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Antitrust Law

An Analysis of Antitrust Principles
and Their Application

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vals or, at minor cost, from independent consultants. All of this is more likely the longer the technology or marketing practices have been around.

We can also assume that earlier experience with a machine (or trademark license)—especially with the same supplier, whose policies have not changed—brings knowledge to the once-ignorant customer. Moreover, it seems reasonable to suppose that the purchaser of multiple units (or dealerships, etc.) would have the incentive to acquire the necessary information or at least to assess the risks.

At the extremes, such "objective" factors in a particular case might suggest that knowledge is either very widespread or very unlikely. If not, we might ask customers about the information they possessed when they bought the machine, their degree of comparative shopping, any lifecycle price calculations, and so forth. If such data fail to point fairly clearly in one direction, jury speculation is not a satisfactory resolution of the parties' conflicting factual speculations. In that event, the party with the burden of persuasion on this point must lose.

To move forward, let us suppose that plaintiffs have proved that a lock-in is substantial for a substantial number of customers who were ignorant and unable to protect themselves. Nevertheless, the defendant cannot exploit them unless the next condition is satisfied.

1740e. Condition III: new knowledgeable buyers superfluous or effectively protected by price discrimination. 1. *Relevance.* No matter how great the lock-in or how numerous the ignorant, the defendant cannot exploit them when (a) profit maximization depends on continuing machine sales to relatively knowledgeable customers, and (b) market circumstances force the defendant to charge relatively uniform (nondiscriminatory) prices for parts and service. When condition *a* is satisfied, the defendant needs to make new sales to the relatively knowledgeable and therefore must offer prices—including parts and service prices—that attract the knowledgeable customers to its machine. When condition *b* is satisfied, ignorant customers pay the same prevailing price for parts and service as the knowledgeable customers. In this way, knowledgeable customers needed by the defendant protect the ignorant.

Therefore, to prove any power to exploit locked-in parts buyers, the plaintiff must show *either* that the defendant does not need new sales to the knowledgeable *or* that it can obtain their patronage by, in effect, charging them market prices for the machine-parts package while discriminatorily charging higher parts prices (directly or via a service tie) only to those already locked in. The disfavored class may

not include any new knowledgeable machine buyers whose patronage the defendant needs and who fear that the defendant would later treat them the same way it treated those now locked in.

1740e2. *New knowledgeable customers presumptively needed; "liquidation" unlikely.* Conceivably, the defendant could profit from exploiting existing owners of its machines even if it thereby lost most or all new sales. As the *Kodak* Court pointed out, "a seller profitably could maintain supracompetitive prices in the aftermarket if the switching costs were high relative to the increase in service prices, and the number of locked-in customers were high relative to the number of new purchasers."⁵⁶

How might either party prove that the defendant does or does not need new customers? Substantial excess capacity implies such a need, as does aggressive selling effort, especially that directed toward knowledgeable customers. Indeed, absent proof that the defendant's sales staff is nonexistent or idle or that high-level documents unambiguously disclaim an interest in additional sales, the tribunal should assume that the defendant is not exiting from the market. After all, the typical manufacturer profits mainly by supplying new machines, not merely by servicing a declining number of old ones.⁵⁷ Even if its current output exceeds its cost-minimizing plant optimum, few firms

56. 504 U.S. at 476. As a simplified illustration, suppose that each year the defendant would lose 5,000 sales to knowledgeable customers if it overcharges for repair parts; that those unmade sales would each have generated \$1,000 profit (for a total of \$5,000,000); and that exploiting locked-in customers (even those who were knowledgeable when they bought the machine) would generate \$6,000,000 more in profit than if the defendant had charged locked-in customers only prevailing prices for parts. However, the latter profit declines with every passing year as the machines wear out or are otherwise abandoned. Moreover, the actual calculation will be very complex. For example, demand elasticity may be uncertain as, accordingly, will be the number of knowledgeable buyers and the level of repair prices that would repel them. Or perhaps the defendant's reduced output of both new machines and repair parts will raise its unit costs, thus diminishing the net gain from charging all locked-in customers higher prices for parts.

57. While exiting a type of product or line of business is more frequent, a reputation for exploiting locked-in customers can hurt the defendant elsewhere. "Liquidation" through obsolescence of a product version is illustrated by *General Business*, note 46, at 973-975. The alleged tying product was a magnetic ledger card (mlc) to store data for Philips's small business computer. When the mlc became obsolete as new computers used disk storage, Philips could price mlcs without fear of repelling new sales of mlc machines once it ceased to make them. Even so, the Ninth Circuit refused to find the requisite power over mlcs: "In due course, Philips abandoned its mlc operation as well. It would not have done so had that market been the separate, profitable market alleged by [plaintiff]. Philips was the victim, not the beneficiary, of its high prices in the mlc market." To find power, according to the court, would dictate that a manufacturer, facing competition against which it cannot prevail in the sale of its end product, could be found to monopolize the market for each unique component that goes into the product. This is surely to lose sight of the forest because of fascination with the trees. Indeed, it would be strange to find *substantial* power for an obsolete product fading from the market. If anything, higher prices for mlcs would speed the transition to new storage devices and thus reduce any foreclosure of rival suppliers.

would voluntarily abandon sales to the new customers who will sustain the firms in the future.

Although the necessary new customers need not be knowledgeable, many of them will be, such as when an office manager's newsletter publishes comparative machine list prices, breakdown rates, annual repair costs, and so on. In addition, those who purchase multiple machines at once or make repeat purchases are likely to be knowledgeable, and it may be possible to estimate the share of annual purchases accounted for by them.

Absent persuasive evidence otherwise, antitrust tribunals have little choice but to begin with the assumption that markets function reasonably well to punish (1) buyers, especially business buyers who do not pay attention to post-purchase costs, and (2) sellers who assume that most buyers are foolish and ignorant of their alternatives. While not true in every instance, this assumption remains a convenient starting point for reasoning about a defendant's power. The plaintiff would have to offer sufficient evidence to persuade a tribunal that it was more likely than not that the defendant was indifferent to new sales to knowledgeable customers.

Kodak did not rule otherwise. To be sure, it noted a logical possibility—that *Kodak* might be indifferent to new sales—in the course of rejecting a categorical proposition that exploitation of locked-in and ignorant customers was impossible. Rejecting summary judgment based on a truncated record is not a ruling that the defendant must affirmatively prove that it needs new, knowledgeable customers. If it makes sense to assume that fact in the absence of contrary evidence—as we think it does—then the lower courts are free to adopt that working presumption. Indeed, the Supreme Court's emphasis was not on the prospect of *Kodak*'s profitable liquidation but on evidence that some buyers were ignorant and that *Kodak* discriminated against them.⁵⁸

1740e3. *With effective price discrimination.* If the defendant can charge locked-in customers more for parts or service than new knowledgeable buyers *believe* they will be charged, it can exploit the former without repelling the latter. To find such price discrimination, we need proof (a) that the defendant charges some customers above-market prices (that is, prices not reflecting cost differences) (b) disfavoring the ignorant customers (c) where resale by low-priced customers is impractical, (d) that the dividing line between high and low

58. E.g., 504 U.S. at 479 n.29.

prices puts all *needed* knowledgeable customers in the low-price category, and (e) that the discrimination is significant in magnitude:

Kodak did not foreclose inquiry into any of these issues or dispense with the plaintiff's burden to prove them. The Supreme Court did not find sufficient price discrimination to prove power over parts where none existed over machines. The Court held only that limited discovery indicated that possibility, which a more complete record might confirm or negate. It did not rule as to what the trial court should do once *Kodak* offers rebuttal evidence.

In addition to discriminating against the ignorant, *Kodak* feared the exploitation of all locked-in customers, including those who bought the machine with lifecycle pricing in mind but who are later surprised with prices for parts higher than had been reasonably expected.⁵⁹ This need not discourage new sales, said the Court, if new customers pay below-market prices for the machine with the knowledge that they will later pay above-market prices for repairs—thus receiving the benefit of price discrimination at the front end. However, such a manipulative defendant can hardly be trusted to refrain from even higher repair prices in the future, once these customers become locked in. Thus, the defendant will have to offer knowledgeable new customers “packages with life-time warranties or long-term service agreements that are not available to locked-in customers.”⁶⁰ Note, however, that such discrimination is readily observed and was not alleged in *Kodak* itself.

(A) *Prices above market for some customers.* In the *Kodak* case the Court pointed to evidence in the truncated summary judgment record that price discrimination against the ignorant might have been underway.⁶¹ The Court observed that even if the patronage of knowledgeable customers were vital to *Kodak*, some evidence suggested that *Kodak* overcharged only (or mainly) the ignorant customers. As evidence of price discrimination, the Court observed only that (1) prices varied among customers for machines, parts, and service; and (2) customers providing self-service were not subject to the tie of allegedly overpriced service. As to the first, no detail was provided. As to the second, the Court simply noted the hypothesis that self-service customers may have used multiple machines and therefore have been the most knowledgeable in buying them. However, higher prices are

59. See *Kodak*, 504 U.S. at 475-476.

60. *Id.* at 476.

61. *Id.* at 472-476. However, the Ninth Circuit on remand ignored the issue entirely. 125 F.3d 1195.

not necessarily "above market," for they may merely reflect the higher costs of serving some customers.

As evidence of the overcharge, the Court cited the plaintiffs' evidence that they charged less for equivalent or better service than Kodak.⁶² Of course, Kodak would not exploit customers if it charged more for better service. Comparative service quality may be hotly disputed, with neither party entitled to summary judgment or a directed verdict on this issue. For example, there may be evidence—but not certainty—that Kodak responds to service calls sooner or completes repairs faster with the aid of comprehensive inventories and greater knowledge of repair problems and their solutions based on far more extensive experience with their machines.

Even if Kodak charged more for identical service, no power would be implied had the premium been temporary and declining or had it been offset by discounts on the machine itself.⁶³ In fact, many tying claims have evaporated because the plaintiff was not able to prove that the sum of prices for the tying and tied products exceeded market levels.⁶⁴ Kodak offered the hypothesis that high service prices were offset by low machine prices but had no factual statement or proof. Indeed, the Court understood Kodak to "claim . . . that it prices its equipment comparably to its competitors."⁶⁵

(B) *Ignorant disfavored.* Had the Kodak service price been above market, would it discriminate against or in favor of the ignorant? Suppose, for example, that Kodak charged market prices for parts while charging relatively uniform service prices based on the average costs of maintaining extensive inventories and a widespread service network that served both multi-machine and single machine users quickly and comprehensively. Suppose that the independent repairers charged less but only for serving multiple machine users. In that case—which is not an unusual one—the disfavored customer is the knowledgeable one who did not receive the benefit of being served at lower cost until the independents arrived. Were this the case, however, such discrimination would not demonstrate significant market power, because the independents are eroding it and because knowledgeable buyers can observe it and, if oppressive, can buy a different brand of machine. But let us assume that the ignorant customers do pay higher prices for parts than knowledgeable buyers (either directly or via a service fee).

62. *Kodak* at 457-458.

63. See ¶1738d (2d).

64. See ¶1769a (2d).

65. 504 U.S. at 472-473, 478-479 & n.26.

(C) *No resales.* A defendant cannot sustain price discrimination if those paying low prices in the "aftermarket" can buy more than they need and resell the excess for less than the defendant charges its other customers. To prevent such undermining of price discrimination, the defendant might sell repair parts at uniform prices but only in connection with its maintenance service, for which it charges differential prices. In that event, those paying the low prices for service have nothing to resell to those paying high prices. There would also be nothing to resell under one scenario postulated in *Kodak*—that the defendant sold unique parts at relatively uniform at-market prices, forbidding self-service customers to resell parts while compelling everyone else to buy Kodak service at above-market prices.

(D) *All needed knowledgeable customers get low prices.* To achieve effective price discrimination, the defendant must identify the ignorant customers it can safely overcharge without mistakenly overcharging many of the knowledgeable. Otherwise, all knowledgeable customers who might fall within the overcharged group will patronize the defendant's rivals instead. Sufficiently accurate identification cannot be presumed; it would have to be proved.

It is true, as the *Kodak* Court said, that a seller can "price-discriminate by varying the equipment/parts/service package, developing different warranties, or offering price discounts on different components."⁶⁶ However, the Court was mistaken in saying that this could be done "easily."⁶⁷ It would very likely be quite difficult to identify knowledgeable customers and to charge only the others above-market prices for parts or service.

In *Kodak*, for example, the defendant alone made certain needed repair parts, which it sold only to users who either (1) serviced the machines with their own employees or (2) purchased repair services from Kodak. The Court speculated that the first group included buyers with multiple machines who were most likely to be knowledgeable. This hypothesis is plausible, though insufficient, unless the self-service category includes all the knowledgeable machine customers needed by Kodak. However, the knowledgeable universe is likely to exceed the self-service group, for many multiple-machine or repeat customers do not service their specialized office machines. In that event, Kodak's tie would embrace many knowledgeable customers, whom Kodak could not afford to overcharge. Hence, relieving self-service customers from any tie would not reflect effective price dis-

66. *Id.*, 504 U.S. at 475.

67. *Ibid.*

crimination favoring all or nearly all *needed* knowledgeable customers and permitting exploitation of the aftermarket without power in the machine market.

(E) *Size of the differential over product lifecycle.* When discriminatory exploitation exists, its magnitude is a function of the lifecycle price rather than of the price for repair parts. To illustrate, suppose that the defendant charges the knowledgeable and the ignorant \$100 and \$200, respectively, for the unique repair parts needed over a machine's five-year useful life. This 100 percent premium for the ignorant may represent a minor portion of the machine's lifecycle price. For example, suppose that all buyers paid \$3,000 for the machine with no operating costs other than repair parts. The resulting lifecycle price of \$3,200 for the disadvantaged buyer exceeds \$3,100 by some 3 percent.⁶⁸

We hesitate to regard such a premium as "substantial" and would remain relatively unconcerned with premiums below 5 or even 10 percent. As a practical matter, moreover, a small premium may be less than the litigation costs and errors inherent in collecting the data and adjusting for quality.

1740f. Condition IV: exploitative power "substantial"; presumptions.⁶⁹ Assume for the moment that the defendant can exploit some purchasers of its unique repair parts, either because few customers are knowledgeable or because the defendant can effectively discriminate against the ignorant or those otherwise already locked in. Although one might read *Kodak* otherwise, it neither held that any exploitation amounts to the power that triggers the per se rule nor indicated how the requisite power is to be proved. All the *Kodak* Court did was to reject the absolute proposition that Kodak's assumed lack of power in the relevant machine market *necessarily* dictated that Kodak also lacked power over unique parts for repairing Kodak-brand machines. The Court rejected the claim that lack of power over machines necessarily precluded power over unique repair parts, for the Court saw possible circumstances in which buyers of parts might be exploited, notwithstanding competition in machines.

Although the Court had no occasion to ask how many Kodak customers were exploited and in what degree, the Court spoke of "appreciable" power without questioning its *Jefferson Parish* holding that a 30 percent market share did not prove sufficient power, notwith-

68. On this point, see ¶517a (2d); and H. Hovenkamp, *Market Power in Aftermarkets: Antitrust Policy and the Kodak Case*, 40 UCLA L. Rev. 1447 (1993).

69. See ¶1735 (2d) for a more general discussion of the need for substantial power and its meaning and proof.