OCTOBER 2008, RELEASE ONE

GCP
THE ONLINE MAGAZINE FOR GLOBAL COMPETITION POLICY

The Complement Market/Final Consumer Distinction: Exclusion & Predation in the U.S. Department of Justice Section 2 Report

Timothy J. Brennan

University of Maryland, Baltimore County

WWW.GLOBALCOMPETITIONPOLICY.ORG

The Complement Market/Final Consumer Distinction:

Exclusion & Predation in the U.S. Department of Justice Section 2 Report

Timothy Brennan [*]

Most competition law falls into one of three categories. The first, cartel behavior, is relatively uncontroversial. The basics of the second, horizontal mergers, are generally accepted, but how best to implement it—efficiency defenses, welfare standards, the need for market definition, or the value of customer testimony—can be hotly contested. The most controversial category is single-firm conduct, called monopolization in the United States and abuse of dominance in much of the rest of the world.

This controversy has three roots. First, acquiring a monopoly can entail doing something better than one's rivals, such as charging lower prices or offering better products. Prosecuting these practices risks frustrating what competition is supposed to promote. Second, even if a firm has a market power, conduct that forecloses entry or rivalry elsewhere in its vertical supply chain would not be in that dominant firm's interest. It thus presumably cuts costs or boosts demand, increasing overall economic benefit. Third, interventions may have the stated goal of protecting competition, but do so only indirectly by preserving the viability of rivals. Consequently, debate about single-

[*] The author is a professor of public policy and economics at the University of Maryland, Baltimore County. Email: brennan@umbc.edu. He was honored and privileged to be among those who testified at one of the many hearings held by the U.S. Department of Justice and Federal Trade Commission on single-firm conduct.

firm conduct has been polarized between those who see these protections as protecting competitors and those who see them as a means to protect consumers.[1]

One indicator of the intensity of the controversy is the contrast between the U.S. statute regarding monopolization and the U.S. Department of Justice's (DOJ) just-released report ("Report") on single-firm conduct.[2] The statutory description of illegal conduct, Section 2 of the Sherman Act, takes only 43 words:

> Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony.[3]

The Report supplies 181 pages of guidance—not counting an executive summary and appendices—on how to interpret this mere sentence for a statute under which it filed only six cases between 1998 and 2007.[4]

A primary focus of the Report is whether a single test allows courts to distinguish between conduct that leads to illegal monopolization and conduct which courts should allow. The document properly rejects a single test—more on that below. But in doing so, the DOJ missed an opportunity to clarify Section 2 jurisprudence by noting that although one size does not fit all, there is a useful distinction between the two types of cases that largely span the continuum. This distinction is between cases where the conduct is

---

[1] For more on this and on the framework proposed below for looking at Section 2 cases, see T. Brennan, *Saving Section 2: Reframing U.S. Monopolization Law* [hereinafter Saving Section 2], *in* THE POLITICAL ECONOMY OF ANTITRUST 417-51 (Vivek Ghosal & Johan Stennek ed, 2007).

[2] 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.

[3] 15 U.S.C. §2.

[4] U.S. DEP'T OF JUSTICE, ANTITRUST DIVISION WORKLOAD STATISTICS, FY 1998 – 2007 *at* 5, *available at* http://www.usdoj.gov/atr/public/workstats.pdf.

directed at consumers and those where the conduct is directed at retailers, distributors, or other firms competing in related complementary markets.

I. END-USER PREDATION AND COMPLEMENT MARKET EXCLUSION

Consider first the type of case where the alleged monopolization depends on the strategic effects of actions directed at consumers. The archetype is predatory pricing, defined as offering low prices to consumers today to drive out rivals or deter entry, thereby allowing monopoly prices to be charged in the future. Bundling, particularly when consumers are getting additional products without a much higher price, can have the same effect. I label this category of unilateral conduct "predation," although it covers bundling and other end-user directed conduct as well. In these predation cases, the anticompetitive effect only occurs in the long run—the direct short-run effect of the conduct is beneficial in order to convince consumers to buy from the monopolist and not the entrant.

To avoid chilling good conduct, cases based on conduct directed at consumers should have a high bar to hurdle. Maintenance of a monopoly comes about by giving consumers more of what they like, e.g., lower prices. The high bar that courts and agencies seem to be evolving toward is whether the conduct *could* be consistent with competition under *some* circumstances. The strict tests proposed in the Report—pricing below some measure of incremental cost, profit sacrifice, no business sense or (excluding equally efficient competitors)—are all variations on that theme. None of these tests strictly distinguishes good conduct from bad. Their justification is that when prices

exceed costs or conduct otherwise is profitable, sensible, and would drive out only less efficient firms, the costs of chilling such presumptively competitive conduct in "predation" cases outweighs the benefits of prohibiting rare anticompetitive outcomes.

The DOJ correctly rejected variations of an "inconceivable competitive response" test for assessing all Section 2 allegations, but in doing so failed to exploit the second category identified above—cases where the conduct is directed at competing firms in complement markets. Since the archetype for this category is exclusive dealing, I label these "exclusion" cases. Monopolization here results from suppressing competition among suppliers in the complement market, e.g., retailers or distributors. With exclusive dealing, harm arises because rivals of the perpetrator are forced to use retailers that are not party to such agreements. If the nonparticipating retailers are inferior substitutes for the retailers covered by exclusive dealing, rivals cannot compete as effectively, allowing the alleged monopolizing firm to increase prices.

It is crucial to recognize that competitive harm in exclusion cases depends entirely on the effect of the conduct on the complement market.[5] For these cases, the appropriate bar should not be an inconceivable competitive response test. Rather, assessing a practice directed at competing providers of inputs or other intermediate goods should focus on the extent to which the practice suppresses competition among providers in that complement market. A lower bar is appropriate, since suppression of competition is no more presumptively beneficial in these settings than with horizontal mergers or cartels.

[5] I have referred to this practice as "complement market monopolization;" Saving Section 2, *supra* note 1 *at* 422-24. For an earlier statement of the principle that harming rivals by raising their costs requires the acquisition of market power over something the rivals need, see T. Brennan, *Understanding 'Raising Rivals' Costs'* 33 ANTITRUST BULL. 95-113 (1988).

Accordingly, the appropriate methods for assessment in exclusion cases—but not predation cases—are those used in assessing mergers and cartel conduct (at least that which is not *per se* illegal). Delineate a relevant complement market and identify whether the practice covers a sufficiently large share of that market to raise prices a significant amount for a significant time. Entry into the complement market is, as always, paramount, including whether rivals could retail or distribute their own products. One should also ask how much the practice at hand actually raises the effective price of the complement to the rivals. Exclusion arises because a complement provider that chooses to deal with a rival has to pay some sort of penalty, e.g., damages for breach of an exclusive dealing contract. If the costs of breach are trivial, the contract would have no competitive effect.

Enforcement against conduct directed toward competing firms in a complement market should recognize that the conduct is harmful only to the degree it creates market power in that market. The Chicago school critique, that such conduct cannot be harmful because a single monopoly already in the production chain can extract all the profit, may roughly hold when a monopoly is already present. But it does not apply when conduct creates a new monopoly, as could exclusive dealing contracts that cover every retailer, distributor, input supplier, or other firm in a relevant complement market.

II. APPLYING THE DISTINCTION TO THE REPORT

Some aspects of the Report reflect this distinction between predation and exclusion. Among these are chapter 3's rejection of a single standard and chapter 8's

portrayal of exclusive dealing. Both discussions, however, would have been stronger had the DOJ exploited the economics of suppressing competition in complement markets. Where the Report strays most is its treatment of bundled rebates in chapter 6; in failing to recognize that the targets in these cases are competing complement providers, not final consumers.[6] The Report's treatments in chapters 4, 5, and 7 of predatory pricing, tying, and unilateral refusals to deal are consistent in stating that a high bar is appropriate for end-user directed conduct, although they fail to appreciate the relevance of regulatory price constraints in making predatory threats credible and using tying—access discrimination—to evade regulatory constraints on market power.[7] I elaborate on these points below, concluding with observations on identifying monopolies (Chapter 2).

A. Chapter 3: Rejecting a Single Standard

The chapter hints at the distinction between exclusion and predation cases; the latter faces the *Brooke Group* requirement that such a price be "below an appropriate measure of defendant's costs in the short term."[8] The DOJ rejects the other candidate tests listed above, but not on grounds that exclusion cases differ in kind from predation. Rather, their flaws are largely operational. The DOJ correctly notes that such tests constitute what I would call an "absolute efficiency" defense—that a $1 in prospective profit could outweigh "tremendous harm to the competitive process."[9] However, having

[6] For more detail, see T. Brennan, *Bundled Rebates as Exclusion Rather Than Predation*, [hereinafter Bundled Rebates], 4 J. COMPETITION L. & ECON. 335-374 (2008).

[7] T. Brennan, *Why Regulated Firms Should Be Kept Out Of Unregulated Markets: Understanding the Divestiture in U.S. v. AT&T*, 32 ANTITRUST BULL. 741-93 (1987).

[8] Report *supra* note 2 *at* 53, citing *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 222 (1993).

[9] Report *supra* note 2 *at* 43.

rejected basing cases on actual effects measurement as being similarly impractical, the DOJ finds a "disproportionality test"—that the harm is "disproportionate to consumer benefits"[10]—is "likely the most appropriate test identified to date for evaluating conduct."[11] By ignoring that exclusion works by suppressing competition among complement providers, the DOJ misses a golden opportunity to set standards based on the delineation, coverage, and entry into the complement market, akin to those in its Horizontal Merger Guidelines.[12]

B. Chapter 8: Exclusive Dealing

The DOJ comes very close to recognizing complement market monopolization in this chapter, beginning by citing an appellate opinion by (now Justice) Breyer that exclusive dealing arrangements "may sometimes be found unreasonable … because they may place enough outlets, or sources of supply, in the hands of a single firm … to make it difficult for new, potentially competing firms to penetrate the market."[13] It also implicitly indicates the importance of the complement market in noting testimony that exclusion is unlikely to be harmful "if access is easy" or rivals can "establish their own distribution networks."[14] The DOJ also correctly suggests that the common view of complement providers as victims of exclusionary conduct is overstated, because "the manufacturer

[10] *Id*. *at* 45.

[11] *Id*. *a*t 46.

[12] U.S. Department of Justice & Federal Trade Commission, 1992 Horizontal Merger Guidelines (19920, revised April 8, 1997, *available at* http://www.usdoj.gov/atr/public/guidelines/hmg.pdf.

[13] *Id*. at 131-32, citing *Interface Group, Inc. v. Massachusetts Port Authority*, 816 F.2d 9, 11 (1st Cir. 1987).

[14] Report *supra* note 2 at 138.

may be able to obtain their acquiescence by sharing with them some of its expected monopoly profits."[15]

Unfortunately, the DOJ never explicitly notes that in such cases, the attention of enforcers and the courts should be directed at the suppression of competition in the complement market. Although stating that "the level of distribution really matters," the DOJ obliterates the distinction between cases directed at "customers" and "distribution" in recommending a safe harbor when arrangements "foreclose less than thirty percent of existing customers or effective distribution."[16] This is exactly where the distinction between end-user directed predation and complement market-directed exclusion would have would have been most helpful.

C. Chapter 6: Bundled Discounts

Failure to give this distinction its dues comes in the DOJ's decision to treat bundled rebates as predation; in particular, by recommending standards comparing prices to cost.[17] Such an analysis treats the recipients of bundled rebates as final consumers. If rebates were akin to predation, the DOJ's approach would be correct. In fact, in virtually all of the bundled rebate cases here and elsewhere, the recipients are competing complement good providers.[18] Accordingly, exclusion, not predation applies. A bundled rebate is qualitatively no different than exclusive dealing in its effect on the price of complement to rivals. A complement provider who carries a rival pays a penalty, where foregoing the rebate is the equivalent of paying damages for breaching an exclusive

[15] *Id*. at 137.

[16] *Id.* at 138, 141.

[17] *Id*. at 101, 102.

[18] Bundled Rebates, *supra* note 6 at 346-50.

dealing contract.[19] Accordingly, the question for courts to consider ought not to be predation-based—whether some or all of a bundle's price is less than some appropriate cost. The test should be whether the bundle covers a sufficiently large share of a relevant complement market and the costs of switching to carrying a rival are sufficiently high, to create, in the terms of the DOJ's Horizontal Merger Guidelines, a "small but significant non-transitory increase in price" of the complement to the rivals.

D. Chapters 4, 5, and 7: Predation, Tying, and Unilateral Refusals to Deal

By and large, these chapters are consistent with the "exclusion/predation" distinction. For predation, the starting point for analysis should be that end users, not competing complement providers, are the tactic's targets. As such, "inconceivable competitive response" tests such as *Brooke Group* are appropriate. The DOJ correctly observes that the purpose of such a test is not to precisely differentiate good pricing from bad, but to avoid chilling good pricing in light of the risks in penalizing prices above cost, even if potentially harmful in special circumstances.[20]

With respect to the other two subjects, observe first that a refusal to deal is, essentially, a tie. The only way to benefit from a good or service an upstream firm supplies is to purchase its downstream product as well, as no other firm in the downstream market can obtain the upstream product. For either tying or refusing to deal,

[19] *Id*. at 365-67. Whether a bundled rebate should be regarded as exclusionary only if the implied penalty from a foregone rebate is equivalent to that from breaching an exclusive dealing contract remains an open question.

[20] Report *supra* note 2 *at* 58-60 (" … above cost pricing should remain *per se* legal.")

the upstream firm is at worst generally choosing how best to exploit whatever market power it already has; only in rare cases will this lead to the creation of a new monopoly.[21]

Unfortunately, the DOJ fails to discuss an exception it pioneered almost thirty years ago—regulated firms that also participate in unregulated markets. In such cases, tying (through access discrimination) or refusals to deal can eliminate competition in an unregulated market and allow the firm to exploit its otherwise regulated monopoly. Any ability to shift costs of providing unregulated services to captive ratepayers can make predatory threats more likely and credible. Such concerns were at the core of the antitrust case the DOJ prosecuted against AT&T, but such concerns appear to no longer be viable after *Trinko*.[22]

E. Chapter 2: Prior Monopoly

We conclude by going to the beginning of the Report, establishing monopoly power or dominance. Doing so is notoriously difficult because it requires a delineated market, and a dominant firm will keep increasing prices until consumers turn to substitutes. The only theoretically sound test would be to ask what a firm would do if faced with a small but significant, non-transitory reduction *below* its going price. A competitive firm, seeing a lower price, would reduce supply; one with market power, realizing cutting output could not increase prices, would increase supply. Unfortunately,

[21] DENNIS CARLTON & KEN HEYER, APPROPRIATE ANTITRUST POLICY TOWARDS SINGLE-FIRM CONDUCT (Economic Analysis Group Discussion Paper No. EAG 08-2, March 2008); *available at* SSRN: http://ssrn.com/abstract=1111665. The DOJ is also right to point out that remedies in such "essential facility" situations require that antitrust agencies or courts become price regulators, an outcome few regard as desirable, Report *supra* note 2 *at* 152-53.

[22] Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398 (2004); T. Brennan, Trinko v. Baxter: The Demise of U.S. v. AT&T, 50 ANTITRUST BULL. 635-64 (2006).

that theoretically sound test is almost completely impractical, leaving us with little more than the intuitive criteria the DOJ presents in this chapter.

The unstated assumption is that one needs to define a monopoly in the first place. The "exclusion/predation" distinction again is instructive. For predation, the credibility of the threat and the strategic significance of the practice likely require that a firm be dominant. For exclusion, however, the *Grinnell* requirement of a prior monopoly undercuts a case.[23] Evidence establishing that a defendant has a prior monopoly is evidence that the practice in question makes little competitive difference and more likely promotes efficiency. A stronger case against exclusionary conduct would be to show that competition would be greater (ideally perfect) but for the practice under scrutiny.[24] Challenging the requirement that only a monopolist can monopolize remains a task for the future.

[23] Report *supra* note 2 at 5, citing United States v. Grinnell Corp., 384 U.S. 563, 570–71 (1966).

[24] The Canadian Federal Court of Appeal applied such a "but for" test to a bundled rebate case. Commissioner of Competition v. Canada Pipe, 2006 FCA 233 [2006] *at* ¶¶38-44.