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Proposed Legal Rule for Unilateral Refusals to Deal

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Basic Requirements

It is a violation of Section 2 of the Sherman Act for a vertically integrated firm with monopoly power to refuse a valid offer by an unintegrated competitor (in the output market) to purchase a product that the defendant manufacturers and uses as an input for its output, if the court finds the following facts:

A1. The defendant has monopoly power in the sale of the product that the purchaser desires to buy.

A2. The defendant has or will achieve monopoly power in the market in which the purchaser will compete.

A3. The potential purchaser has made a genuine offer to buy at or above the appropriate “non-exclusion benchmark” price, as defined below; whereas defendant has failed to accept such an offer or made a genuine offer to sell at or below that benchmark price.

A4. The refusal to deal likely would cause prices to be raised or maintained at a supra-competitive level in a relevant market affected by the refusal to deal. (These relevant markets potentially include the product being purchased, the market(s) in which the potential purchaser would compete, and market(s) in which the purchaser’s customers or producers of complementary products would compete with the defendant.)

Basic Defenses

B1. This standard applies to all refusals to deal, even where the defendant has not previously sold the product. However, under no circumstances would this rule require the defendant to supply its product at a price below its incremental cost of supplying the purchaser.

B2. The integrated firm may refuse to deal if selling the product to the purchaser would be technologically infeasible or raise the defendant’s own costs to a prohibitive level (e.g., would make the defendant unable to supply its own needs or would subject the defendant to prohibitive reputational or other free rider problems). However, it is not a valid justification to claim that selling to the purchaser would increase competition and thereby reduce the defendant’s investment or innovation incentives. This is because the benchmark price provision ensures adequate incentives by compensating the defendant for incremental profit-margin lost on output sales taken by the purchaser.

Non-Exclusion Benchmark Price

C1. The non-exclusion benchmark price W compensates the defendant for profits lost on output sales taken by the purchaser. This price is presumed to be measured as follows:

$$W = Cu + D \times Md,$$

where P is the defendant's price of output in the market in which the potential purchaser would compete; Cu is the defendant's incremental unit cost of producing the product that the purchaser wishes to acquire; Md is the defendant's price-cost margin; and, D is the fraction of output sales of the purchaser that entail a reduction in the output sales of the integrated firm.[1]

The non-exclusion benchmark may be calculated differently under certain circumstances:

C2. If the defendant and the potential purchaser have a prior course of dealing for the product at some other price and that relationship has been terminated by the defendant, or where the defendant sells the product to other purchasers, the non-exclusion benchmark price would presumptively be equal one of these alternative prices, subject to evidence by either party that these alternative benchmarks are not appropriate.

C3. If the defendant shows that selling to the purchaser would raise the defendant's own costs, but not prohibitively (e.g., because of the defendant's limited capacity or a valid concern regarding reputational free riding, etc.), the court will apply a higher benchmark price to take these costs into account.

C4. If the court finds that the defendant has not responded in good faith to valid offers from the potential purchaser and has made no valid offers or counteroffers of its own ("non-negotiable" or "flat" refusals to deal), the burden of overcoming the purchaser's claim that its price offer was valid and exceeds the benchmark price will be placed on the defendant.

C5. If the defendant's monopoly power in the input market has not been acquired or maintained legitimately, such that that the court would have less concern about providing the firm with an adequate return on input sales, the court may apply a lower benchmark price. However, under no circumstances would the benchmark price be set below the defendant's incremental cost of supply.

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[1] Example: Suppose that defendant has incremental input costs of $10 and currently earns a monopoly margin over costs of $50. Suppose that if the defendant deals with the entrant, 50% of the entrant's sales will come at the expense of the defendant and half will be new customers or customers substituting from other products. In that case, the protected-profits benchmark input price would be $35 (i.e., W = 10 + 50% x 50 = 35).