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One of the most important changes in the antitrust laws over the past 40 years has been the diminished reliance of rules of *per se* illegality in favor of a rule of reason analysis. With the Court's recent rulings in *Leegin* (eliminating *per se* rule for minimum RPM) and *Independent Ink* (eliminating the *per se* rule against intellectual property tying), the evolution of the antitrust laws has left only tying (under a "modified" *per se* rule) and horizontal price fixing under *per se* rules of illegality. This movement reflects advances in law and economics that recognize that vertical restraints, once condemned as *per se* illegal when used by firms with antitrust market power, can be pro-competitive. It also reflects the judgment that declaring such practices *per se* illegal produced high type I error costs (the false condemnation and deterrence of pro competitive practices).

The widespread use of the rule of reason can be problematic, however, because of the inability of antitrust agencies and courts to reliably differentiate between pro- and anticompetitive conduct. Conduct analyzed under Section 2 often has the potential to generate efficiencies and be anticompetitive, and finding a way to reliably differentiate between the two has been described as "one of the most vexing questions in antitrust law."² Under these conditions, applying a rule of reason analysis on a case by case basis may not substantially reduce error costs and can drastically increase the costs of enforcement. Thus, under the decision theory framework widely used by economists and courts, which teaches that optimal legal standards should minimize the sum of error costs and enforcement costs, "bright line" *per se* rules of legality and illegality can dominate more nuanced but error prone standards under the rule of reason.

To its credit, the Section 2 Report has a useful discussion of the use of decision theory and the benefits of using administrable *per se* rules.³ The Report's discussion is also balanced, discussing both the utility of bright line *per se* rules of illegality and safe harbors, including an extended discussion of the most familiar example of a bright line safe harbor, the Court's *Brooke Group* rule for predatory pricing. The Section 2 Report provides a succinct analysis of how the *Brooke Group* rule serves the goal of having an

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² U.S. DEPARTMENT OF JUSTICE, COMPETITION AND MONOPOLY: SINGLE-FIRM CONDUCT UNDER SECTION 2 OF THE SHERMAN ACT, 12 (Sept. 2008) (Hereinafter "Section 2 Report")

³ *Id.* (15-18).

administrable rule, and also provides a safe harbor for above-cost pricing in order to protect against type I error costs.

In general, antitrust analyses under Section 2 employ very few bright line rules. As noted above, the use of *per se* illegality has been effectively eliminated under Section 2 in favor of the rule of reason. And other than the *Brooke Group* rule, the only safe harbors that come to mind are the extensions of *Brooke Group* to cover predatory buying in *Weyerhaeuser* and price-cost squeezes in *LinkLine*, and the Court's limitations on sham litigation under *Professional Real Estate* and *Walker Process*. While the Section 2 Report suggests the further development of similar conduct specific tests is appropriate,⁴ it does not provide specific guidance on how this should be achieved. Indeed, the report pessimistically notes that while "there is general consensus that clearer and more predictable standards are desirable, legal scholarship and the record from the hearings suggest far less consensus on what those standards should be."⁵

There is little evidence that the use of bright line rules in antitrust analyses under Section 2 will expand in the near future. Indeed, there is some reason to believe that their use will be curtailed on the margin. As noted above, the Federal Courts have largely moved away from *per se* rules toward a rule of reason approach. And recent actions by antitrust officials, including the recent withdrawal of the Section 2 report, suggest little support for expanding or even maintaining the use of bright line safe harbors. The new AAG for Antitrust and a majority of the FTC have expressed pessimism regarding the importance of avoiding type I errors in antitrust. Indeed, the new AAG for Antitrust has stated her pessimism regarding the *existence* of type I errors in antitrust.⁶

Moreover, there is continuing pressure to alter the *Brooke Group* rule in ways that would narrow the above-cost safe harbor. The Court relied upon the pre 1980 economic literature to conclude that "there is a consensus that predatory pricing schemes are rarely tried, and even more rarely successful."⁷ Since then, economic studies have challenged this consensus. These include game theoretic models of rational predation, including models of predation that do not require prices below cost. These also include empirical studies presenting evidence consistent with the existence of successful predation, and questioning the conclusions of the earlier empirical studies relied on by the Supreme Court.

⁴ *Id.* (47).

⁵ *Id.* (34).

⁶ The new AAG for Antitrust has stated her pessimism regarding the *existence* of type I errors in antitrust, *see* <http://tinyurl.com/kr8235>.

⁷ *Brooke Group v. Brown and Williamson Tobacco Corp.*, 509 U.S. 209 (1993) (citing *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986)).

Based on these analyses, some have called for elimination or curtailment of the *Brooke Group* safe harbor for above cost pricing.⁸ However, it is far from clear that such a change is warranted. While the recent literature on predatory pricing has demonstrated both the theoretical viability of predatory pricing strategies, and has provided useful analysis and re-analysis of antitrust cases involving predatory pricing, there is still very little conclusive evidence on the rate and success rate of predatory pricing.⁹ Moreover, while this literature may have cast doubt on the Court's assumption that predatory pricing was rare and economically irrational, perhaps the most important reason to keep the above-cost safe harbor, the benefits of having an administrable rule, remains. As Areeda & Hovenkamp note:

[t]he reason these tests for predatory pricing were adopted was *not* because there is widespread consensus that above-cost pricing strategies can never be anticompetitive in the long run. Rather, it is because our measurement tools are too imprecise to evaluate such strategies without creating an intolerable risk of chilling anticompetitive behavior.¹⁰

Indeed, the extent to which the proponents of modifying the *Brooke Group* rule are successful ultimately will be decided by the courts. On this front, it is far from clear that they will be successful. Even considering the recent advances in economic theory, the benefits of having an administrable rule should provide a strong underlying reason to keep the above-cost safe harbor for pricing behavior, and to seriously consider administrable rules to cover other conduct analyzed under Section 2.

A related issue is the extent to which the *Brooke Group* rule, in its current form, will remain an administrable standard. In practice, the *Brooke Group* above-cost rule is not as bright as one might wish. The Achilles heel of the *Brooke Group* cost-based rule is the failure to clarify what the relevant cost is.

Chapter 4 of the Section 2 Report for the most part does a nice job of setting out the leading alternatives. The report notes that there is a broad consensus that prices above Average Total Cost ("ATC") should be *per se* legal.¹¹ The report also discusses the measures preferred by Areeda-Turner, Marginal Cost ("MC"), and Average Variable Cost ("AVC") as an administrable proxy for MC, and criticisms of these measures. The Report endorses Average Avoidable Costs ("AAC"), which includes both the variable and non sunk product-specific fixed costs of producing the incremental output as the preferred measure. AAC is the preferred measure because it correctly measures the avoidable cost of producing the incremental predatory output.

⁸ *Supra* n. 2 at 58.

⁹ See Bruce Kobayashi, *The Law and Economics of Predatory Pricing*, George Mason University Law & Economics Research Paper Series No. 08-4, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1154052&rec=1&srcabs=1145529

¹⁰ See PHILLIP E. AREEDA & HERBERT HOVENKAMP, *ANTITRUST LAW*, 2006 SUPP., 324, (2006)

¹¹ *Supra* n. 2 at 61

While Chapter 4 of the Section 2 Report provides a very useful review and analysis of the alternative cost measures, I thought the discussion simplified away several important issues. The nature of problems created as a result of this oversimplification can be illustrated by considering the numerical example used to illustrate the difference among the various cost measures.¹² One problem is that the constant cost of producing the incremental output is constant, so that the AAC is equal to MC. Thus, the example fails to clearly illustrate the differences between the Areeda Turner preferred measure (MC) and the DOJ's preferred measure (AAC). Moreover, the example suppresses several other important issues. For example, it measures the incremental output relative to the predating firm's pre-entry output instead of measuring it relative to the but-for post entry output. The simplicity of the example has the advantage of being easier to understand, but it suppresses issues that make use of the AAC measure less administrable than an accounting measure such as AVC.

A more serious issue is the Report's failure to clearly address the opportunity cost issue, a critical issue in the recent airline cases.¹³ In *AMR*, the DOJ's position was that when an airplane is shifted from a profitable route (Route S) to expand capacity in the alleged predation route (Route P), avoidable costs for Route P should include the forgone profits from Route S as an opportunity cost. These costs would be added to the flight costs (cost of fuel, crew, passenger costs, etc.). The *AMR* court rejected inclusion of such forgone profits, but the *Spirit* court accepted forgone revenues as part of the incremental costs of expanding output.¹⁴ The report notes general agreement among panelists at the Section 2 hearings that opportunity costs should be included in the calculation of avoidable costs, but far less agreement with regard to whether lost inframarginal revenues should be considered.¹⁵

Later, the Section 2 Report concludes "that consideration of foregone revenues [as part of avoidable costs] is neither appropriate nor likely to be administrable. The Department consequently will not consider the lost revenues on inframarginal sales as a cost when evaluating predatory pricing claims."¹⁶ The first line suggests that the Department would not consider the forgone profits from Route S or the forgone inframarginal profits from Route P as part of avoidable costs for Route P. However, the second line suggests that the limitation applies only to consideration of reduced inframarginal profits for Route P, which would allow consideration of the forgone profits for Route S.

¹² *Supra* n. 2 at 64.

¹³ *U.S. v AMR Corp.*, 355 F.3d. 1109 (10 Cir. 2003) and *Spirit Airlines v. Northwest Airlines*, 431 F.3d. 917 (6th Cir. 2005).

¹⁴ *Supra* n. 9 at 304-11.

¹⁵ *Id.* at 66.

¹⁶ *Id.* at 67.

Given the Report's clear statement that forgone inframarginal profits for Route P would not be considered, coupled with the Departments position in *AMR* that forgone profits for Route S should be part of avoidable costs, the second interpretation may be a plausible one. However, it does not seem to be an analytically consistent one. If one used a profit-sacrifice test in predatory pricing cases, one would want to consider both the forgone profits for Route S and the forgone inframarginal profits for Route P in calculating whether the shift of capacity and altered prices constitute a profit sacrifice. However, one could conclude that use of such a test in predatory pricing cases would not be administrable. Given that the administrability of the forgone profit calculations for Route P and Route S would in general be similar (e.g., Route S is reduced from four flights a day to three, while Route P is increased from two flights to three), administrability concerns would suggest eliminating consideration of both the Route S and Route P forgone profits when evaluating predatory pricing claims. The DOJ approach would eliminate the latter on administrability grounds, but allow the former, which would generally present the same issues of administrability.

In general, the airline cases illustrate the potential complications encountered in applying the *Brooke Group* cost test. In addition to the issue of forgone profits, any incremental revenue calculations will have to account for the fact that passengers in hub and spoke systems will generate revenue by flying connecting segments, as well as the airlines' complex yield management systems. In addition, narrow definition of markets that include distinct classes of flyers (e.g., the leisure versus business travel markets used in *Spirit*) requires that the courts address the difficult issue of how joint and common costs are to be allocated between these markets.

All of these complicate the analysis and increase the number and complexity of the issues litigated in these cases. And while such developments may improve the economic analysis in the cases, one has to wonder whether these "advances" will "through the vagaries of administration, prove counterproductive, undermining the very economic ends they seek to serve."¹⁷ If so, the Department and the courts may be wise to adopt the unconditional version of its decision not to consider foregone profits in predatory pricing cases in order to preserve the administrability benefits of the *Brooke Group* rule.

¹⁷ *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227, 234 (1st Cir. 1983).