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Predation by the Dominant Buyer

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Just as a monopolist may eliminate its rivals through predatory pricing, a monopsonist may eliminate rivals through predatory buying. This, in fact, is what the Ross-Simmons Hardwood Lumber Company accused Weyerhaeuser of doing. This article uses the resulting antitrust case as a platform for defining the twin concepts of overbuying and overbidding, which satisfy the first prong of the modified *Brooke Group* test for predation. We then examine the feasibility of recoupment, which is the second prong of the modified *Brooke Group* test.

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I. INTRODUCTION

Section 2 of the Sherman Act condemns anyone who monopolizes or attempts to monopolize a relevant antitrust market.² Over time, the standards for unlawful monopolization evolved as judicial decisions put flesh on the bare bones of the statute.

In its *Grinnell* decision, the U.S. Supreme Court spelled out a two-part test for unlawful monopolization:

The offense of monopoly under section 2 of the Sherman Act has 2 elements: (1) the possession of monopoly power in the relevant market and (2) the willful acquisition and maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.³

The notion of “willful acquisition and maintenance” refers to competitively unreasonable, i.e., unlawful conduct. Conduct that is anti-competitive is forbidden, but competition on the merits is not.

Since 1911, the quintessential exclusionary conduct has been predatory pricing, that is, pricing below cost to drive rivals from the market.⁴

From 1911 to 2007, the focus had been on dominant sellers and their predatory efforts to become monopolists. In the *Weyerhaeuser*⁵ litigation, the focus shifted to allegations of predation on the part of a dominant buyer that was aiming to become a monopsonist.⁶ In this article, we address the law and economics of buyer side predation.

In order to put our analysis in context, we begin with a brief overview of the *Weyerhaeuser* case. We then examine the incentive to engage in predatory bidding (or buying). Next, we present several attempts to identify predatory buying. We follow up with a brief examination of recoupment and close with some final remarks.

II. THE *WEYERHAEUSER* LITIGATION

In 1980, *Weyerhaeuser* entered the Pacific Northwest by buying an existing hardwood lumber company. It invested some \$75 million in modernizing the facilities between 1990 and 2000, which improved its hardwood lumber yield from the sawlogs.⁷ By the time of the suit, it operated six sawmills in the region. While *Weyerhaeuser* was apparently flourishing, *Ross-Simmons* was floundering financially. For several years, it had lost substantial sums until 2001, when *Ross-Simmons* succumbed and closed down its business. It then sued *Weyerhaeuser* for violating §2 of the Sherman Act.

The dispute involved an allegation that *Weyerhaeuser* had engaged in predatory conduct in the alder sawlog market. Unlike most predatory price claims, *Ross-Simmons* did not allege pricing below cost in an effort to drive rivals out of the market. Instead, it involved claims that *Weyerhaeuser* overpaid for alder sawlogs and, thereby, denied an essential input to *Ross-Simmons*. In essence, *Ross-Simmons* alleged that *Weyerhaeuser*'s purchasing practices were aimed at denying *Ross-Simmons* and other hardwood lumber companies access to the inputs that were essential for their continued vitality as competitors in the hardwood lumber market.

At the District Court, the jury found *Weyerhaeuser* guilty and awarded damages to *Ross-Simmons* which were trebled to \$78.8 million. In its appeal to the Ninth Circuit, *Weyerhaeuser* argued that *Ross-Simmons* had failed to satisfy the *Brooke Group* test for predatory pricing.⁸ The Ninth Circuit rejected *Weyerhaeuser*'s appeal and affirmed the District Court's ruling, but the tide turned at the U.S. Supreme Court.

² 15 U.S.C. § 2.

³ *United States v. Grinnell Corp.*, 384 U.S. 563, 570-571 (1966).

⁴ *Standard Oil Co. of New Jersey v. United States*, 221 U.S. 1 (1911), and *United States v. American Tobacco Company*, 221 U.S. 106 (1911).

⁵ *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co.* - 549 U.S. 312 (2007).

⁶ For an extensive economic analysis, see Roger D. Blair & John E. Lopatka, *Predatory Buying and the Antitrust Laws*, 2008 Utah Law Review 415 (2008).

⁷ It appears that *Ross-Simmons* did not make similar investments in its facilities.

⁸ *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

The U.S. Supreme Court found that monopsony and monopoly should be treated symmetrically.⁹ Consequently, allegations of predatory bidding (or overbuying) would have to meet the standards set out in *Brooke Group*.¹⁰ More specifically, a successful plaintiff would have to prove two things. First, the plaintiff would have to prove the existence of predatory bidding. This requires proof that the defendant overpaid for the input in question such that the average cost of its finished product exceeded the market determined price.¹¹ In essence, the overbidding resulted in unprofitable sales.

Second, the plaintiff had to prove that the defendant had a reasonable probability of recouping its losses after the plaintiff's demise as a rival.¹² In the case of *Ross-Simmons*, they had to prove that Weyerhaeuser paid so much for the sawlogs that the prices that it could realize in the output market were below its costs, and that Weyerhaeuser has a reasonable probability of recouping the losses that it experienced during the period of predation. Since *Ross-Simmons* failed to satisfy this modified *Brooke Group* test, the U.S. Supreme Court reversed the judgement of the lower court.¹³

III. MOTIVATION TO EXCLUDE ROSS-SIMMONS

A dominant buyer's efforts to maximize its profits are offset to some extent by the competitive responses of its smaller rivals. Consequently, it has an incentive to exclude these smaller rivals from the market. This can be illustrated with the aid of the dominant buyer model.¹⁴

The dominant buyer is a close cousin of the pure monopsonist. In this model, a single large buyer is surrounded by a collection of small buyers, which are referred to collectively as the competitive fringe. For the purposes of our analysis, we will consider Weyerhaeuser to be the dominant firm and *Ross-Simmons* represents the competitive fringe. Due to its size, Weyerhaeuser recognizes that its purchases of alder sawlogs will influence the market price.

As a result, it will act as a price setter rather than a price taker. *Ross-Simmons* is small enough that it acts as a price taker because it believes that its purchases are too small to influence price in the market. In essence, the fringe of competitive buyers accepts the price that Weyerhaeuser pays as the market determined price. Behaving competitively, *Ross-Simmons* and the other fringe buyers will buy the sawlogs up to the point where their collective demand equals the price set by Weyerhaeuser.

In the Pacific Northwest, red alder sawlogs are a byproduct of soft wood harvesting. When a tract of timberland is clear cut, the pine forest contains relatively few hardwood trees, but there are some. Consequently, the supply of red alder sawlogs from a harvest is fixed, i.e. it does not respond to changes in the purchase price of these sawlogs. After separating the hardwood from the softwood, a certain fraction of the resulting sawlogs are red alder.

The supply is perfectly inelastic above the minimum price necessary to bring the hardwood to market. Below that minimum, the supply available to the market will be zero. Thus, the supply is horizontal at the minimum price until the total quantity in the harvest is reached as that reflects the costs of making the already harvested sawlogs available for sale, which we will refer to as P_R or the reservation price. From there, the supply curve is vertical.

The price is determined by the demands of the hardwood lumber companies. This can cause some firms to experience problems in acquiring sawlogs, which are an essential input in producing hardwood lumber.

Now, Weyerhaeuser's problem is to adjust its purchases to maximize profit subject to the competitive behavior of the fringe buyers such as *Ross-Simmons*. This is shown in Figure 1 where D_{rs} represents the demand for alder sawlogs by *Ross-Simmons*, D_w represents the demand

9 "[M]onopoly and monopsony are symmetrical distortions of competition from an economic standpoint....The kinship suggests that similar legal standards should apply to claims of monopolization and claims of monopsonization." *Weyerhaeuser* at 322.

10 There is no distinction between overbidding and overbuying. The only way to buy too much is to stand ready to bid too much; if one bids too much, one must stand ready to buy too much. Identifying what constitutes "too much" is no mean feat.

11 *Weyerhaeuser* at 325.

12 *Weyerhaeuser* at 325-326.

13 *Weyerhaeuser* at 326.

14 What follows is an adaptation of the dominant firm price leadership model. See Roger D. Blair & Jeffery L. Harrison, *Monopsony in Law and Economics* (2010) at 55-61.

of Weyerhaeuser, and S is the supply of red alder sawlogs. Weyerhaeuser recognizes that at any price that it sets, Ross-Simmons will purchase the quantity of sawlogs where D_{rs} equals that price.

Weyerhaeuser incorporates this behavior into its decision calculus by subtracting D_{rs} from S to obtain the residual supply of alder sawlogs, which is denoted by S_r in Figure 3. The curve marginal to S_r , which is labeled ME_r , represents the marginal expenditure for Weyerhaeuser. Given the presence of the competitive fringe, Weyerhaeuser acts like a monopsonist. Weyerhaeuser purchases the quantity (Q_w) that corresponds to the equality of ME_r and D_w . The price (P) is found at the residual supply at that quantity. At a price of P , Ross-Simmons will purchase Q_{rs} where P equals D_{rs} . At price of P , sellers will provide Q , which is equal to the sum of Q_{rs} and Q_w . The marginal expenditure (ME_r) exceeds the price of the sawlogs (P).

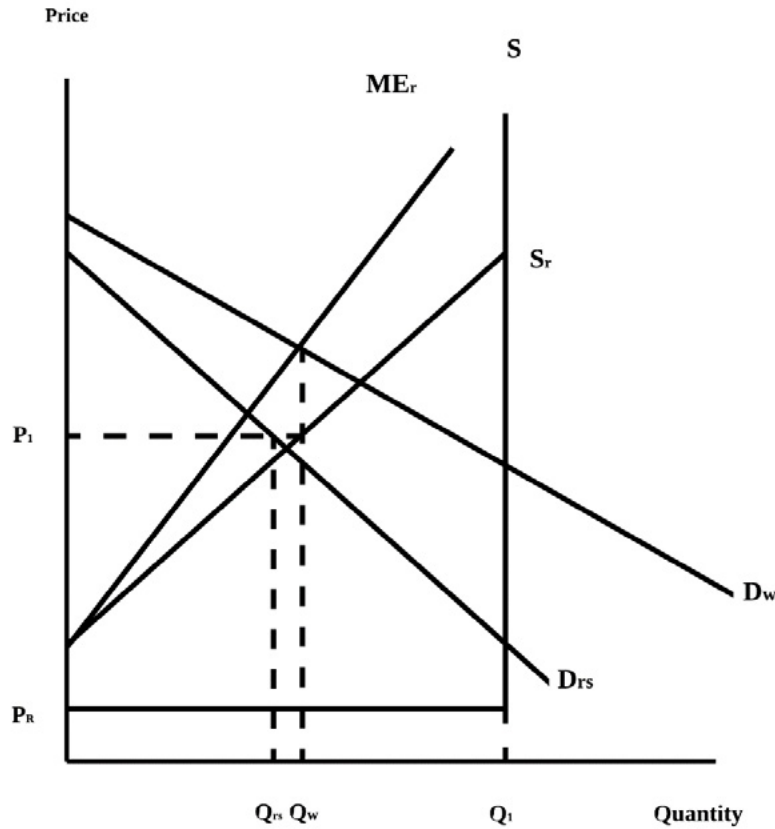


Figure 1

At the equilibrium price and quantity, Weyerhaeuser enjoys buyer surplus equal to the trapezoidal area below its demand (D_w) and above the price (P) between the origin and Q_w . This is nice but it could be better. If Weyerhaeuser can exclude Ross-Simmons, it can operate as a pure monopsonist. Weyerhaeuser would be able to purchase all the hardwood supplied in the market, and so Q_w would equal Q_1 . In the limit, Weyerhaeuser could depress the price paid to P_r because it is the only buyer in the market.

This would expand their buyer surplus to the entire trapezoidal area below Weyerhaeuser's derived demand but above the reservation price. The potentially extreme increase in buyer surplus produces the economic incentive to exclude rivals, as shown in Figure 2.

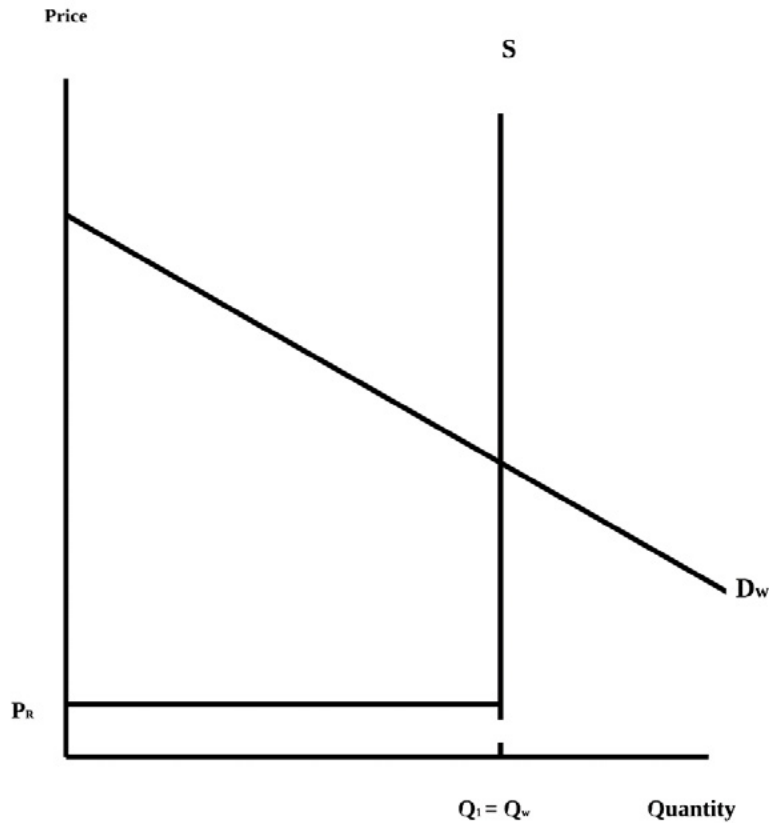


Figure 2

IV. PROBLEMS IN IDENTIFYING PREDATION

Identifying the fact of overbuying may not be easy. Consider the economic situation depicted in Figure 3, where VMP is the derived demand, S is the supply, and ME is the corresponding marginal expenditure. In order to maximize its profit, the buyer will expand its purchases until ME equals VMP, which is Q_1 . The price that corresponds to this quantity is P_1 . This decision does not involve predation. The firm is not incurring losses; it is maximizing its profits.

If rival buyers are priced out of the market, they must be decidedly less efficient. If the buyer were to buy Q_2 at a price of P_2 , one might object that the firm is behaving in an odd way since its profits will be lower than it would be at Q_1 and P_1 . But a price-quantity combination of P_2 and Q_2 is the competitive solution – supply and demand are equal. It would be difficult to characterize the competitive solution as predatory. In this case, the firm has monopsony power, but is not exercising it.

If the buyer purchases Q_3 at a price of P_3 , it is overbuying in the sense that the price paid exceeds the value of the inputs being purchased – at least at the margin. The problem of proof in litigation is the fact that we cannot see the lines in Figure 3. All we know is the actual price-quantity combination.

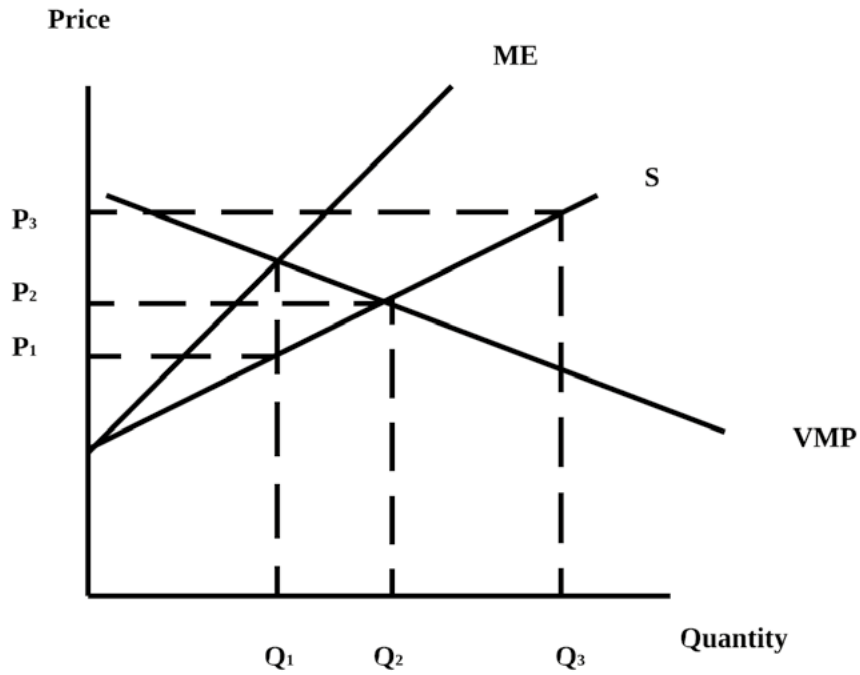


Figure 3

In Figure 4, D_{rs} and D_w are the derived demands for red alder sawlogs by Ross-Simmons and Weyerhaeuser, respectively. The aggregate demand $D_w + D_{rs}$ is their resulting sum. As shown in the figure, the market clearing price will be P_1 . At that price, Ross-Simmons will buy Q_{rs} while Weyerhaeuser will buy Q_w . Of course, Q_{rs} plus Q_w equals Q_1 .

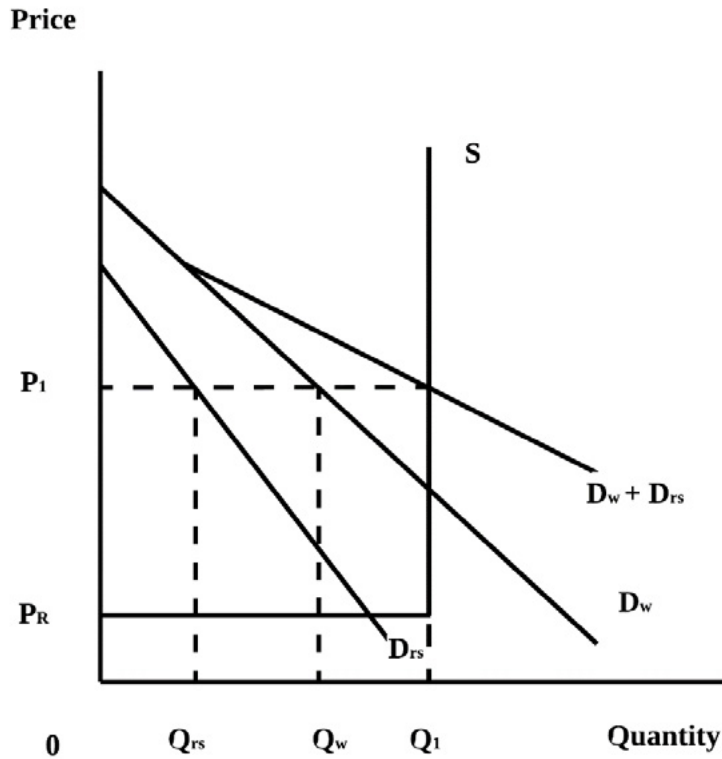


Figure 4

Weyerhaeuser's sawmills generally produced more hardwood lumber from a given quantity of sawlogs than Ross-Simmons facilities. Consequently, the derived demand for Weyerhaeuser (D_w) will be higher than that for Ross-Simmons (D_{rs}). In that case, Ross-Simmons may not be able to buy any sawlogs. It is apparent from Figure 4 that a smaller harvest could result in Ross-Simmons being priced out of the market. In that event, its hardwood lumber production will be zero. It is true that Weyerhaeuser is buying more than Ross-Simmons, but it is not overbuying. The greater quantity of purchases is due to Weyerhaeuser's greater size of its purchases and efficiency.

There are even extreme cases where Ross-Simmons is essentially shut out of the market simply because of its own inefficiency. In Figure 5, the derived demand for Ross-Simmons is so small in comparison to that of Weyerhaeuser's that when the market clears, Weyerhaeuser is the only firm purchasing hardwood in the market. This is not predation by a large buyer. Instead, it reflects Weyerhaeuser's greater efficiency in converting sawlogs into lumber.

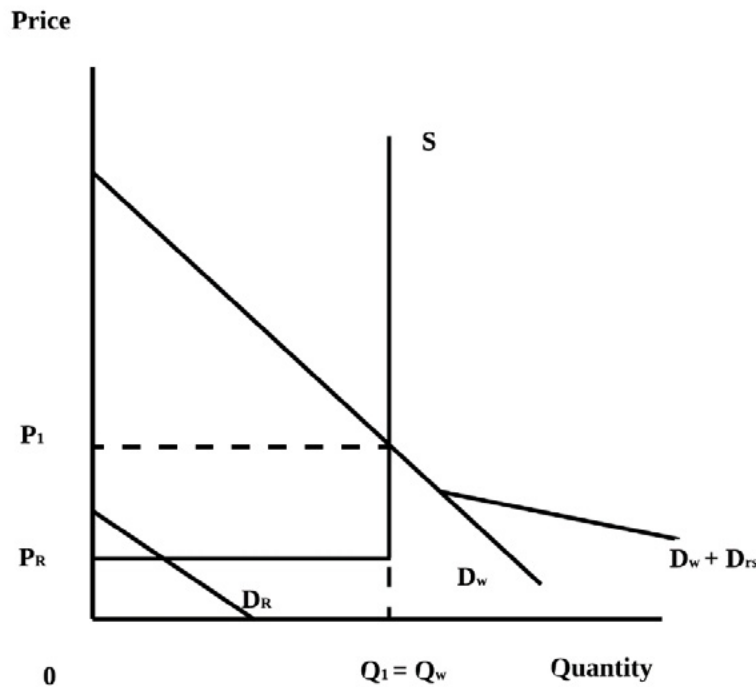


Figure 5

V. THE REQUIREMENT OF RECOURPMENT

When a dominant firm engages in predation, it incurs losses during the time it takes to eliminate its smaller rivals. One can think about these losses as an investment. Economically rational firms only make investments if they expect them to be profitable. For this to be the case, the firm must recover its investment and earn some positive return. The U.S. Supreme Court recognized this in its *Brooke Group* opinion.

In *Brooke Group*, the U.S. Supreme Court made it clear that an alleged predator must have a reasonable expectation of recouping its losses after the demise of the prey. This, of course, makes economic sense because the purpose of predatory pricing is to eliminate competition to charge monopoly prices – and earn monopoly profits. If the period of predation is so prolonged and the losses so large that recouping seems unlikely, the predatory pricing would be economically irrational. As a result, allegations of predatory pricing would be undermined. Much the same is true for allegations of monopsonistic predation.

If Weyerhaeuser had embarked on a predatory buying campaign aimed at eliminating Ross-Simmons as a rival buyer of alder sawlogs, it would expect to experience reduced profit, or even losses, during the campaign. These losses should be viewed as an initial investment in acquiring monopsony status. The return on this investment comes in the post-predation period in the form of monopsonistic profits. For this investment to be rational, the net present value (“NPV”) must be positive:

$$NPV = \sum_{t=0}^T \frac{L_t}{(1+R)^t} + \sum_{t=T+1}^{\infty} \frac{\Pi_t}{(1+R)^t} > 0$$

Put differently, the present value of the future profits must be greater than the present value of the losses during the period of predation.

In this expression, Σ is the summation operator, t denotes time, T is the length of the period of predation, L_t is the loss incurred in period t , Π_t is the profit earned in period t , and R is the discount rate. For this to be positive, the discounted present value of future profits must exceed the discounted present value of the losses experienced during the period of predation.

A. Monopsonistic Profits

The return on investments by eliminating a rival depends on market structure. Suppose that Ross-Simmons had been the only rival in purchasing alder sawlogs. The market structure would have been duopsony, which simply means that there were two buyers.

What is relevant in the NPV calculations is the incremental profit. This sum will depend on how the duopsonists behaved before one of them was eliminated. If they were acting as Cournot duopsonists before the elimination of Ross-Simmons, Weyerhaeuser was earning its share of the Cournot duopoly profit. Following the elimination of Ross-Simmons, Weyerhaeuser would earn all the monopsony profit. If they had been competing as Bertrand duopsonists, i.e. competing on price, they would have been paying the competitive price. Consequently, the price that Weyerhaeuser paid would have dropped from the competitive level to the monopsony level. The incremental profit would have been much larger in that event.

B. Uncertainty of Future Profits

All investments involve costs now and profits later. This makes investments risky since unforeseen events may reduce or even eliminate future profits. This is no less true when the investment is aimed at eliminating a rival. For one thing, the predatory campaign may be unsuccessful. In effect, the prey refuses to die. In that event, the losses will not be recouped.

Second, if the prey exits the market, another firm may purchase its assets at distress prices and begin competing. To head off this risk, the predator may have to buy these assets and then neutralize them.¹⁵

Third, government regulations could reduce timber harvests and thereby reduce the predator's ability to earn monopsonistic profits.

Fourth, there could be a surge in imports of hardwood lumber, which would reduce the demand for domestic production.

C. A Numerical Example:

A numerical example may be useful in understanding the risks associated with an investment in predation. Suppose that Weyerhaeuser had to experience losses of \$2.0 million per year for five years in order to eliminate Ross-Simmons as a rival buyer of alder sawlogs. At a 10 percent discount rate, the present value of that investment would be about \$7.5816 million.

Given the fact that Weyerhaeuser did not have any power in the hardwood output market, all the future profits would have to come from its monopsony power in the local alder sawlog market. This investment would be marginally profitable if Weyerhaeuser could earn profits of \$2.0 million per year over 10 years. The flow of profit begins in year 6 and extends to year 15. The present value of \$2.0 million per year for 10 years beginning six years out is \$7.6306 million. Thus, at the end of the 15 years, Weyerhaeuser would be ahead by \$49,000. Given the risks of engaging in a predatory buying campaign, this sum seems pretty meager.

¹⁵ Arguably, this was the strategy adopted by American Tobacco. For an account, see Malcolm R. Burns, *Predatory Pricing and the Acquisition Cost of Competitors*, 94 *Journal of Political Economy* 266 (1986).

VI. SUMMARY AND CONCLUSION

Predatory buying requires paying more than an input is worth in an attempt to deny rival buyers access to an input that is essential for competition. This is a risky business strategy. First and foremost, it is a violation of §2 of the Sherman Act. Consequently, a predator would be vulnerable to public sanctions and private damages. Second, during the predatory period, the predator incurs losses due to forgone profits and excessive payments. If recoupment turns out to be infeasible, the strategy will have backfired.

As with predatory pricing, this business strategy may be “seldom tried and rarely successful.”¹⁶

¹⁶ Paraphrase from *Brooke Group* at 226.

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