

GCP

THE ONLINE MAGAZINE FOR GLOBAL COMPETITION POLICY

A Short History of the DOJ Section 2 Report

Michael Salinger
Boston University School of Management

A Short History of the DOJ Section 2 Report

Michael Salinger¹

I. THE HEARINGS

Given the embarrassing outcome of the Federal Trade Commission/Department of Justice (“FTC/DOJ”) single-firm conduct hearings, it is worth revisiting why the agencies held the hearings and what they were trying to accomplish.

In my opinion, an important impetus for the hearings was the sharp divide across the Atlantic with respect to the antitrust treatment on unilateral conduct. The European Commission’s Directorate General for Competition (“DG-Comp”) was working on Article 82 Guidelines. The United States and Europe were vying to provide leadership to the many countries with new (or relatively new) antitrust laws. Without a document from the United States, the EC Guidelines were likely to become the model for the rest of the world. Issuing formal guidelines on unilateral conduct would have been an even harder task than issuing a joint DOJ/FTC report, and one might question the value of guidelines in an area where such controversy remains.

A primary challenge in organizing the hearings was to make them a contribution rather than a re-hashing of arguments that one could find by reading *The Antitrust Law Journal*. The Federal Register notice announcing the hearings provides some key insights into how the organizers hoped to meet that challenge. It read, in part:

The Agencies expect to focus on legal doctrines and jurisprudence, economic research, and business and consumer experiences. To begin, the Agencies are soliciting public comment from lawyers, economists, the business community, consumer groups, academics (including business historians), and other interested parties on two general subjects: (1) The legal and economic principles relevant to the application of section 2, including the administrability of current or potential antitrust rules for section 2, and (2) the types of business practices that the Agencies should examine in the upcoming Hearings, including examples of real-world conduct that potentially raise issues under section 2. With respect to the

¹ Michael Salinger is Professor/Everett W. Lord Distinguished Faculty Scholar, Finance and Economics Department, Boston University School of Management.

Agencies' request for examples of real-world conduct, the Agencies are soliciting discussions of the business reasons for, and the actual or likely competitive effects of, such conduct, including actual or likely efficiencies and the theoretical underpinnings that inform the decision of whether the conduct had or has pro-or anticompetitive effects....

The Agencies encourage submissions from business persons from a variety of unregulated and regulated markets, recognizing that market participants can offer unique insight into how competition works and that the implications of various business practices may differ depending on the industry context and market structure. The Agencies seek this practical input to provide a real-world foundation of knowledge from which to draw as the Hearings progress. Respondents are encouraged to respond on the basis of their actual experiences.²

Particularly with the outreach to business historians and to the business community, the notice reflected a desire to get input from more than the "usual suspects" (i.e., former agency officials, prominent members of the antitrust bar, and antitrust scholars) to gather evidence about the rationale for the single-firm conduct that can be subject to antitrust scrutiny.

Rational antitrust doctrine necessarily rests on decision theory (or relative error cost analysis). This point is not merely an economist's perspective. It is Supreme Court doctrine (in, for example, *Matsushita*). An indication of the wide acceptance of this principle within the antitrust community is the terms "Type I" and "Type II" errors, "false positive" and "false negative" are sprinkled liberally throughout the hearings transcripts as well as the DOJ report.

The problem is that despite general agreement that decision theory should in principle form the foundation of antitrust doctrine, the necessary inputs into the analysis are not readily available. Formulating doctrine on, say, predatory pricing or tying requires knowing the relative frequency of pro- and anti-competitive instances (or potential instances) of the practice, the magnitudes of the benefits and harm (which determine the costs of false positives and false negatives), and the availability and quality of screens to distinguish between pro- and anti-competitive instances of the practices. There is remarkably little solid evidence about these inputs into the analysis. The rationale for reaching beyond "the usual suspects" was to gather such evidence.

The hearings yielded some but not much of this sort of evidence. One of the challenges in finding "false positives" is that, because they include actions firms do not take for fear of antitrust liability, they are inherently hard to observe. An example of the

² Federal Trade Commission, Notice of Public Hearings and Opportunity for Comment, 71 Federal Register 17872, (April 7, 2006.)

type of information the organizers were hoping to elicit came out in the business history session. The Alcoa Board had, as a central concern, avoiding liability for predatory pricing. This concern both occupied the board's time and resulted in higher prices than Alcoa otherwise would have charged. This bit of evidence was sparse, however. Despite the outreach, companies were not forthcoming with testimony like, "We would like to have exclusive deals; we do not do so for fear of antitrust liability; the additional costs we bear because we cannot pursue our preferred strategy is \$x/year." Perhaps such testimony did not materialize because the antitrust laws are not a significant constraint. More likely, companies perceive little private benefit from sharing their deliberations on strategy in a public hearing.

The amount of evidence yielded by the hearings was disappointing, but law enforcement cannot wait for more evidence to be gathered. Absent objective evidence, rational, consistent policy necessarily rests on a set of subjective estimates about the frequency of pro- and anti-competitive uses of practices, the benefits from the competitive uses and costs of the anticompetitive uses, and the quality of the available screens to distinguish between the competing hypotheses. It would be useful both for companies trying to stay within the law and for the United States in providing antitrust leadership worldwide if the U.S. agencies could find common ground with respect to these beliefs and articulate what these beliefs imply about their enforcement.

II. THE SPLIT BETWEEN THE AGENCIES

The joint statement by Commissioner Harbour, then-Commissioner, now Chairman Leibowitz, and Commissioner Rosch (henceforth, "HLR") took issue with many aspects of the DOJ Report. Arguably, the root of the disagreement lies in chapter 3, which discusses general standards for Section 2 liability.

A major portion of chapter 3 goes through specific proposals for a unifying principle to evaluate all behavior challenged under Section 2: "effects balancing," "no economic sense," "profit sacrifice," "equally efficient competitor," and "disproportionality." I agree with most of the discussion. The problems it cites with the effects balancing test are well-founded. It would be a great test for the incomes of consulting economists, but it requires more precision in economic analysis than the current state of the art can deliver and will likely lead to errors in both directions. The discussion of the profit sacrifice and no economic sense tests helps clarify the distinction between the two. A mere profit sacrifice test is too loose a liability standard. A no economic sense test is sometimes useful, but it should not be the universal standard for Section 2 liability. The discussion of the equally efficient competitor test was balanced and useful.

The most controversial part of the chapter is the discussion of the

disproportionality test and in particular the conclusion that, even though the Department does not believe that there is a preferred test, the disproportionality test is its preferred test. I am puzzled by that conclusion. It is at odds with the ultimate conclusion that different kinds of conduct warrant different tests because of differences in the costs of false positives and false negatives.

The standard for predatory pricing established in *Matsushita* and *Brooke Group* is, in effect, a no economic sense test. Pricing below the relevant notion of cost is behavior that qualitatively makes no sense unless it drives out rivals. (Of course, they also include the requirement that the exclusionary hypothesis makes economic sense.) *Aspen Ski* relies on no economic sense logic. (Exclusion was the only plausible reason that Aspen would not sell lift tickets to Aspen Highlands on the same terms as it sold them to the general public.) In my opinion, predatory pricing and refusals to deal are both classes of conduct for which we should be more concerned with false positives than false negatives.

If a “no economic sense” test is the right conceptual standard for predatory pricing and refusals to deal, should it apply generally? One of the standard criticisms of the no economic sense test is that \$1 of efficiencies can get a company off the hook for behavior that generates \$100 of competitive harm. The disproportionality test addresses that criticism. A disproportionality test may be a better conceptual standard than “no economic sense” for refusals to deal (and perhaps *Aspen Ski* is more accurately characterized as a disproportionality test), but the difference between the two is relatively minor. Substituting a disproportionality test (which one can think of as a “little economic sense” test) for a “no economic sense” test does not address the primary concern with these tests as general standards. There might be other classes of behavior (like bundled discounts) where the relative concern with false positives and false negatives dictates a standard which trades off those two risks much differently.

The DOJ embrace of the disproportionality test reflects a greater concern with false positives than false negatives for all behavior subject to challenge under Section 2. I agree with HLR’s objection to this aspect of the DOJ report.

Notwithstanding my very high personal and professional regard for Chairman Leibowitz and Commissioners Harbour and Rosch, I found other aspects of their statement regrettable. Part of the problem was the rhetoric (“a blueprint for radically weakened enforcement”). If one of the ultimate objectives is to provide a U.S. consensus, as I believe it should be, it would have been better to paint the agencies as being yards, not miles apart.

While just a single word, the reference to “stakeholders” was a poor choice. The historical position of the FTC has been that consumers are the only proper stakeholders

in antitrust. What other stakeholders did they have in mind? I doubt that I was alone in reading the term to mean the plaintiff's side of the antitrust bar. I would not object if HLR had asserted that the hearings did not reflect the full range of informed opinion. I do not agree that this was a major problem with the hearings, but my concern with the term "stakeholder" goes beyond mere disagreement. In a rational discussion of antitrust policy, the income of antitrust attorneys (and economists) is a cost of the system, not a benefit. I took the term "stakeholder" to reflect insensitivity to the critique that policy recommendations from the antitrust community are colored by its own financial interest rather than sound public policy.

My other main criticism of the HLR statement is that the discussion of the individual topics fails to reflect a nuanced, decision-theoretic analysis of which practices require standards that tolerate false negatives to avoid false positives and which require standards where a risk of false positives should be tolerated. They take issue with DOJ on virtually every aspect of Section 2 behavior. Perhaps most notable was the critique of the predatory pricing chapter for failing to acknowledge the possibility of above-cost predation (and by implication, the possibility of bringing a suit alleging above-cost predation.) In establishing the *Matsushita/Brooke Group* standard, the Supreme Court acknowledged the possibility of above-cost predation and, using insights from decision theory, nonetheless ruled that a successful predatory pricing claim requires proof of pricing below the relevant notion of cost. *Weyerhaeuser* reveals no second thoughts by the Supreme Court with respect to predatory pricing doctrine. (This is in distinct contrast to the implications of *Independent Ink* with respect to tying.)

The real challenge for standards with respect to unilateral conduct is whether the standards for all practices should be like predatory pricing, i.e., subject to something akin to a "no economic sense" or "disproportionate harm" test or, alternatively, whether different classes of standards should apply to different areas of conduct. Having called into question whether the Supreme Court has gotten predatory pricing right, HLR missed the opportunity to articulate which practices should fall under different types of standards because they are different from predatory pricing.

III. GOING FORWARD

There is a temptation to read AAG Christine Varney's speeches in which she renounced the DOJ report as tacit agreement with HLR. Time will tell exactly what the implications of the speeches are. One distinct possibility, though, is that the Varney speeches are another example of an Obama administration pronouncement of dramatic policy change masking what is at most a far more subtle shift.

There are two key points underlying this interpretation. First, Varney did not suggest a move toward a more European-style of antitrust enforcement. Instead, she

suggested a policy rooted in existing U.S. doctrine. The second key is the three cases she singled out: *Lorraine Journal*, *Microsoft*, and *Aspen*. There is little controversy that *Lorraine Journal* was at least a relatively good Section 2 case. Most people I know think it was correctly decided, and anyone who thinks it was not probably thinks Section 2 should be repealed. While there is substantial controversy about how the DOJ tried *Microsoft* and about Judge Jackson's decision, there is far less controversy about the appeals court's decision. *Aspen*, of course, is far more controversial. Many people think it was wrongly decided, and Varney mentioned *Aspen* without reference to the *dicta* in *Trinko* that it lies on the outer boundaries of antitrust enforcement. Still, one reading of *Aspen* is that imposes either a "no economic sense" or a "disproportionate harm" test for unilateral refusals to deal. Some would argue that unilateral refusals to deal should be *per se* legal. Varney's speeches make it clear that she does not. However, if she would require facts as strong as *Aspen's* refusal to sell to Highlands at retail prices to bring a unilateral refusal to deal case, then policy might not change much. Read this way, refusal to deal cases are still going to be quite rare. That is not *per se* legality, but the difference is not dramatic.

Now that the Antitrust Division has withdrawn the Section 2 report, there is an opportunity for the two agencies to issue a joint report. I hope they will do so. Agreement between the U.S. agencies is essential for the United States to be able to lead within the international communities of antitrust enforcers; and it is important to avoid the perception in the business community that the threat of an antitrust challenge hinges on a coin flip as to which agency considers their case. The question then becomes how big a change is needed to make the document acceptable to the new U.S. antitrust leadership. I predict there will be a major rewrite so that the report appears much different. As for the substance, however, they will promote neither the interests of consumers nor competition if they ignore the very real possibility that Section 2 enforcement can punish companies for competing successfully.