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Not Implementing the Hypothetical Monopolist Test!

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I recently argued in this magazine that a style of critical loss calculation I termed "CLAD" (Critical Loss Analysis by Defendants) does not properly implement the hypothetical monopolist test (HMT) for market delineation and is often highly misleading.[1] I argued that CLAD should be excluded under Rule 702 of the Federal Rules of Evidence on the grounds that it ignores essential demand, cost, and other features of an industry. Instead, I argued that economists on both sides of a case should properly implement the HMT with simple models reflecting essential industry features.[2] Malcolm B. Coate and Jeffrey H. Fischer take issue with my arguments.[3]

Coate and Fischer are correct when they state that CLAD is "applicable when the simplifications implicit in the calculation are reasonable" but not when they assert that CLAD is misleading only in "special cases." My experience from three decades of

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[1] Gregory J. Werden, *Beyond Critical Loss: Properly Applying the Hypothetical Monopolist Test*, GCP MAGAZINE 2 (Feb. 2008), *at* http://globalcompetitionpolicy.org/index.php?&id=862&action=907.

[2] For more on the relevant analysis, *see* Gregory J. Werden, *Beyond Critical Loss: Tailored Application of the Hypothetical Monopolist Test*, 4 COMPETITION L.J. 69 (2005).

[3] *Critical Loss: Implementing the Hypothetical Monopolist Test*, GCP MAGAZINE 1 (Mar. 2008), *at* http://globalcompetitionpolicy.org/index.php?&id=982&action=907.

applying the HMT[4] led me to conclude that CLAD has obscured as much as it has illuminated. Coate and Fisher call my objections to CLAD "conceptual," but each objection was based on multiple actual cases in which I found CLAD was misleading while a proper implementation of the HMT, yielding a very different conclusion, was not difficult.

Coate and Fischer are correct when they state that "the plaintiff bears the burden of proof on market definition" but not when they assert that a court should presume that CLAD properly implements the HMT and that the plaintiff therefore is obliged to "present the evidence necessary to rebut" that presumption. The proponent of any evidence has the burden of establishing its admissibility, and Rule 702 of the Federal Rules of Evidence (FRE) requires that expert evidence be shown to be "the product of reliable principles and methods" applied "reliably to the facts of the case."[5] Thus, in the first instance, the onus is on the proponent of CLAD (or any other analysis purporting to implement the HMT) to provide a factual basis for concluding that it really does implement the HMT within the context of a particular case.

In the most significant application of Rule 702 in an antitrust case, the court declared that Rule 702 demands a "thorough analysis of the expert's economic model," which "should not be admitted if it does not apply to the specific facts of the case." In that case, the court excluded the evidence on which the plaintiff's damage award had

[4] I coined the term "hypothetical monopolist" and first applied the HMT in U.S. DEP'T OF JUSTICE, ANTITRUST DIVISION, COMPETITION IN THE COAL INDUSTRY 26-27 (May 1978).

[5] For a detailed discussion of the implications of Rule 702 for expert economic testimony in antitrust cases, *see* Gregory J. Werden, *The Admissibility of Expert Testimony*, *in* ABA SECTION OF ANTITRUST LAW, ISSUES IN COMPETITION LAW AND POLICY (W. Dale Collins ed. forthcoming 2008), *at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=956397.

rested because the model used by the plaintiffs' economist was "not grounded in the economic reality" of the industry.[6] The court did not find that the model was inherently unreliable, but rather that it was irrelevant in that case.[7] CLAD, or any other purported implementation of the HMT, is no different. Even if only implicitly, it posits a model of a profit-maximizing monopolist that should not be admitted when "it does not apply to the specific facts of the case."

Finally, Coate and Fischer contend that some of CLAD's departures from the HMT are actually a good thing. They contend that the simple experiment implicit in CLAD—with uniform price increases across different products and uniform output reductions from all plants—is apt to be more indicative of the likely competitive effects of a merger than the more profitable policies a monopolist could adopt. Coate and Fischer base this contention on beliefs about what is "realistic," but their beliefs run counter to the unilateral effects theories in many merger cases. Shutting down a block of capacity commonly has been part of such a theory, but CLAD ignores the consequent avoidance of fixed costs, which can affect profitability substantially.

Furthermore, Coate and Fischer are wrong to conflate market delineation with the assessment of competitive effects. In neither the case law nor the *Horizontal Merger Guidelines* does market delineation mirror the competitive effects analysis. Indeed, the HMT itself is fundamentally incompatible with that idea. By positing a hypothetical monopolist, the HMT intentionally abstracts from the realities of actual and potential competition within the candidate market and explicitly delineates a relevant market

[6] Concord Boat v. Brunswick Corp., 207 F.3d 1039, 1055-56 (8th Cir. 2000).

[7] Rule 402 of the FRE categorically states: "Evidence which is not relevant is not admissible."

without regard to specific competitive effects that might flow from a merger.

There is a consensus that the HMT is the best available tool for market delineation in merger cases, but it must be implemented properly. That requires a simple model incorporating demand and cost assumptions supported by the facts of the case, which Coate and Fischer agree "is often straightforward." Contrary to their assertion, a court should not presume that CLAD properly implements the HMT because there is no sound theoretical or empirical basis for such a presumption.