Federal Trade Commission

MARKET POWER AS A SCREEN

IN EVALUATING HORIZONTAL RESTRAINTS

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The views expressed are those of the Commissioner and do not necessarily reflect those of the Federal Trade Commission or the other Commissioners.

Good morning. It is a pleasure to participate in the Antitrust Section's "Cutting Edge of Antitrust" series and in today's program on market power as a screen for antitrust violations. The subject of my talk is using market power as a screen in assessing the lawfulness of horizontal agreements. As usual, the views I express are my own and do not necessarily represent the views of the Commission or any other Commissioner.

Over the last decade, the analysis of concerted activity by competitors has evolved in some interesting ways. The Supreme Court has moved away from the per se/rule of reason dichotomy. We now look to the so-called "truncated rule of reason" to analyze conduct that does not clearly require per se treatment, but which also does not clearly require a full rule of reason analysis.

The Supreme Court has provided for new flexibility but has not yet supplied a roadmap for identifying and analyzing novel restraints that should fall in the middle category. As both my copanelists know, at the Federal Trade Commission we have spent a good deal of effort to develop our own map. Although we have made a start, many or perhaps most of the hard questions lie ahead.

In Broadcast Music, Inc. v. CBS[1] and NCAA v. Board of Regents of the University of Oklahoma,[2] the Supreme Court signalled that restraints that enhance efficiency or cure market failure can be lawful. Nonetheless, the Court left standing the principle that naked restraints on competition are per se unlawful. Indeed, in Superior Court Trial Lawyers Association,[3] the Court appears to have reaffirmed the per se rule as it applies to conduct that seems easily to fit in the long-established category of per se offenses. To quote the Court, those offenses include "practices [that] are so 'plainly anticompetitive' . . . and so often 'lack . . . any redeeming virtue' . . . that they are conclusively presumed illegal without further examination under the rule of reason generally applied in Sherman Act cases."[4]

In addressing similarly serious conduct, the Commission has imposed many orders in cases involving health care professionals without requiring proof of market power. If there is plainly anticompetitive conduct, such as an agreement to exclude a competitor by denying him hospital privileges, little may be gained by a complex, time-consuming, and expensive market power

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[1] 441 U.S. 1 (1979).

[2] 468 U.S. 85 (1984).

[3] FTC v. Superior Court Trial Lawyers Association, 110 S. Ct. 768 (1990).

[4] Broadcast Music, Inc., 441 U.S. at 8, citing National Society of Professional Engineers v. United States, 435 U.S. 679, 692 (1978); Northern Pacific R. Co. v. United States, 356 U.S. 1, 5 (1958).

inquiry. Of course, we could debate this point. I can say with some certainty, however, that if a market power inquiry always were required, many or, possibly, most health care cases would not be brought simply because the litigation cost would outweigh the benefits of the case even assuming anticompetitive effects. Our cases in the health care field tend to be local and to involve only a handful of professionals or a single health care facility.

This is not to say that it may not be useful in health care cases to use market power as an analytical check when other questions about the case arise. For example, it might be useful at least to think about market power if a genuine question arises about whether individual actions are motivated by an agreement with anticompetitive intent or by incentives for simultaneous unilateral actions. If the conduct is suspect but unfamiliar in an antitrust context, we also may wish to apply market power as an analytical tool. I will return to the question of conduct that is in this gray area.

In the twelve years since the BMI decision, no scholarly consensus on how to approach the problem of analyzing horizontal restraints has emerged. Starting from the position that rules that err "on the side of excusing questionable practices are preferable," Judge Easterbrook has promoted the adoption of a

series of filters to screen allegedly anticompetitive practices.[5] His first filter would require a showing of market power.

Professor Areeda has observed that years of experience in antitrust has taught that proof of market power is "difficult, complex, expensive and time-consuming."[6] He has said: "Once we decide that a class of practice is in the vast generality of cases detrimental and unjustified, why bother with the complicated and expensive inquiry into power?" [7] Professor Areeda would reserve the market power screen for the tough cases that fall in the gray area between per se unlawfulness and plain lawfulness. If a practice initially appears to be a restraint of trade within the meaning of the Sherman Act, but does not rise to the level of a restraint that is subject to summary condemnation, then Professor Areeda would require proof that the restraint is of "significant magnitude" either by proof of an actual reduction in output or by proof of its surrogate, market power.[8]

Professor Sullivan believes that antitrust should incorporate values other than economic efficiency.[9] He has said that certain conduct, such as coercion, can be harmful and should

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[5] Easterbrook, The Limits of Antitrust, 63 Texas Law Rev. 1, 15 (1984).

[6] Areeda, The Changing Contours of the Per Se Rule, 54 Antitrust Law J. 27, 28 (1985).

[7] Id.

[8] VII P. Areeda, Antitrust Law ¶ 1511 at 429 (1986).

[9] Sullivan, The Viability of the Current Law on Horizontal Restraints, 75 Cal. Law Rev. 835, 841 (1987).

be condemned, regardless of market power.[10] Sullivan correctly has observed that the courts have not yet resolved the problem of a restraint that both confers market power and demonstrable efficiencies.

It should not come as a surprise that the internal debate at the Commission reflects many of the divergences of view found in the academic community. In 1988, the Commission adopted a framework of analysis in Massachusetts Board of Registration in Optometry.[11] Former Commissioner Calvani authored the opinion, and the Commission drew on earlier work done by Tim Muris, Bill Baxter and others.[12]

The first question in the Commission's Mass. Board analysis is whether the practice is inherently suspect. Conduct that is not inherently suspect is examined under the rule of reason. If it is inherently suspect, then the next question concerns a plausible efficiency justification for the conduct. If an efficiency justification is plausible and valid, then the conduct is analyzed under the rule of reason. Inherently suspect conduct without an efficiency justification is condemned without further inquiry.

To discern whether a practice is inherently suspect, the opinion in Mass. Board asks whether the practice is "the kind

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[10] 75 Cal Law Rev. at 849.

[11] 110 F.T.C. 549, 602-04 (1988).

[12] See Muris, The New Rule of Reason, 57 Antitrust Law J. 859, 861 (1989).

that appears likely, absent an efficiency justification, to 'restrict competition and decrease output.'"[13] This closely tracks language in BMI.[14] The examples of inherently suspect practices are price fixing and market allocation. Both practices have long been condemned as per se unlawful, so that was a fairly safe beginning. In Mass. Board, the Commission also determined that certain restrictions on price and other advertising imposed by the state optometry board were inherently suspect.

Now we must ask: What is inherently suspect conduct? What kinds of efficiencies are valid? Who has the burden to propose and prove efficiencies? Is there any requirement that some or all of the savings from an efficiency be passed on to consumers? Under what conditions will this occur? Where does market power fit in the analysis, if at all?

Some have suggested that market power must always be considered, even when the conduct is price fixing, because anticompetitive effects cannot be sustained unless the group of competitors party to the agreement collectively have market power. The latter point is well accepted and important. Others have recognized the point, but nonetheless have argued that an analysis of market power is not always necessary, noting the difficulty and expense of a full scale inquiry. The Supreme Court has provided support for both sides of the debate. In

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[13] 110 F.T.C. at 604.

[14] 441 U.S. at 19-20.

NCAA, it said: "[a]s a matter of law, the absence of proof of market power does not justify a naked restraint on price or output."[15] In the same opinion, the Court went on to discuss market power, suggesting that a market power inquiry may indeed be appropriate even when the restraint alleged is naked.[16]

The Commission has not addressed directly the role of market power. In Superior Court Trial Lawyers Association,[17] the Commission did not undertake a full-fledged discussion of market power, but did find actual anticompetitive effects from the trial lawyers' boycott to raise prices. In addition, the Commission repeatedly described the boycott as coercive, implying a degree of market power. The Court of Appeals did not find these implicit findings and surrogate references to market power sufficient. The Supreme Court simply applied the per se rule to the coercive boycott to raise prices and left unanswered whether an inquiry into market power should have been undertaken in a truncated rule of reason analysis.

In Detroit Auto Dealers Association,[18] the Commission did not address the market power of the car dealerships in the Detroit metropolitan area whose conduct was at issue. The

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[15] 468 U.S. at 109.

[16] 468 U.S. at 111-13.

[17] 107 F.T.C. 510, 575-78 (1986), rev'd, 856 F.2d 226 (D.C. Cir. 1988), rev'd in part and remanded, 110 S. Ct. 768 (1990).

[18] 111 F.T.C. 417 (1989).

underlying factual findings show such a high degree of participation in the unlawful conduct that if the Commission had addressed the market power issue, it almost certainly would have found such power.[19]

Again, in Mass. Board, the Commission did not make explicit findings on market power, but the concept may be implicit in the opinion. The Commission observed that the challenged restrictions by the state board "have the force of law,"[20] suggesting a degree of market power. The Commission also cited the findings that the advertising bans posed a barrier to entry and that prices tended to be lower in states that permitted certain advertising.[21] If market power had been obviously negligible or nonexistent, it is an open question, I think, whether the Commission would have viewed the case in exactly the same light.

Is market power necessary or useful in determining whether conduct is inherently suspect? Many suggestions have been made about how to identify inherently suspect conduct, and each raises its own set of questions. One proposal is that inherently suspect means an agreement among competitors not to compete with respect to a significant form of rivalry. Not everyone agrees about what aspects of rivalry are significant or, indeed, about what rivalry means. Does the proposal mean that essentially all

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[19] 111 F.T.C. at 425.

[20] 110 F.T.C. at 605.

[21] 110 F.T.C. at 605-606.

horizontal agreements are inherently suspect? In the context of a joint venture among competitors, should all rules of the joint venture that restrict independent behavior be treated as inherently suspect? Should all rules of an association of competitors be treated as inherently suspect if they proscribe any kind of independent behavior?

Others have proposed a two-part test: first, a sound theory of how the restriction reduces output and raises quality adjusted price; and second, some evidence to confirm that the theory has merit.[22] Absent an anticompetitive theory, any challenge to a practice will lack an explanation of how the practice harms consumers, and the requirement of some evidence would appear to provide a "reality check" on whether the anticompetitive theory holds water. Presumably everyone would agree that a plaintiff should have a sound theory, but what are the standards for deciding whether a theory is sound? Do we need evidence of market power to ascertain whether the restriction reduces output or raises price? If not, what other evidence would be needed, and how much evidence is enough? Still others have argued that the Commission should apply a market power screen to help determine whether conduct is inherently suspect, both to avoid condemning desireable or competitively neutral practices and to shift the focus to evaluating other aspects of a case, especially efficiencies.

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[22] Langenfeld, Antitrust Enforcement: The Gray Area of Agreements Among Competitors, ATRS Report (Spring 1991)

Much of the debate on the use of a market power screen has been theoretical or even philosophical, revolving around the question of justification for antitrust intervention absent proof of market power. Although the question is important, this debate has tended to overshadow the mundane, but not unimportant, consideration whether enforcement agencies and courts can in fact develop an efficient and effective market power screen for horizontal restraint cases.

Having invested much of my professional life litigating about mergers under Section 7 of the Clayton Act, for me market power analysis conjures up images of exhaustive and exhausting document production by the respondent and third parties both in and close to the market, endless debates about elasticity of supply and demand, and all the minutiae that may need to be tied down in a full rule of reason case. But a market power screen need not be so complete. That would make little sense at the preliminary stage of deciding whether to use the rule of reason. A screen can be either fine or coarse. It may be possible to devise an abbreviated market analysis, a low-cost screen, to eliminate a significant number of cases where the likelihood of harm to consumers is small or nonexistent.

Would the analysis that we use at the Federal Trade Commission every day in reviewing mergers be a satisfactory tool for these purposes? Some adjustment might be needed. In defining markets in horizontal merger cases, we are presented with a given state of competition and ask the forward looking

question: what would happen if the producers in a particular market imposed a small but nontransitory price increase? In analyzing horizontal restraints, the parties, through the use of the restraint, already may have pushed the price up to an artificially high level just below that of a good substitute. The prospective market definition test of assuming a five percent price increase, which works well for prospective merger analysis, may not be suitable in horizontal restraint cases. Perhaps it would be appropriate to focus on a five percent price decrease in some restraint cases, as I understand Bill Baxter suggested yesterday.

Although we have no formal guidelines for market power screening in horizontal cases, the Commission and its staff do in fact have a good sense of how to go about the task. Defining markets, identifying barriers, estimating concentration and the reasons for market power, discussing how market power might be exercised, and generally figuring out how markets work are the everyday business of an antitrust agency, and even without a guidebook, we know what to look for. At the preliminary stage, the real problem is not in knowing what to do, but rather in knowing how far to pursue the inquiry.

One way to apply the Mass. Board test is to reserve any consideration of market power in deference to an analysis of efficiencies, employing market power as part of the full rule of reason analysis after deciding that efficiencies are plausible and valid. This might be a more enticing idea if the

identification and measurement of efficiencies were an exact and costless process. Although most antitrust lawyers and economists recognize the cost, complexity, and difficulty of market power analysis, the difficulty of justifying a restraint on efficiency grounds has received less attention. In merger cases, parties have argued efficiencies with varying degrees of success, and the Commission has taken them into account, notably in connection with joint ventures. But we still have relatively little experience in identifying the nature and estimating the magnitude of efficiencies.

The Mass. Board and the Detroit Auto Dealers cases offer little guidance on efficiencies. In Mass. Board, the respondent did not try to defend on efficiency grounds and possibly did not even recognize the opportunity to address the issue. Similarly, on appeal in Detroit Auto Dealers, the respondent did not argue efficiencies. Only in dictum buried in a footnote did the Commission even refer to the efficiency claims argued to the ALJ.[23]

To the best of my knowledge, the Commission has not held that an efficiency justified a horizontal restraint, and the question of efficiencies often gets short shrift from all sides. Proponents of a case argue that the burden of identifying and proving efficiencies is on the defense. Defense counsel frequently have not argued efficiencies, even in situations where

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[23] 111 F.T.C. at 498 n.22.

they seem promising. I am not sure whether unfamiliarity with this approach or concern about the burden of proof has led to this omission.

Just to add another wrinkle, I will interject my personal observation that the Commission may never get to the full rule of reason using the Mass. Board analysis. As a practical matter, I think the Commission will decide virtually every case after addressing efficiencies. The full implications of this possibility we will have to save for another day.

It may be useful to consider some specific applications in the context of trade and professional associations. The Detroit Auto Dealers Association case, for example, involved an agreement among virtually all automobile dealers in the Detroit area to close on Saturdays and on most weekday evenings. The agreement originated in the 1950's and 1960's as part of an effort by the dealers to forestall unionization of their work forces by giving the staff shorter hours. The agreement was not achieved easily. Overt coercion in the form of violence, vandalism and intimidation was necessary to bring some dealers into line.

Although the Commission did not find a body of precedent declaring such agreements on hours of operation to be unlawful per se, it did find the agreement to be a violation of Section 5. No formal market power analysis was performed, but as I said earlier, market power seems implicit in the factual findings of the Administrative Law Judge.

Change the facts slightly, and it becomes a harder case. Assume that only the Buick dealers in the Detroit metropolitan area agreed to eliminate Saturday and evening hours in order to prevent unionization of their shops. The use of a market power screen might, and I emphasize might, permit the agreement. One could say that a Chevrolet or Toyota is a good substitute for a Buick, and because substitutes were available in the evening and on Saturday, no consumer could be harmed by the agreement among Buick dealers. On the other hand, one might be able to identify a group of consumers who were so committed to buying Buicks and Buicks only, that they were injured by the restraint. If we employ a market power screen, the outcome for Buick dealers would seem to depend on whether a market could be defined on the basis of an overriding brand preference for Buicks above all other cars.

As a second example, take a specialty medical professional association that adopted an ethical code prohibiting unsubstantiated advertising claims and also prohibited advertising as a specialist without passing a rigorous board certification. The Commission has found that some advertising restrictions, such as restrictions on price advertising and total bans on solicitation, violate Section 5.

The potential for anticompetitive effects from restrictions imposed by a purely voluntary, private, professional association is very different from that of a state licensing authority like the one in Mass. Board. In the absence of power to revoke a

license, the market power of an association is not obvious. Even the circumstance that the association has a large membership may not be dispositive of the market power issue. It might reflect efficiencies generated by the ethical rule. The notion of an efficiency generated by an ethical rule is fairly abstract. The argument generally would be that the members of the group, seeking to differentiate themselves from other providers, are able through a professional association efficiently to insure the quality or the distinction of their services and to convey information of quality or distinction to the public.

An effective means to discipline violators of ethical rules would seem a necessary prerequisite for adverse effects stemming from an anticompetitive ethical rule. Expulsion from membership is an obvious possible means, but its coercive force depends on the benefits of membership. Proof that membership confers important competitive advantages unrelated to a challenged restraint would therefore be significant.

Virtually all association ethical rules could be characterized as an agreement among competitors to limit forms of rivalry, in my example, advertising. Some would deem all such restraints to be inherently suspect and unlawful absent proof of efficiencies. This approach could easily lead to condemnation of virtually all ethical rules because, just as it is difficult to establish that a private association has market power, it is also difficult to establish that particular ethical rules of an association are efficient.

Returning to the example, the usual governmental reason for an advertising substantiation rule is to prevent fraud and deception. But the governmental purpose is to protect consumers. When horizontal competitors claim that they must agree to restrain themselves to protect consumers, it is a little hard to accept. An economist, on the other hand, might theorize that such rules prevent a market failure caused when fraud discourages clients from seeking or obtaining professional services, but proof is another matter.

The other ethical rule in my example involves a restriction on specialist advertising without board certification. A very broadly drafted rule might prohibit dissemination of any information regarding a physician's training, experience or other qualifications that could limit opportunities for comparison shopping. But if the association adopted a carefully drafted specialist-advertising rule in order to promote a public perception that its certified members were particularly expert in their field, would that be an efficiency?

The association might argue that it was trying to build a public image of a premium quality provider and needed the rule on board certification to guarantee quality. If the association succeeded in creating the public perception of quality, it is possible that the association might make membership a distinct competitive advantage in attracting clients. Can evidence be developed suggesting that this is the likely explanation, rather

than an effort of one group of competitors to prevent competition from another, which may lead to higher prices to consumers?

Most cases involving association rules are vastly more complicated than these examples that isolate a single rule. Most associations have many rules and activities, some of which may be efficient and create value for members and others of which may be anticompetitive. It can be very difficult to sort out which rules have which effect. I raise these examples to demonstrate that much antitrust territory remains to be explored and to suggest that when we venture into this territory, we may want to take some of the traditional analytical safeguards along for the ride, at least until the new territory has been tamed, if not entirely conquered.

Let me return to the original question implicit in my assigned topic: should we employ a market power screen in analyzing horizontal conduct? I see two important advantages of a market power screen. First, adoption of a market power screen would reduce the danger that the inherently suspect label will be used to expand the category of conduct that is summarily condemned without adequate basis to do so. Second, if -- and I emphasize if -- the burden of proof is shifted to a defendant to prove an efficiency justification for its conduct, a market power screen could be useful as part of a prima facie showing for prosecutors. The defendants are the parties who possess the facts relevant to an efficiency claim, but there should be some meaningful threshold showing before requiring them to assume this

burden. A market power screen can also be useful in applying the truncated rule of reason without reference to the Commission's Mass. Board framework.

It is important to keep in mind that a market power screen can be carried too far and cost too much, but I think we can control for that in many if not most cases. Given our relatively limited experience with the Mass. Board analysis, I think it makes sense to attempt at least a rough estimate of market power as we gain experience in the workings of the various alternative tests of inherently suspect or to assist in the exercise of prosecutorial discretion.

Plainly, the Commission is still grappling with questions that the Supreme Court left open in NCAA and BMI. The opinion in Mass. Board was not appealed, and the Commission has yet to defend one of its orders based on a Mass. Board analysis in federal court. Whether a market power screen should be grafted onto the truncated rule of reason or even hung temporarily on one of its branches is truly an important, cutting edge question. Like you, I await further developments from the Commission and the courts.