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Luke M. Froeb & Pingping Shan

Owen Graduate School of Management & ERS Group

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Reconciling the Conflicting Views Of the DOJ Report on Single-Firm Conduct

Luke M. Froeb & Pingping Shan [*]

The U.S. Department of Justice ("DOJ") report, *Competition and Monopoly: Single-Firm Conduct Under Section 2 of the Sherman Act* ("DOJ Report") is either (1) an extraordinarily useful and well written summary of the legal and economic analyses in the most difficult and contentious area of antitrust or (2) a set of standards that makes it nearly impossible to bring a monopolization case. In this essay, we attempt to reconcile these competing views of the report and determine what it means for policy.

I. INTRODUCTION

In 2005, Chairman Deborah Majoras and acting Assistant Attorney General Thomas O. Barnett announced a set of hearings on Section 2 and single-firm content, the most difficult and contentious area of antitrust. At the time, the report[1] seemed like a good idea. On November 28, 2005 Assistant Attorney General Thomas Barnett stated:

> I … hope these hearings can advance our state of knowledge regarding the proper treatment of such conduct even in those areas in which there is not yet a

[*]Luke Froeb is the William Oehmig Associate Professor of Free Enterprise at the Owen Graduate School of Management at Vanderbilt University, Nashville, Tenn. Pingping Shan is a consultant at the ERS Group in Emeryville, CA. They can be reached at luke.froeb@owen.vanderbilt.edu and pshan@ersgroup.com. I wish to thank Michael Williams, Michael Doane, Gregory Werden, and Lindsay McSweeney for their advice and comments. I also note that I used to have friends at both agencies.

[1]U.S. DEP'T OF JUSTICE, COMPETITION AND MONOPOLY: SINGLE-FIRM CONDUCT UNDER SECTION 2 OF THE SHERMAN ACT (2008) [hereinafter Report], available at http://www.usdoj.gov/atr/public/reports/236681.pdf.

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consensus. Having clear standards helps businesses comply with the antitrust laws and works to the advantage of consumers.[2]

But now, it is not so clear. After 18 days of joint hearings, 28 different panels, and 130 panelists, the DOJ released the report. Only hours later, Federal Trade Commissioners Harbour, Leibowitz, and Rosch blasted the report as a set of "standards that would make it nearly impossible to prosecute a case under Section 2 of the Sherman Act."[3] Moreover, they promised to fill the implied enforcement void with strong Federal Trade Commission ("FTC") action. The extraordinary disagreement between the two agencies raises the prospect of different agencies enforcing the same law using different standards.

According to the three Commissioners, "the Department's Report erects a multi-layered protective screen for firms with monopoly or near-monopoly power," the Commissioners promised that "[t]his Commission stands ready to fill any Sherman Act enforcement void that might be created if the Department actually implements the policy decisions expressed in its Report." Notably absent from the statement was any substantive discussion of how they would do this, or even the principles they would follow when deciding which cases to prosecute.[4]

In this essay, we attempt to: (1) reconcile the competing views of the report; (2) understand how the agencies' common attempt to achieve a more uniform guidance on

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[2]Acting Assistant Attorney General Thomas O. Barnett, November 28, 2005, *available at* http://www.ftc.gov/opa/2005/11/unilateral.shtm

[3]P. Harbor, J. Liebowitz, & J. T. Rosch, *Statement of Commissioners Harbor, Liebowitz, and Rosch on the Issuance of the Section 2 Report by the Department of Justice* 5 (Sept. 8, 2008) [hereinafter Harbor, Liebowitz, and Rosch] *available at* http://www.ftc.gov/os/2008/09/080908section2stmt.pdf.

[4]*Id*, at 10-11.

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enforcement instead illuminated the differences between them; and (3) try to determine what this state of affairs means for policy.

II. RECONCILING THE COMPETING VIEWS OF THE REPORT

A. Uncertainties in Enforcement

One of the more refreshing parts of the DOJ Report is its discussion of the inherent uncertainties in Section 2 enforcement. The report recognizes not only that the kind of single-firm conduct targeted by antitrust enforcement can either harm or promote competition but also that it is very difficult to tell one from the other. For an enforcement agency to raise the specter of uncertainty and implicitly recognize limits to its own enforcement ability reflects an appreciation of the history of enforcement in this area. In fact, this is one of the biggest differences between the United States and the newer antitrust regimes overseas. Mature regimes have investigated and prosecuted more cases—and some would say "and made more mistakes"—so they are more likely to be aware of the limits of their ability to identify good cases.

The problem, as pointed out in the report, is that in many cases, "conduct enhances economic efficiency or reflects the kind of dynamic and disruptive change that is the hallmark of competition but at the same time excludes competitors through means other than simply attracting consumers."[5] For example, tying products together can harm competition by facilitating the exercise of market power in secondary markets.

We can also understand the difficulty of assessing competitive effects by comparing Section 2 enforcement, which typically involves vertical restraints, to antitrust

[5]Report *supra* note 1 *at* 13.

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treatment of horizontal restraints like collusion or mergers. Elimination of competition between substitute products harms consumers under a wide variety of easy-to-understand models of competition.[6] These same models would, however, predict that eliminating competition between complementary products (vertical) helps consumers.[7] In fact, business students are typically taught how to use vertical restraints to align the incentives of retailers, distributors, and manufacturers, in a way that benefits consumers.[8]

These are what Carlton and Heyer call "extraction"[9] theories of vertical restraints, where a firm uses restraints to extract profit as a reward for developing goods and services that consumers want. To realize anticompetitive effects from these restraints, you have to tell a more complicated story involving the "extension" of market power, where a firm uses the restraints to weaken the competitive constraints on its own behavior. These stories typically involve economics of scale, or entry or exit of rivals. And it is in this respect that the DOJ report takes a big step forward. Not only does it succinctly catalog the pro- and anticompetitive theories of vertical restraints,[10] but it goes further by describing the kind of evidence that would support these theories. For instance, tying can have anticompetitive effects if it allows a monopolist in one market to force

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[6] GREGORY WERDEN & LUKE FROEB, *Unilateral Competitive Effects of Horizontal Mergers II: Auctions and Bargaining, Issues in Competition Law and Policy*, *in* 2 ABA SECTION OF ANTITRUST LAW 1343 (W. Dale Collins ed., 2008) *available at* SSRN: http://ssrn.com/abstract=956400.

[7] *See* e.g. MICHAEL D. WHINSTON, LECTURES ON ANTITRUST ECONOMICS, Ch.4 (2006).

[8] LUKE FROEB & BRIAN MCCANN, MANAGERIAL ECONOMICS: A PROBLEM-SOLVING APPROACH, (2008).

[9] DENNIS CARLTON & KEN HEYER, APPROPRIATE ANTITRUST POLICY TOWARDS SINGLE-FIRM CONDUCT 13 (Econ. Analysis Group, Working Paper No. EAG 08–2, 2008), *available at* http://www.usdoj.gov/atr/public/eag/231610.pdf.

[10] *See also* JEFFREY CHURCH, THE IMPACT OF VERTICAL AND CONGLOMERATE MERGERS ON COMPETITION, (2004) *available at* http://ec.europa.eu/comm/competition/mergers/others/merger_impact.pdf.

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rivals to exit or to remain small in a secondary market. Specifically, when a monopolist ties a monopoly product to a complementary product, rivals cannot attain sufficient scale in the secondary market to survive and grow:

> …using a tie can effectively bar rivals in the tied-product market from selling to many customers that buy the tying product and therefore may deprive those rivals of sufficient sales to achieve scale efficiency in the tied-product market. That may, in turn, induce rivals' exit from the tied product market (or keep them inefficiently small) and thus create a monopoly in the tied product market.[11]

The catalog of anticompetitive theories in the report allows practitioners to look for evidence that would support or refute these theories in a given case, such as the existence of scale economies in the tied market.[12]

B. Uncertainty, Inference, and Belief

Although the DOJ report tells us what evidence to look for to inform the anticompetitive theories about single-firm conduct, interpreting the evidence remains difficult and contentious. To see this, we build a simple analogy between a physician trying to figure out whether one of his patients has cancer and an antitrust agency trying to figure out whether competition is harmed by unilateral firm behavior. The crucial decision is whether to treat the patient in the former case, and whether to prosecute unilateral conduct in the latter.

Suppose that a patient presents with a symptom that is known to be associated with cancer. Here the symptom is analogous to the kinds of evidence categorized in the DOJ report. Specifically, suppose that all patients who have cancer exhibit this symptom.

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[11]Report *supra* note 1 *at* 83.

[12]*Id*. at 84 and Dennis Carlton & Michael Waldman, *The Strategic Use of Tying to Preserve and Create Market Power in Evolving Industries*, RAND J. ECON. 33 (2002).

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Suppose also that ten percent of the patients without cancer also exhibit the symptom. These "false positives" are analogous to the uncertainty surrounding the effects of vertical restraints. To infer from the symptom whether a patient has cancer, a physician has to know the incidence of cancer in the general population. To make this example concrete, imagine two physicians with different beliefs about the incidence of cancer.

Physician DOJ believes that cancer is relatively rare, e.g., one percent. In this case, it is much more likely that the symptom is associated with someone who does *not* have cancer. Out of 1,000 patients, 10 will have cancer, and all will exhibit the symptom. Of these same 1,000 patients, 990 will not have cancer, but 99 will exhibit the symptom. So the probability that a patient with cancer exhibits the symptom is only 10/(10+99) or about nine percent.

On the other hand, Physician FTC believes that cancer is more common, e.g., ten percent. In this case, the association of cancer with the symptom is much higher. Of 1,000 patients, 100 will have cancer and all will exhibit the symptom. Of these same 1,000 patients, 900 will not have cancer, but 90 will exhibit the symptom. In this case, the probability that a patient has cancer and exhibits the symptom rises to 100/(100+90) or about fifty-three percent.

This simple example illustrates the crucial role that beliefs play in the interpretation of evidence. Presented with the same evidence, Physician DOJ is skeptical that the patient has cancer and may withhold treatment; while Physician FTC is more likely to infer cancer and treat the patient. And it does not take much of a disagreement

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between the beliefs of the two physicians to reach different treatment conclusions. The big difference between a physician and an antitrust agency is that there are objective statistics on the incidence of cancer in the population. Chairman Kovacic's call for more research notwithstanding,[13] it is unlikely that we will be able to collect the kind of data that will cause the different beliefs to converge.

C. Making Decisions with Uncertainty

When an enforcement agency makes an enforcement decision under uncertainty, the agency can make one of two error types. The agency might challenge pro-competitive behavior (Type I error); or the agency might fail to challenge anticompetitive behavior (Type II error). A rational decision maker will choose the alternative with smaller expected error costs, i.e. the probability of an error multiplied by the cost of the error.[14]

Enforcement is thus tied to beliefs through the assessment of the probability and costs associated with each type of error. If an enforcement agency believes the probability of Type II error is relatively large (relative to the probability of Type I error), or that the costs of Type II error are relatively high (relative to the costs of Type I error), then it is more likely to challenge the behavior.

Modeling policy disagreements in this way allows us to isolate at least two potential sources of disagreement about policy, even when policy makers agree on what evidence means. Different beliefs about the incidence of anticompetitive behavior in the

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[13] WILLIAM KOVACIC, MODERN U.S. COMPETITION LAW AND THE TREATMENT OF DOMINANT FIRMS: COMMENTS ON THE DEPARTMENT OF JUSTICE AND FEDERAL TRADE COMMISSION PROCEEDINGS RELATING TO SECTION 2 OF THE SHERMAN ACT (Sept. 8, 2008) *available at* http://www.ftc.gov/os/2008/09/080908section2stmtkovacic.pdf

[14] Report *supra* note 1.

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economy at large, or about the relative magnitudes of Type I and II errors, will lead to different enforcement standards.

III. SECTION 2 ENFORCEMENT

What does this mean for Section 2 enforcement? The answer is "probably not very much." Much of what is in the DOJ Report reflects what the courts have already said. But the search for good Section 2 cases within the agencies goes on, and the report gives us some guidance about where they are likely to find them. Below, we draw a distinction between enforcement standards based on necessary conditions for illegality, and those based on sufficient conditions. Enforcement standards based on necessary conditions are equivalent to safe harbors, i.e., if the behavior does not exhibit the necessary condition, then it is not illegal. On the other hand, sufficient conditions lead directly to challenges and are similar to per se rules.

A. Standards Based on Necessary Conditions

Safe harbors are designed to reduce enforcement costs and to provide more enforcement certainty by excluding a range of behavior from enforcement consideration. In the DOJ Report, the DOJ develops safe harbor categories from both economic theory and court decisions for several types of single-firm conduct. For example, the safe harbor regarding predatory pricing states that a firm's pricing can be justified as long as prices are above the firm's "average avoidable cost."[15]

Based on our discussion about the role of beliefs in developing enforcement policy, standards based on necessary conditions may not be acceptable to enforcement

[15] *Id*. at 65-67.

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agencies with different beliefs about the prevalence of anticompetitive behavior or about the likelihood and size of type I and II errors. Moreover, unless we can do a better job of specifying what happens outside the safe harbors, i.e., conditions under which we should bring cases, these necessary conditions have a way of becoming sufficient, especially in the hands of agencies that do not share the DOJ's assessment of the magnitude and frequency of type I and II errors.

B. Sufficient Conditions

In the DOJ Report, the "no economic sense" test is rejected as a necessary condition, but the DOJ comes very close to labeling it sufficient.

> Although the DOJ does not recommend the no economic sense test as a necessary condition for liability in all section 2 cases, it believes that the test may sometimes be useful in identifying certain exclusionary conduct.

The leading example is Dentsply,[16] where the Court found no business rationale for the exclusive agreements between Dentsply and its dealers other than to exclude competitors.

Evidentiary standards, like natural experiments, are another fruitful area where sufficient conditions might arise to guide Section 2 enforcement. These have already been used in other areas of antitrust (merger and price fixing) and their application to Section 2 enforcement is an obvious extension. In particular, a decision-maker may estimate the effects of unilateral behavior by comparing markets with the behavior (the

[16] United States v. Dentsply Int'l, Inc., 399 F.3d 181, 197 (3d Cir. 2005).

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"experimental group") to those without (the "control group") to draw inference about the behavior.[17]

IV. CONCLUSION

The DOJ report does an outstanding job of cataloging the economic and legal analyses underpinning Section 2 enforcement and should prove to be a valuable reference for anyone working in the area. However, some of the enforcement standards endorsed by the report could be seen as reflecting a set of beliefs about the prevalence of anticompetitive behavior that may not be shared across different agencies or countries. The difference need not stem from different welfare standards or a rejection of economic analysis.[18]

The strong reaction by the three Commissioners against the report indicates that FTC enforcement thresholds are likely to be lower than the DOJ's and it is important for businesses to know this. And it is in this sense that the report may have accomplished its stated mission. By exposing the fault lines between the agencies, we may be one step closer to the goal of establishing economically sound and administratively clear standards for Section 2 enforcement. It is just one step further than we realized we had to go.

[17] J. Cooper, L. Froeb, L, D. O'Brien, D., & M. Vita, *Vertical Antitrust Policy as a Problem of Inference*, 23 INT'L J. OF INDUS. ORG. (2005).

[18] *See*, for example, JOSHUA WRIGHT, COMMISSIONER ROSCH VS. ECONOMICS, AGAIN (Oct, 7, 2008) *available at* http://www.truthonthemarket.com/2008/10/07/commissioner-rosch-v-economics-again/

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