Prepared Remarks on the Relationship between Antitrust and Regulation and on Effects-Based Analysis[*]

by

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[**]The opinions expressed are those of the author and do not necessarily reflect the views of the Federal Trade Commission or any individual Commissioner

I. Regulation and Antitrust

First of all, I would like to thank the Jevons Institute for the honor of asking me to be here this evening and of being on the same stage with Damien Nevin, Dennis Carlton, and Amelia Fletcher.

I must, of course, issue the standard disclaimer. What I say reflects my own opinions and not necessarily those of the Federal Trade Commission or any of the individual Commissioners.

Amelia promised me you would be familiar with Dennis the Menace, the comic strip about an impish 5-year old boy. My favorite[1] Dennis the Menace strip is one in which Dennis asks his father, "What causes tides?"

"The moon," replies his father.

Dennis is skeptical. "I don't think that's right."

"Really," replies his father. "What do you think causes tides?"

"I think there is a big whale in the middle of the ocean. When it swishes its tail one way, the tide moves in. When it swishes it the other way, the tide moves out."

"You don't really believe that, do you?" asks his father.

"No," replies Dennis, "but it makes a lot more sense than the moon."

Competition officials often have to deal with skepticism akin to Dennis'. The notion that market outcomes reflect competitive processes and that these outcomes are often desirable from the standpoint of society as a whole is at least as abstract a concept as the effect of the gravitational pull of the moon on the movement of the oceans. It can be a very tough sell to both the public at large and their elected representatives; and one sometimes has to contend with alternative explanations that have a certain ring of plausibility even if they are ultimately not sound.

In my remarks on the relationship between antitrust and regulation tonight, I will describe two examples from my experience at the FTC where we must be cautious about taking actions based on unsound theories of failures of competition.

One is gasoline prices. Viewed at the national level, the industry is structurally competitive – not perfectly competitive, but sufficiently unconcentrated not to raise serious antitrust concerns. If you look at smaller geographic areas, particularly if you focus on particular stages of the value chain, concerns about the extent of competition do

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[1] I read this strip many years ago, so the quotes here are at best approximate. I have not gone back to find it in part out of laziness and in part because it might reveal that I was still reading the funny pages at an advanced age.

arise, which is why the Commission has sought divestitures in several petroleum industry mergers.[2]

Yet, in the time I have been at the Commission, no industry has occupied more of my time. When prices go up, politicians demand an explanation.[3] By themselves, the inquiries are not economic regulation, and they serve a very useful function. Even if price increases are simply the result of the normal workings of supply and demand, it is important for the public to know that the government is monitoring the situation. In addition, as structurally competitive as the industry is, it would be a mistake to assume that antitrust violations cannot occur. Still, as we follow up each ebb and flow of prices, we are placed in a position similar to economic regulators. We have to judge whether prices are somehow outside the range of what they "should be," which requires that we need to determine a range where they "should be." That is close to what price regulators do.

Moreover, the persistent inquiries about prices have behind them a threat of regulation. Congress might pass Federal price gouging legislation similar to laws already enacted in several individual states.[4] Such legislation would place a limit in some way on the prices that can be charged for gasoline and other necessities in time of emergency. The mere threat can itself be harmful. We would like suppliers to hold inventories and plan for diverting supplies to areas in need in order to alleviate shortages when and where they arise. Just as "it is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner,"[5] we cannot rely on the benevolence of oil companies to make investments to have the capacity to react to shortages. They will only do so if in anticipation of a profit opportunity, which in turn requires that we allow prices to rise during shortages. One of the roles of antitrust is to ensure that markets are competitive enough that we do not need to regulate in this way. As I said, though, convincing people that price increases are the result of competitive forces, which I would analogize to the gravitational pull of the moon, rather than manipulation, which is often analogous to the swish of the whale's tail, can be a tough sell.

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[2] "FTC Sues to Block Acquisition of The Peoples Natural Gas Company from Dominion Resources," *Federal Trade Commission Oil and Gas Industry Initiatives*, March 15, 2007 <http://www.ftc.gov/opa/2007/03/equitableresources.htm>; "Commission Approves Application for Proposed Divestiture in Matter of Dan L. Duncan, et al." *Federal Trade Commission Oil and Gas Industry Initiatives*, February 23, 2007, < http://www.ftc.gov/opa/2007/02/fyi07220.htm>; "Announced Action for October 4, 2005: Commission Approval of Proposed Divestiture," *Federal Trade Commission Oil and Gas Industry Initiatives*, October 4, 2005 < http://www.ftc.gov/opa/2005/10/fyi0572.htm>.

[3] Deborah Platt Majoras, Committee on Commerce, Science, and Transportation, Committee on Energy and Natural Resources, *Energy Prices and Profits: Joint Hearing Before…* 109th Cong., 1st sess., 2006; House Committee on Energy and Commerce, *Gasoline: Supply, Price, and Specifications: Hearings Before…* 109th Cong., 2nd sess., 2006; House Committee on Government Reform, *Gasoline: what's causing record prices at the pump?: hearing before…* 109th Cong., 1st sess., 2005; Federal Trade Commission, *Gasoline Price Changes: The Dynamic of Supply, Demand, and Competition*, 2005.

[4] *Gasoline Consumer Anti-price-gouging Protection Act*, S 94, 110th Cong., 1st Sess., 2007.

[5] Adam Smith, *An Inquiry Into the Nature and Causes of The Wealth of Nations* (New York: Modern Library Edition, 1937), 14.

My second example is the debate raging in the United States over so-called "net neutrality."[6] The principal issues include whether internet access providers can charge differential rates for different types of access, whether they can charge for termination, whether they can impose limits on content, and whether internet access providers should be able to provide content of their own. This is a much more difficult case than gasoline. It is one in which it is harder to state with great confidence that antitrust can guarantee an approximately desirable outcome. In the United States, many homes can get high speed internet access either from their cable company or from their telephone company. Additional sources might arise, but many customers will have a choice between only two providers for some time to come. If we had only two oil companies, we would be much more skeptical that gasoline prices reflect the workings of competition; and I don't think we should assume that two internet access providers make the markets competitive enough to alleviate concerns about anticompetitive behavior.

Against that judgment, though, we must weigh the imperfections of regulation. The deregulatory movement in the United States that started in the mid-1970's reflected the recognition that regulation itself is highly inefficient,[7] particularly in industries in which technical change is rapid.

However we resolve the "net neutrality" debates, the solution is likely not going to be perfect. The choice between how much to rely on regulation and how much to rely on antitrust will depend in part on what sorts of errors we are more willing to tolerate.[8] Antitrust challenges to corporate behavior entail a relatively high burden of proof of a harm to competition. Relative to regulation, there will be some heightened risk of "false negatives." On the other hand, we will not be able to regulate in a way that will not pose some risk of chilling investments that would otherwise occur or lead to some other types of market distortions. One specific example is priority pricing. Some internet applications, like voice-over-internet-protocol telephony, require delivery without delay to be effective. Other applications, such as e-mail, do not suffer anywhere near the degradation of quality from minor delays. If we do not allow priority pricing, we run a serious risk having too much congestion both because users will have no incentive to forego the top-priority usage and because the incentive to invest in network capacity will be diminished.

I started with Dennis the Menace, which might seem too unsophisticated for this audience. You can, though, find an analogy between economic forces and the effect of

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[6] "FTC to Host Workshop on Broadband Connectivity Competition Policy," *Federal Trade Commission Home Page*, December 7, 2006 <http://www.library.unr.edu/depts/bgic/guides/government/cite.html#10>; Joseph Farrell and Philip J. Weiser, "Modularity, Vertical Integration, and Open Access Policies: Towards Convergence of Antitrust and Regulation in the Internet Age," *Institute of Business and Economic Research* (2003): 1-53; J. Gregory Sidak, "A Consumer-Welfare Approach to Network Neutrality Regulation of the Internet," *Journal of Competition Law and Economics* 2.3 (2006), 349-474

[7] Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions,* 2nd ed.(Cambridge, MA: The MIT Press, 1988), xv-xxxvii; Clifford Whinston, "Economic Deregulation: Days of Reckoning for Microeconomists." *Journal of Economic Literature* 31, No. 3 (September 1993), 1263-89.

[8] Keith N. Hylton and Michael Salinger, *Tying Law and Policy: A Decision-Theoretic Approach,* 69 ANTITRUST L. J. 469 (2001).

the moon on tides in the works of Alfred Marshall.[9] Given the setting, it would be better if it were Jevons, but I hope a reference to Marshall will be sufficient to give these remarks a sufficiently serious tone. Let me conclude by modifying the moon and the whale analogy a little bit. If you regulate economic activity – be it as an antitrust enforcer or a sector regulator – think of an economic sector as a boat on the ocean, and think of yourself as a whale in the proximity of the boat. Recognize that there are market forces like the gravitational pull of the moon that are too powerful for you to control. Of course, as a whale, you do have a potentially powerful effect. Ideally, you will swish your tail to advance the boat in the right direction. Remember, though, that misuse of your power can do harm. Above all, make sure you do not capsize the boat.

Thank you.

II. Effects Based Analysis

Last fall, there was a session at the American Bar Association's Fall Forum entitled "Monopolization and Abuse of Dominance: With the US and the EU both Contemplating New Approaches, Will the Best One Win?" I found that to be an interesting title. To explain why, I will need to be presumptuous enough to speak in London – at a great university no less – about proper English usage.

The closest thing we have in the United States to your rivalry between Oxford and Cambridge is the one between Harvard and Yale. They compete against each other both intellectually and on the athletic fields. At one point, the annual game between them in what we in the U.S. call football was enough of a happening that securing a ticket was difficult. Legend has it that in the days when telegrams were the fastest form of written communication, the Yale team sent a telegram to the Harvard team the night before their game saying, "May the best team win." The Harvard team responded with a telegram of its own saying, "May the better team win."

Whether the people who titled the session had this subtlety in mind, the question they posed was the right one. The question is not whether it is the US approach or the European approach that will prevail, and it is not whether antitrust enforcement should be "forms-based" or "effects-based." There is a richer set of alternatives.

In the U.S., we do not generally use the terms "forms-based" and "effects-based" to describe antitrust enforcement. The distinction is closely related, however, to the one between "per se" and "rule of reason" analysis. There are not many per se rules in the U.S. The ones against horizontal price fixing and market allocation agreements remain and are not controversial. The two other per se rules that are more controversial may be

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[9] Alfred Marshall, *Principles of Economics: An Introductory Volume*, 8th ed. (London and Basingstoke: MacMillan Press Ltd, 1920), 26.

on their way out. The U.S. Supreme Court has agreed to hear the Leegin case[10], which will give it an opportunity to revisit the per se condemnation of minimum resale price maintenance, or "RPM." We do not know what the outcome will be. However, the academic literature has widely criticized the per se rule against minimum RPM,[11] and one might reasonably speculate that the Court would not have agreed to hear the case if it did not intend to strike down the per se rule. One other area of U.S. antitrust doctrine in which a per se rule continues to prevail is tying doctrine. In the *Independent Ink* case last year,[12] the Court narrowed the scope of that doctrine by ruling that the ownership of a patent on the tying good did not create a presumption of the monopoly power needed to trigger the per se rule. It did not overturn the per se rule on tying altogether, but some read the wording of the decision to suggest that it might overturn the per se rule should the opportunity arise.

Getting rid of the per se rules on RPM and tying will be a positive development in U.S. antitrust law; but by itself, the switch to a rule of reason will create its own problems. In particular, we need to figure out exactly how the rule of reason analysis is going to be conducted. The per se bans against these practices were formulated when we did not understand as well as we might how these practices might serve pro-competitive ends. It would overstate matters considerably, however, to say that we now completely understand their use and that we know exactly how to tell when they are procompetitive and when they are anticompetitive.

Last fall, I was asked to speak about the legacy of the *Matsushita* decision, which the Supreme Court decided 20 years ago.[13] It was a landmark decision in large part because of the key role that it laid out for economics in antitrust analysis. As I argued at the time, *Matsushita* can be read to imply two quite different roles for economics in antitrust. One is for economic modeling to play a role on a case-by-case basis. An alternative is that economics would help inform somewhat more formulaic rules that are based on a recognition of the risk of error. In my view, the latter is the proper reading of the decision. The Court has refused to outlaw above-cost predation even though an efficient company could drive out a rival by cutting prices below those that maximize its short-run profits but above its own costs; and such behavior could cause long-run harm to consumers.

Whether or not antitrust enforcement with respect to monopolization and abuse of dominance should be effects-based raises similar issues. If we are not confident in our

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[10] *Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit at 4, Leegin Creative Leather Prods., Inc. v. PSKS, Inc.,* 127 S.Ct. 763 (2006) (No. 06-480).

[11] Pauline M. Ippolito, *Resale Price Maintenance: Economic Evidence from Litigation: Bureau of Economics staff report* (Washington, DC: Federal Trade Commission, 1988); James C. Cooper et al. "Vertical Antitrust Policy as a Problem of Inference," *International Journal of Industrial Organization* 23, no. 7-8: 638-64.

[12] *Illinois Tool Works Inc. v. Independent Ink, Inc.,* 547 U.S. 28 (2006).

[13] Michael A. Salinger, "The Legacy of *Matsushita*: Has This Thing Called Economics Gotten Way Out of Hand?" (paper presented at Loyola University School of Law, Institute for Consumer Antitrust Studies, Chicago, September 29, 2006); "The Legacy of Matsushita: The Role of Economics in Antitrust Litigation," *Loyola Law Journal* (forthcoming).

ability to determine effects on a case-by-case basis, we may want a more structured approach. Structured approaches are not inherently bad. It is just that the past structural approaches certainly in the US and probably in Europe as well have been flawed for two reasons. First we have had the wrong structures. Some legal categories encompass two or more types of behavior that have different effects. There are other legally distinct categories that have similar economic effects. For example, as Justice O'Conner pointed out in her concurring decision in *Jefferson Parish*,[14] the behavior at issue could just as well have been described as exclusive dealing as tying. The standard governing the practice should not have turned on an arbitrary choice of label. Second, and related, per se rules (other than on horizontal conspiracies) are too rigid. A structured approach can create a set of presumptions, but the presumptions should be rebuttable. In other words, some practices might be deemed inherently suspect. The presumption of illegality would be rebuttable subject to a "quick look," which would fall short of full-blown rule-of-reason analysis.[15] Other types of behavior would be treated as presumptively legal, but the presumption could be overcome with compelling evidence of net consumer harm. These presumptions could be captured by "safe harbors" or, to the extent that a presumption is rebuttable, "pretty safe harbors."

Let me push on this notion of "pretty safe harbors" a bit harder. A problem with completely safe harbors is that competition authorities and courts might be too conservative if they have to define completely safe harbors. For example, if forced to commit to market share thresholds under which they will never find anticompetitive harm from a particular practice, they might choose very low values. If they instead define "pretty safe harbors" that leave some scope for considering unforeseen fact patterns, they should rationally be willing to make the harbors larger.

Returning to the title of the session at the Fall Forum, the question of whether the "best" approach will win might seems to hold out the hope that enforcement policies on both sides of the Atlantic will converge. I do think they will move closer together, but I would be surprised to see complete convergence in the near future. Relative to the U.S., there seems to be greater concern in Europe with false negatives – i.e., failing to prevent anticompetitive behavior – than with false positives – i.e., with condemning and thereby chilling efficient behavior. I also sense a greater willingness in Europe to consider what are sometimes called dynamic effects but might otherwise be termed uncertain future effects than is the case in the U.S. "Dynamic" sounds more sophisticated than "static." I would caution, though, that the use of the word "dynamic" in antitrust is akin to the use of the word "fair" in international trade. It is used to justify prohibiting behavior that is competitive in the short run, but drives out rivals and thereby results in higher prices at some future date. At some level, of course, there is little controversy that some consideration of the long run is necessary. Otherwise, predatory pricing would not be illegal. At the same time, consideration of long term effects can run perilously close to protecting competitors rather than protecting competition.

Thank you.

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[14] *Jefferson Parish Hospital Dist. No. 2 v. Hyde*, 466 U.S. 2 (1984) (O'Connor, J., concurring).
[15] *PolyGram Holding, Inc. v. FTC*, 416 F.3d 29, 33–35 (D.C. Cir. 2005).