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### The FTC's Anticompetitive Pricing Case Against Intel

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## The FTC's Anticompetitive Pricing Case Against Intel

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While the FTC has statutory authority to enforce the Clayton Act,<sup>2</sup> it cannot enforce the Sherman Act directly. The Supreme Court has repeatedly held, however, that §5's prohibition of "unfair methods of competition" reaches everything in the Sherman Act plus a "penumbra" of practices that fall outside its reach.<sup>3</sup> The FTC's wide-ranging complaint against Intel Corp. indicates that the FTC hopes to reach this penumbra, although it does not make clear which of the many challenged practices would require legal standards beyond the Sherman Act's reach.<sup>4</sup>

The complaint alleges that Intel used market share discounts, exclusive dealing arrangements, and bundling in order to suppress computer manufacturer's attempts to use CPU chips made by Intel's rival AMD. It also claims that Intel secretly redesigned a software compiler<sup>5</sup> in a way that retarded the performance of rival's CPU chips.

With respect to graphics processing chips ("GPUs"), where Intel's market share is smaller, Intel has been playing catch-up. Increasingly, GPUs are being used as substitutes for CPUs, and GPU growth threatens Intel's CPU market share. The complaint alleges that Intel tried to suppress competition, particularly from GPU maker Nvidia, and that there is a dangerous probability that Intel will acquire a GPU monopoly as well.

Many of these claims fall well within the reach of §2 as historically applied. For example, market share or loyalty discounts can be unlawful, although courts disagree about whether the test for illegality must be cost-based, and what that test should be.<sup>6</sup> There is also some precedent for heightened scrutiny of loyalty discounts when a portion of the dominant firm's output is incontestable—a device that effectively makes a loyalty discount operate like a bundled discount,

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<sup>2</sup> 15 U.S.C. §21(a) (2006).

<sup>3</sup> 15 U.S.C. §45 (2006). See *FTC v. Sperry & Hutchinson Co.*, 405 U.S. 233, 239-244 (1972). Other decisions are discussed in Herbert Hovenkamp, *The FTC and the Sherman Act*, \_\_\_ FLA.L.REV. \_\_\_ (2010) (available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1531136](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1531136)).

<sup>4</sup> Complaint, ¶1, In re Intel Corp. (FTC Dec. 16, 2009) (No. 9341) available at <http://www.ftc.gov/os/adjpro/d9341/091216intelcmpt.pdf> (the author was consulted by Intel in a prior proceeding before the Korean Fair Trade Commission in 2007). See also the separate *Statement of Chairman Leibowitz and Commissioner Rosch, in the Matter of Intel Corp., Docket No. 9341*, available at <http://www.ftc.gov/os/adjpro/d9341/091216intelchairstatement.pdf> ("it has been understood for many years that Section 5 extends beyond the borders of the antitrust laws, and its broad reach is beyond dispute").

<sup>5</sup> Compilers are programs that turn source files, written in human-readable programming language, into machine-executable files. See BJARNE STROUSTRUP, *THE C++ PROGRAMMING LANGUAGE*, 197-98 (3rd ed. 2003). See also *Reiffin v. Microsoft Corp.* 214 F.3d 1342, 1344 (Fed. Cir. 2000).

<sup>6</sup> *LePage's Inc. v. 3M*, 324 F.3d 141, 154-57, 162-63 (3d Cir. 2003) (en banc); *Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883 (9th Cir. 2008). See Erik Hovenkamp & Herbert Hovenkamp, *Exclusionary Bundled Discounts and the Antitrust Modernization Commission*, 53 ANTITRUST BULL. 517 (2008); Erik Hovenkamp & Herbert Hovenkamp, *Complex Bundled Discounts and Antitrust Policy*, 57 BUFF.L.REV. 1227 (2009).

enabling it to exclude even an equally efficient rival.<sup>7</sup> Tying by a dominant firm in order to exclude rival products is reachable under §2,<sup>8</sup> as is exclusive dealing.<sup>9</sup> So is deception designed to keep customers loyal or to steer them away from the dominant firm's rivals,<sup>10</sup> and occasionally anticompetitive product design creating incompatibility with rivals' products.<sup>11</sup>

This naturally invites the question, why bother emphasizing the FTC's power to reach beyond §2 if most of the Commission challenges are covered by §2 anyway? Here are some possibilities:

- a) The FTC has procedural advantages as fact finder or expertise advantages as law maker;
- b) The FTC might wish to condemn conduct without inviting tagalong private lawsuits;
- c) The FTC may use §5's "unfair methods of competition" language to reach conduct that falls outside the prohibitory language of the Sherman Act; or
- d) The FTC would like to address the same practices that the Sherman Act addresses, but under more aggressive standards than the courts' current interpretations of §2 permit.

First, the FTC has distinct procedural advantages over courts of general jurisdiction, including streamlined processes of inquiry, expert administrative law judges and internal technical expertise, and lack of jury trials.<sup>12</sup>

Second, private plaintiffs cannot enforce §5. To the extent the most severe dangers of antitrust overreaching come from private treble damages actions,<sup>13</sup> claims that are limited to §5 obviate that problem. Indeed, in their separate statement accompanying the announcement of the Intel complaint Chairman Leibowitz and Commissioner Rosch articulated this rationale:

... concern over class actions, treble damages awards, and costly jury trials have caused many courts in recent decades to limit the reach of antitrust. The result has been that some conduct harmful to consumers may be given a "free pass" under antitrust jurisprudence, not because the conduct is benign but out of a fear that the harm might be outweighed by the collateral consequences created by private enforcement. For this reason, we have seen an increasing amount of potentially anticompetitive conduct that is not easily reached under the antitrust laws, and it is more important than ever that the Commission actively consider whether it may be appropriate to exercise its full Congressional authority under Section 5.<sup>14</sup>

Item c on the list suggests situations where the substantive reach of the FTC might exceed that of a court applying the Sherman Act. Both sections of the Sherman Act contain important

<sup>7</sup> See 3A PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶749e (3d ed. 2008); *Masimo Corp. v. Tyco Health Care Group, L.P.*, 2009 WL 3451725, \*2-3 (9th Cir. Oct. 28, 2009). In the European Union, see Commission Decision of 13 May 2009, COMP/C-3/37.900, *Intel*, available at [http://ec.europa.eu/competition/sectors/ICT/intel\\_provisional\\_decision.pdf](http://ec.europa.eu/competition/sectors/ICT/intel_provisional_decision.pdf), at ¶¶1255-1259 (discussing Dell's incontestable share).

<sup>8</sup> *E.g.*, *United States v. Microsoft Corp.*, 253 F.3d 34, 76-77 (D.C. Cir. 2001) (en banc).

<sup>9</sup> *United States v. Dentsply Int'l, Inc.*, 399 F.3d 181, 186-187 (3rd Cir. 2005).

<sup>10</sup> *Microsoft*, 253 F.3d at 76-77.

<sup>11</sup> *C.R. Bard, Inc. v. M3 Sys., Inc.*, 157 F.3d 1340, 1369-72 (Fed. Cir. 1998).

<sup>12</sup> See Hovenkamp, *The FTC and the Sherman Act*, *supra* note 2; and William H. Page, *The FTC's Procedural Advantage in Discovering Concerted Action 2-3 (2008)*, ANTITRUST SOURCE (Feb. 2009), available at <http://www.ftc.gov/bc/workshops/section5/docs/wpage.pdf>.

<sup>13</sup> William H. Page & Roger D. Blair, *Controlling the Competitor Plaintiff in Antitrust Litigation*, 91 MICH. L. REV. 111 (1992) (reviewing a study of private antitrust lawsuits). See also Christina Bohannon & Herbert Hovenkamp, *IP and Antitrust: Reformation and Harm*, \_\_\_ BOSTON COL.L.REV. \_\_\_ (2010).

<sup>14</sup> Statement of Chairman Leibowitz and Commissioner Rosch, *supra* note 3.

limitations. Section 1 reaches cartel behavior only when there is a provable “contract,” “combination,” or “conspiracy” among two or more actors. But the prohibition of “unfair methods of competition” contained in §5 of the FTC Act does not contain such language. So theoretically the FTC Act can be used against coordinated oligopoly behavior that does not satisfy these contract-like requirements. In practice, the FTC’s record in challenging such conduct is sporadic and not consistently better than that of the courts applying §1 of the Sherman Act.<sup>15</sup>

More relevant to the Intel case, §2 of the Sherman Act reaches dominant firm conduct only when it “monopolizes” a market or creates a dangerous probability of doing so. The “abuse ... of a dominant position” language of EU Article 82 as well as some other jurisdictions is broader.<sup>16</sup> For example, under U.S. law a firm that uses a monopoly position in one market to “leverage” an improper advantage in a second market has not violated §2 unless there is a dangerous probability that a monopoly will be created in the second market as well.<sup>17</sup> The “unfair methods of competition” language of §5 is less categorical and seems at least as broad as the EU’s “abuse of dominance” standard. That of course leaves open the policy question whether use of §5 in this way is a good idea. Critics liken it to using the antitrust laws for the protection of competitors rather than competition. But that need not be the case; secondary markets can become less competitive, thus harming consumers, even though they do not become monopolized.<sup>18</sup>

The most problematic item on the list above is item d, the possibility of more aggressive standards applied to the same conduct. Here the issue is not that some shortcoming in the Sherman Act’s language disables it from reaching conduct that §5 language might reach. Rather, the thinking is that the courts have imposed technical requirements on certain §2 offenses that could be relaxed if the prosecutor was an expert administrative agency such as the FTC.

The Supreme Court accepted this principle in its 1966 *Brown Shoe* decision, which condemned quasi-exclusive dealing by a non-dominant firm in a retail market with low entry barriers. While there appeared to be no present harm to competition at all, and no likely violation of the Sherman Act, the Supreme Court held that the FTC had the power to “arrest trade restraints in their incipiency.”<sup>19</sup> The term “incipiency” implies that there was a serious, although currently inchoate, danger to competition, sort of like catching and treating cancer at an early stage. The problem with *Brown Shoe* is that there was no reason for thinking that a non-dominant shoe manufacturer’s insistence that its retail stores handle predominantly Brown shoes would ever have produced a monopoly of anything.

The remedy contemplated by the Intel complaint would severely limit Intel’s power to use bundled prices and quantity discounts. It would create a presumption that a discount tagged to a purchase exceeding 60 percent of a reseller’s needs is anticompetitive.<sup>20</sup> It would also prohibit agreements forbidding resellers from purchasing from a rival or specifying a maximum percentage

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<sup>15</sup> Hovenkamp, FTC, *supra* note 2.

<sup>16</sup> Treaty Establishing the European Community art. 82, Nov. 10, 1997, 1997 O.J. (C340) 3 (“Any abuse by one or more undertakings of a dominant position ... shall be prohibited...”).

<sup>17</sup> See *Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447, 455 (1983); 3 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶652 (3d ed. 2008).

<sup>18</sup> See Herbert Hovenkamp, *The Legal Periphery of Dominant Firm Conduct, Lisbon Conference on Competition Law and Economics* (Nov. 2007) (in press), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1014426](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1014426).

<sup>19</sup> *FTC v. Brown Shoe*, 384 U.S. 316, 320-322 (1966).

<sup>20</sup> Complaint, Notice of Contemplated Relief ¶2.

or number that they may purchase from a rival; as well as restraints on the way that computer makers advertise or promote non-Intel chips.<sup>21</sup> It would also prohibit Intel from discriminating against computer makers who fail to meet purchase share standards or who deal with Intel's rivals by charging them a higher price, withholding R&D funds, or allocating fewer chips in times of shortage.<sup>22</sup> It would prevent Intel from distributing hardware or software that might degrade the performance of rivals' products.

The large range of price and non-price practices that are being challenged strongly suggests that the pricing behavior alone was not sufficient to create or sustain the challenged monopoly. Indeed, it may not be possible to tell which actions have contributed to Intel's market dominance in CPUs and which have not. Further, in fashioning a remedy the FTC must be mindful that its goal is to make this market more competitive, a goal that will not likely be realized if the FTC forbids Intel from competing on price.

The FTC's proposed remedies concerning Intel's pricing practices are problematic. Exclusionary pricing challenges always put antitrust policy makers in a tight spot. Antitrust's goal is low prices, but such challenges invariably reduce to a claim that a price is anticompetitive because it is too low to permit a rival to compete. The relief almost always takes the form of forcing the defendant to increase its price. Admittedly, part of our reluctance to have more aggressive pricing rules than we do pertains to uncertainty in fact finding and administration, and no small part pertains to the fear of a crush of private treble damage suits that is certain to follow a government victory in a Sherman Act pricing case. These are all valid points. But the social cost of a bad remedy is not simply excessive private suits. The remedy itself will be costly if it serves to blunt competition in the industry. In that case the FTC will have succeeded in raising the profits of Intel's rivals, but at consumers' expense.

Pricing is particularly complex in a market with high fixed costs and short product cycles, as is the case for processor chips.<sup>23</sup> The combination of high R&D costs plus high fixed setup costs, plus relatively low production costs, means that the key to success in the microprocessor market is high volume. Further, prices are generally set at the beginning of a chip cycle, which is relatively short.<sup>24</sup> When setting a price a firm such as Intel faces two types of risk to its high volume—one is general market risk and the other is risk of customer defections. A firm in Intel's position might profit by bearing the market risk, which is largely outside of the control of both its customers and itself. But the risk of customer defection is one that it needs to control if it is to keep its output high and per unit cost down. The price Intel can bid is critically dependent on the number of sales it can confidently predict. Bids conditioned on market share discounts, quantity discounts, and related practices such as exclusive dealing give Intel the assurance of output that it needs to bid a low price.<sup>25</sup>

As a general proposition market share discounts in such markets work better than quantity discounts because quantity discounts tend to discriminate against smaller firms who are unable to purchase enough to obtain the deeper discounts. Depending on how deep the discounts are, they

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<sup>21</sup> *Id.*, ¶2c-f.

<sup>22</sup> *Id.*, ¶¶3, 4.

<sup>23</sup> The EU noted the existence of high fixed costs in the Intel case, but relied on it mainly to infer the existence of high entry barriers. See Intel, *supra* note 6 at ¶¶876-882.

<sup>24</sup> *Id.*, ¶1018.

<sup>25</sup> See EU decision, *supra* note 6 at ¶1019 (noting unreliability of predictions).

may even force smaller firms to exit from parts of the market. The result is greater downstream market concentration, which injures Intel but also injures consumers.

High fixed costs entail some other complexities. One is that price discrimination is to be expected. Once R & D and other up front costs have been incurred, any price sufficient to cover variable costs is “profitable” to the extent that it makes a contribution to fixed costs. There is nothing competitively suspicious about a firm bidding more competitive sales at a lower price than less competitive ones, provided that the lower price is sufficient to cover the incremental cost of producing and delivering the order. The FTC’s suggestion in its proposal for relief that every price be high enough to cover some (unspecified) element of fixed costs is tailored to impose lower output on Intel and greater profits for Intel’s rivals, but also higher consumer prices.<sup>26</sup> This is not a competitive solution. Looking at the overall product cycle, a firm with high fixed costs needs to recover its fixed costs plus all of the variable costs of production. The socially beneficial way for a firm to do that is to charge what it can for each sale, which is simply another way of saying that it bids what it has to. Bids at prices below variable costs deserve close scrutiny under predatory pricing rules, but bids at prices above variable costs are making a contribution to fixed costs and enabling Intel to bid lower prices elsewhere.

For example, suppose that fixed costs have been paid and production is underway. The incremental (variable) costs of producing a chip are \$100. If a firm has a chance to bid for the business of a customer for whom there are no good rivals the firm will take its best guess about what the market will bear and bid accordingly. For example, a price of \$150 will cover all variable costs and contribute \$50 toward fixed costs. But if the firm is facing competition it will bid any price down to \$100. That price will be profitable in the sense that it covers all the costs of servicing that buyer and makes some contribution to reduction of the fixed cost pool. This is just another way of saying that firms with fixed costs bid more competitively when there is greater competition.

The relief presumptively forbidding discounts requiring purchase of at least 60 percent of the buyer’s needs appears to be completely unrelated to any cost measure whatsoever.<sup>27</sup> The fully discounted price could be double a firm’s costs, giving any equally efficient rival an opportunity to take all the sales, and yet be unlawful.

The FTC would also condemn bundled discounts on “kits,” or groups of chips that work together in a computer.<sup>28</sup> For these bundles the FTC would apparently apply an “attribution” test. If rivals make only a subset of the products in the bundle, attribute the entire discount to those and see if it drives that price below cost. If so, then an equally efficient rival cannot match the price. However, instead of using an average variable cost test<sup>29</sup> it would require that the minimum markup include an unspecified multiple of fixed and sunk costs. This test creates the same problem as just described. The attribution test is mathematically identical to asking whether the incremental price a firm receives when it adds an additional product to a bundle is sufficient to cover the incremental cost of adding it. Once again, when fixed costs are high any sale at a price above incremental cost should be counted as pro-competitive. So the FTC’s remedy will force prices that are irrational for Intel and costly to consumers.

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<sup>26</sup> See Complaint, *supra* note 3, Notice of Contemplated Relief, ¶6, which would prohibit below cost pricing and stating that “[p]ricing will be presumed to be below cost even if it exceeds Intel’s average variable cost but does not contribute to its fixed sunk costs in an appropriate multiple of that average variable cost.”

<sup>27</sup> Relief, ¶2.

<sup>28</sup> Relief Request, ¶6.

<sup>29</sup> As in Cascade Health, *supra* note 5.

Only if the FTC's remedy is limited to truly anticompetitive acts and does not seek to impose irrational pricing constraints can the FTC be confident that its pricing order will make the market in question more competitive. In that case, however, it will be following the same sensible economics that the courts generally apply in Sherman Act pricing decisions.