question.

MELAMED: Gary is right that there are different kinds of conduct that could injure competition. But the distinction is not between price and non-price conduct. To me, the key difference is between output expanding conduct on the one hand—inventing a new product or increasing capacity, as well as lowering price—and conduct that does not expand output, like blowing up a rival factory.

EDLIN: I agree with Doug, but want to modify slightly what he said. The issue is not price versus non-price conduct. It is whether you are giving short-run value and surplus to consumers by expanding output, creating higher quality products, or possibly by lowering prices without expanding output. In those cases, there is a presumption that you are bringing some value to the market. Overcoming this presumption should be somewhat harder than when the alleged predatory conduct appears at first cut to be injurious to consumers, as in *Aspen* or *United Shoe*, or polluting Java in *Microsoft*. Whether consumers are helped or harmed in the first instance should be the distinction, rather than a price versus non-price characterization. If that is the distinction, then *LePage's* should be in the same category as predatory pricing because these discounts across five or six lines of products are pro-consumer.

KALT: The distinction is shaky, and it's also real. Economists can often collapse these models down to two dimensions of price and quantity with homogeneous quality. In those circumstances, we recognize that all of these various forms of monopolization—pricing below cost, or whatever it might

be—have, at the core, some attempt to capture monopoly gain. But our concepts of predatory pricing and other kinds of monopolization are appropriately distinguishable, for the reasons that have been set forth, as well as for judicial workability. For example, we apply different standards to tying than we do to predatory pricing, even though, in some sense, tying is a predation strategy—because tying involves conduct that is distinguishable from pricing below cost. That’s the flavor, of course, of *LePage’s*.

ROBERTS: I agree that different types of conduct may require different types of analysis. Moreover, the different types of analysis may place different weight on particular factors, such as the efficiency implications of the conduct. For example, one of the several claims in *LePage’s* is that there were exclusive dealing requirements in return for either direct price discounts or promotion payments that had the effect of decreasing the amount the customer paid. This claim involves a mixture of both price and non-price conduct and requires a specialized analysis. When I say there shouldn’t be different standards, I mean only that there should ultimately be a consistent standard of proof that competition is actually harmed.

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—*Douglas Melamed*

MELAMED: Let me agree with Gary and respond to what Joe Kalt said a minute ago. Rules have to be tractable for courts. They also have to be tractable for businesses, in the sense that they have to be sufficiently understandable that businesses know how to conform their conduct to the requirements of the law long before it gets to court. But I don’t think that should lead us to having lots of different, bright line rules depending on what category the conduct falls into. Among other things, that would lead to a lot of formalism in the law and a lot of argument about whether, for example, *AMR* was a capacity expansion case or a predatory pricing case, all of which has little to do with the underlying economic substance.

In almost all exclusionary conduct cases, certainly in those that involve output-expanding conduct that might give more surplus to consumers in the short run, some kind of sacrifice or predation principle provides a workable conceptual underpinning. At least in a rule of reason world, tying would be analyzed precisely that way. One would ask, would the defendant have linked these two products together if its strategy wasn’t exclusionary recoupment? Does the linking serve some

legitimate, efficiency-enhancing, output-enhancing purpose, or is it something that appears to entail sacrifice that makes sense only for recoupment? That is, after all, nothing but a generalization of the core principle of predatory pricing law, at least as it exists today. I don’t see why the need for judicially tractable rules should take us in the direction of more formalistic distinctions depending upon what category of conduct we’re talking about.

KALT: Let me respond briefly. I agree it is appropriate to have something like the sacrifice test as a guide. If I am a plaintiff, if I am supposed to prove that the defendant has market power, if not a monopoly, in the tying market, that seems to be a quite reasonable thing to do. A defendant’s strategy of tying isn’t going to work if its customer can just go and buy the tying good elsewhere. I find it hard to generalize about this issue of bright line rules, though. We are in a sort of case-by-case situation. I think the guide should be what’s been put on the table, which is really what Areeda and Turner were getting at originally—i.e., whether this conduct is potentially welfare-improving, either in the short term or long term. Where it is, the law ought to be more judicious in its approach.

ANTITRUST: No one has mentioned raising rivals’ costs in our discussion of distinguishing price versus non-price predation. Is that still an important component of inquiry that might help to distinguish price from non-price predation cases?

EDLIN: That falls into my category of conduct that is not, at first blush, giving value to consumers. So, that conduct should be given much stricter scrutiny by antitrust courts.

MELAMED: To me, raising rivals’ costs denotes a mechanism for injuring a rival, but does not describe the conduct. Suppose, for example, I raise my rival’s costs by getting exclusive distribution deals with all the best distributors in town. That conduct could well enhance welfare if it improves my ability to distribute my product. One could analyze that conduct using the same sacrifice test to determine whether the efficiency justified the investment.

ANTITRUST: Think about the adequacy of the legal framework we now have from the Supreme Court. On the one hand, we have *Aspen* and *Eastman Kodak Co. v. Image Technical Services, Inc.*, which seem to address the standard for defining non-price predation, and we have *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.* and *Matsushita Electrical Industrial Co. v. Zenith Radio Corp.*, which define price predation. In both *AMR* and *LePage’s*, we saw those cases advocated on both sides in favor of different standards. If what we’ve said is true about the price/non-price distinction, is that legal framework simply inadequate? Is it out of date?

MELAMED: I don’t necessarily agree with the characterization. The government, in both the *Microsoft* case and its *Trinko*

amicus brief, relied heavily on *Aspen* for the proposition that there is a general principle of sacrifice, or the predation principle. In other words, in both those cases, the government reads *Aspen* as applying predatory pricing principles in non-pricing contexts.

ANTITRUST: Is that a fair reading of *Aspen*, Doug?

MELAMED: I think it is. Although *Aspen* may not have articulated the principle in those terms, as an economist might, the intuition that drove *Aspen*—that there was something funny going on because there appeared to be sacrifice that made no sense but for exclusionary recoupment—is correct for both price and non-price predation cases.

EDLIN: It is true that, in both price and non-price predation cases, the courts first ask if there is a sacrifice. What is curious about the pricing cases is that we ask whether price actually is less than marginal cost or average variable cost. So, we have this measure of sacrifice that is not actually immediately related to sacrifice. Whereas in *Aspen* we have what in many cases would be a more lenient test. Ski Company was not selling below cost at all. Yet it still was thought to be sacrificing and, in consequence, its behavior was viewed as being exclusionary. At the moment, I think the test of sacrifice is different depending upon whether it is applied in a pricing case or a non-pricing case, and it's not really clear on what basis we make that distinction.

KALT: I agree with Aaron that the principle of sacrifice is present in both predatory pricing cases and broader, non-predatory pricing exclusion cases that we have been talking about. But I will come back to the theme discussed earlier: While I agree with Aaron that we may not be articulating the clearest of reasons why we treat different conduct differently, I think the notion that we should be searching for different standards for different *conduct* makes sense. The way in which a firm tries to exclude a competitor can matter for the reasons of potential welfare improvement or harm that we have been discussing.

MELAMED: I have a somewhat different take on this issue. I agree with Joe that the principle of sacrifice is the same. And, I agree with Aaron that there is a difference in the application between price and non-price circumstances. The price case raises an issue that is not present in non-price cases—the issue of what do you do with the infra-marginal customer. Aaron outlined this earlier. In a price-cutting case, unless you can engage in price discrimination, the infra-marginal customer, as well as the marginal customer, will get the benefit of a price cut. Therefore, the outcome will be different depending upon whether the legally relevant sacrifice includes the forgone revenues from the infra-marginal customers, or focuses solely on the cost incurred in serving the marginal customer.

That question does not arise in the non-price case. But the courts have had to address the question in pricing cases, even if they are applying the same sacrifice principle to both price and non-price cases. How do we answer that question? For a lot of policy and economic reasons that we can debate, the courts have said that, in price cases, we're not going to use profit sacrifice; we're going to insist upon below-cost pricing. In the non-price context, conduct that involves sacrifice entails incremental revenues that are less than incremental costs. In other words, when the sacrifice test is understood to be a below-cost test, it is the same for both price and non-price conduct.

ROBERTS: I want to raise a bit of caution in talking about the general application of a sacrifice standard. While I agree that a sacrifice standard may be a useful organizing principle in many predation cases, not all forms of predation require much, or perhaps any, sacrifice by the predating firm. In the extreme example, it may cost a firm virtually nothing to blow up the factory of a competitor. In a tying case, there may be very little if any cost involved in tying two products. More generally, the potential gain to the predator and harm to competition may be very large in relation to the direct sacrifice by the perpetrator.

MELAMED: When you blow up your competitor's factory, you have to pay the hit man, buy the explosives, and run the legal risk of getting caught. Aren't these costs?

ROBERTS: They may well be. However, the cost may be very small relative to the harm to competition and to the power it may give the firm over price. Consider the case of a single product monopolist. Under some circumstances, such a firm may be able to increase profit by increasing the nominal price of the monopoly product substantially while offering a similarly substantial discount to customers that also agree to buy some other product from it for an artificially inflated price. By bundling the two products, the monopolist may have been able to profitably leverage its monopoly power into another product, without sacrificing much or any of the revenue on the original monopoly product.

MELAMED: If the fact-finder knew all those facts to be true, why wouldn't there be an obvious sacrifice entailed in charging a supra-monopoly price for the tying product?

ROBERTS: Not if the unbundled price is sufficiently unattractive. There are economic models of this type in which there is very little, if any, sacrifice and substantial harm to competition. More generally, if one focuses only on initial sacrifice, there are forms of predation that will be missed. Indeed, that is an important insight from the raising rivals' cost paradigm—conduct targeted at rival producers rather than consumers may be more effective and less costly compared to traditional predation schemes.

EDLIN: The same thing applies with regard to predatory pricing. Low pricing can be exclusionary in certain circumstances even when the prices involve no sacrifice at all. Such exclusionary pricing can lower welfare. It is possible to lower welfare without sacrifice in either the pricing or non-pricing context. Despite this fact, sacrifice very often has been the guide.

ANTITRUST: Let's move on to the *Trinko* case, which is now pending in the Supreme Court. The case has gotten a great deal of attention in the antitrust community and from amici. Let's start with whether or not our panelists agree with Verizon's position, that the antitrust laws do not impose any obligations on it to deal under the circumstances of the case.

KALT: You are asking for a legal opinion.

ANTITRUST: That's an interesting response. Why is it a legal opinion as opposed to an economic one?

KALT: Well, if you ask *do* the antitrust laws impose the kinds of obligations that the original plaintiffs are searching for, that's what the court will decide. If you ask, *should* the antitrust laws impose those kinds of obligations, I would side with those who say this is a Federal Communications Commission matter under the 1996 Telecommunications Act and related acts. It's appropriate that these kinds of cases be brought under the jurisdiction of the FCC, not strictly under the Sherman Act or other antitrust acts.

ANTITRUST: Given that the Telecommunications Act of 1996 itself includes a "savings" clause that specifically addresses the question and purports not to exclude antitrust cases, where do we go from there?

EDLIN: Given that the 1996 Act preserves antitrust enforcement, questions like those in *Trinko* should not be reserved to the FCC and the Telecommunications Act. The appellate court probably got it right, that you can bring a cause of action under the antitrust laws. We are then left with the question whether under essential facilities doctrine AT&T and its customers for local telephone service were disadvantaged by the monopoly incumbent in violation of Section 2, by analogy to *Aspen*. The situation with regard to telephone companies is surprisingly similar to the situation that we have in *Aspen*. In *Aspen*, a skier desires interconnection to be able to ski on any mountain he or she chooses on any given day. Likewise, a telephone user wants to be able to call someone on any network on any given day. Users want their local provider to be able to hook up at a reasonable cost to the incumbent's network. If the incumbent denies that interconnection unreasonably, then Section 2 of the Sherman Act may intercede because this denial may maintain its monopoly and constitute an abuse of monopoly power.

MELAMED: The last two comments on *Trinko* raised the same

question in my mind as the last two comments that immediately preceded our discussion of *Trinko*. There are lots of things companies do that could disadvantage competition in the long run. Inventing a new product could be one, if it is only a marginal improvement over prior products, but enables the defendant to have an enduring monopoly with which to charge higher prices. But the antitrust laws do not condemn all such conduct. They rest on a policy judgment that goes beyond the ability of an economist to imagine that the world would be better off if a defendant had behaved differently.

In the *Trinko* context, the plaintiff is asking the court to say that a company has to deal with a rival even where refusing to deal entails no sacrifice and where dealing with a rival is something that the company would never do voluntarily because it would prefer to reap the fruits of its own commercial success and to enjoy its own property. The requirement in the 1996 Telecom Act that the company had to deal with the rival under those circumstances might make sense as a matter of telecommunications policy. But I don't think it can be reconciled with sound antitrust analysis.

ROBERTS: Any time property rights are granted, there is potential disagreement over how broad those rights are or should be. For example, if I have property rights over a particular product, I may be able to exercise those property rights in a way that enables me to gain monopoly power over other arguably distinguishable and potentially distinct products. In this case, you may decide that I'm unlawfully leveraging my legitimate monopoly over one product into an illegitimate monopoly over another. The same thing could be true here. The court may decide to encourage competition by forcing the company to deal with its rivals.

KALT: Let me stay on my public policy horse for a moment. It seems to me that if there has been a public policy decision at the congressional level to change the way in which we regulate this sector—if we truly believed that the industry was characterized by extensive essential facilities—then we have a problem in our public policy. If essential facilities are real, we should properly be tilted toward public utility-style regulation of prices and access—rather than merely relying on judicial enforcement of antitrust laws.

In industries like telecommunications and natural gas, where we conclude that we have elements of essential facilities and attendant natural monopoly, we've kept vestiges of public utility regulation for the essential facilities/natural monopoly segments. But our public policy has also recognized—for example, in natural gas—that, to a very large extent, the kinds of disputes that might arise because an incumbent could be (or is) engaged in conduct that is anti-competitive (or is not as competitive as our economic models might like) should be turned over to experts in agencies built to oversee the industry, such as the Federal Energy Regulatory Commission, the Federal Communications Commission, and so forth.

My argument about the appropriate scope of the antitrust laws from a public policy perspective is *not* that we should be any less diligent about addressing anticompetitive conduct. Rather, it is a question of, first, do we really have essential facilities, and hence the need for something that feels like public utility regulatory oversight? Second, wouldn't we be wiser in those situations where we see a potential for abuse in the use of such facilities to carry out our antitrust policies in the agencies rather than in the courts and before the juries?

ANTITRUST: The government's amicus brief in *Trinko* has raised the profile of the case and may have contributed to the Supreme Court's decision to grant certiorari. It has also brought a great deal of additional attention to the case and to the government. Let's look at three components of that brief: what it says about essential facilities doctrine, what it says about leveraging doctrine, and how it would define exclusionary conduct. Where would the DOJ take us, or ask the Supreme Court to take us, with respect to the essential facilities and leveraging doctrine?

There are three separable concepts: essential facilities, exclusionary conduct, and sacrifice.

What we are watching in this case is a tussle over whether sacrifice is a component of the definition of exclusionary conduct.

—Joseph Kalt

MELAMED: As to leveraging, it says that you cannot ignore *Spectrum Sports, Inc. v. McQuillan*. There is no leveraging offense without meeting the elements of Section 2. As to essential facilities, it says largely the same thing. There is no stand-alone essential facilities violation. A plaintiff has to satisfy the broader Section 2 requirements. Whether the oft-quoted criteria from *MCI Telecommunications Corp. v. AT&T* have some utility in helping courts apply the broader Section 2 requirements in refusal to deal cases is one thing. But they certainly do not state a stand-alone offense.

ANTITRUST: Is the status of leveraging doctrine more settled than the status of essential facilities doctrine?

MELAMED: In my view, yes, because of *Spectrum Sports*. I think that should put leveraging to rest. The Supreme Court has not yet taken up essential facilities.

ANTITRUST: Is there a place in antitrust law for an essential facilities doctrine?

EDLIN: I think there is a place. While the Supreme Court said

that *Aspen* was not an essential facilities case, I think that *Aspen* and *Otter Tail* are best understood as essential facilities cases. It is conceivable that one might want to require some sort of showing of sacrifice—that the person is denying the essential facility at a price that would actually make money. Maybe that should be a requirement of the plaintiff's case. It's not clear that in *Aspen* there was any short-run sacrifice by Ski Company, although perhaps a jury could reasonably conclude that. My guess is that there was no short-run sacrifice in *Aspen*. Once denied the ability to buy four-area ski passes, lots of people bought Ski Company's three-area ski passes, and Aspen probably made more money in the short run. So, there is room for an essential facilities doctrine. We came awfully close to that in *Otter Tail* and *Aspen*, and it will be interesting to see how the Supreme Court sees it here.

ANTITRUST: Given our prior discussion today about the possible tension between *Aspen* and *Eastman Kodak* on the one hand, and *Brooke Group* and *Matsushita*, on the other, where does the government's definition of exclusion fall? Would it be a possible unitary standard that would bring the cases together, if adopted? What has the government urged to the court as the definition of exclusion?

KALT: Certainly, the government is advocating that the words "exclusionary conduct" entail a demonstration of sacrifice. This issue has been on the table throughout our discussion. Economists can create models in which there is not sacrifice in the sense "sacrifice" has traditionally been defined. The issue has two layers. First, does the essential facilities doctrine require that I demonstrate not only that your facility is essential, but also that you have engaged in exclusionary conduct? The next layer is, does the attempt to demonstrate exclusionary conduct require me to show that you also sacrificed in the sense that the government argues in the case?

There are three separable concepts: essential facilities, exclusionary conduct, and sacrifice. What we are watching in this case is a tussle over whether sacrifice is a component of the definition of exclusionary conduct. The government uses some very well-known and well-educated economists to help make its case for not requiring that sacrifice be demonstrated in order to hold exclusionary conduct culpable under the antitrust laws.

MELAMED: Interestingly, though, the economist's brief in that case did not make an economic argument; it made a normative argument. It said, where Congress has determined that there should be some other standard, then our economic insights do not apply. I thought that was an odd sort of argument.

KALT: The Department of Justice does argue, however, that it can come up with cases where there isn't sacrifice, in the way that term has been used, and yet there still is exclusionary

conduct that has the effect of worsening competition in the market.

ANTITRUST: Does anyone want to address whether or not *Trinko* is the best vehicle for the government's brief, given its context as a motion to dismiss for failure to state a claim?

MELAMED: Implicit in your question is a notion that hard cases should wait for a fuller record. But there is a countervailing reason why the courts ought to want antitrust pleadings to be required to plead all the elements with some care. It is very easy for plaintiffs and for class action lawyers to put these complaints in over the transom, and the cases often settle for reasons of costs and so forth. I think Verizon has already been named in about fifteen class action suits after *Trinko* that essentially parrot the theory in *Trinko*. So, it is useful for courts to look at cases at the pleading stage.

ANTITRUST: Is it reasonable to expect the plaintiff to plead consistent with Rule 11 what the value of the conduct is to the defendant before any opportunity for discovery?

MELAMED: Suppose a plaintiff has no good faith basis to allege a sacrifice by the defendant. Should it be enough for the plaintiff to say, I'm really harmed by this conduct, so let me have the benefit of discovery, and the settlement benefit of the threatened cost of discovery, so that I can find out? That is a very provocative legal process proposition.

ANTITRUST: Should a plaintiff at least have an opportunity for limited discovery on value before we dismiss the case?

EDLIN: Doug's point is certainly a good one. On the other side, it's not clear in many cases that you will be able, without some discovery, to have very good evidence of sacrifice. Take a fairly extreme case, like *Aspen*. The best evidence of sacrifice in *Aspen* is Ski Company's refusal to sell tickets at retail that Highlands wants to assemble into its Adventure Pack. Highlands knows that. It knows that Ski Company is being very difficult. On the other hand, it seems plausible, perhaps even likely, that this doesn't involve any short-run sacrifice by Ski Company, because the customers who would otherwise buy the four-mountain adventure pack may go to Ski Company and buy its three-mountain passes. Before looking at Ski Company's records, why would Highlands think Ski Company's actions involved sacrifice? You might see substantially fewer cases filed if courts take Rule 11 seriously and require plaintiffs to allege sacrifice.

ROBERTS: This whole notion of sacrifice could work to the benefit of the defendant. A defendant may be able to assert the absence of sacrifice as a defense to an antitrust claim, or as an alternative legitimate, profit maximizing rationale for the conduct in question. This wouldn't necessarily require a large amount of discovery by the plaintiff.

ANTITRUST: Are there any broader themes to be drawn from the three Section 2 cases we have discussed today? Do they take us in a particular direction? Do they represent any change of direction for Section 2 law?

EDLIN: One theme is what we were talking about at great length earlier. Currently, the courts are thinking of price and non-price predation as being very different. In fact, they are often fairly similar. A more sensible distinction is whether the behavior at issue is a pure restriction that doesn't give rise to consumer benefit or whether it is something that, at first blush, *does* produce consumer benefit. As an illustration of how similar these problems are, assume that *AMR* is a price predation case. If we take the very restrictive standards we have for price predation, maybe the government or Vanguard wouldn't have a case against American Airlines. On the other hand, the case alternatively could be about essential facilities. If we are going to allow essential facilities cases to be brought without much notion of sacrifice, then you will see the case brought in a different way, wherein Vanguard asks American Airlines, can we have access to your hubs—can we fly passengers to Dallas and then put them on American Airlines to go from Dallas to other cities? American Airlines presumably will say no to that, and Vanguard will sue, alleging that it could compete and would not be disadvantaged if it could interconnect with American Airlines' hub. All the cases have a very similar flavor. What's funny is that, when we start putting them into legal boxes, we often end up treating them very differently. Ultimately, we will discover that treating them very differently is a mistake, at least in the case of price and non-price predation. It may be sensible on the value-enhancing versus non-value enhancing distinction.

ROBERTS: I agree with that. It suggests that the answer is not in these very simple and clear rules with regard to specific types of conduct. Rather, there is a need for more general principles—like the sacrifice principle—which identify standards that can be applied more generally.

KALT: When you ask what trends do we see here, I find myself initially thinking that we are watching new debates. But as I step back, it seems to me that in *AMR*, we basically said we are going to have pretty bright lines with respect to predatory pricing and the definition of predation in that setting. *LePage's*, in many ways is quite similar to many other bundling and tying cases. With respect to *Trinko*, we are worried from a public policy perspective that we have deregulated an industry that may still have some essential facilities characteristics and we are trying to handle access to those facilities—in this case, debating whether we should handle the issue through antitrust standards or federal telecommunications regulation. Those are the kinds of debates we have had in many other sectors. So, I find myself saying not much has changed. We will see how the Supreme Court rules on a couple of these, certainly one of them. ■