UNITED STATES FEDERAL TRADE COMMISSION

and

UNITED STATES DEPARTMENT OF JUSTICE

SHERMAN ACT SECTION 2 JOINT HEARING

WELCOME AND OVERVIEW OF HEARINGS

TUESDAY, JUNE 20, 2006

HELD AT:

UNITED STATES FEDERAL TRADE COMMISSION

HEADQUARTERS BUILDING, ROOM 432

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Reported and transcribed by:

Susanne Bergling, RMR-CLR

MODERATOR:

WILLIAM BLUMENTHAL

Federal Trade Commission

PANELISTS:

Deborah Platt Majoras

Thomas O. Barnett

Dennis Carlton

Herbert Hovenkamp

C O N T E N T S

P R O C E E D I N G S

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MR. BLUMENTHAL: Ladies and gentlemen, good afternoon. I'm Bill Blumenthal from the FTC, and I'd like to welcome you to the first of the joint Justice Department Antitrust Division and Federal Trade Commission hearings into Section 2 of the Sherman Act.

The purpose of these hearings is to explore how best to identify anticompetitive exclusionary conduct for purposes of antitrust enforcement. We are envisioning a series of hearings that will kick off today and will continue through December, probably two, three, four hearings a month, with the exception of August. After today's kick-off hearing, we are going to have another hearing on Thursday of this week examining predatory pricing, we will have a hearing in mid-July examining refusals to deal, take a little bit of a breather, and then resume in September with what would then be a series of examinations.

The agencies are expecting to focus on legal doctrine, on jurisprudence, economic research, and business and consumer experience. We have a Federal Register notice that is outstanding. We invite public comment on a wide range of topics, and we hope that those of you who are here, as well as many others, will have an opportunity to submit comments on the topics that we address. We are open to receiving those any time through the final hearing, that is, through December, although the earlier the better for our purposes.

We are honored today to have a special panel to kick off the hearings. They probably do not need much introduction, so I am going to be very brief in offering the introductions. In the order in which they will be speaking, first we have Deborah Platt Majoras, Chairman of the Federal Trade Commission. Thomas Barnett, the Assistant Attorney General for Antitrust in the Justice Department. Herb Hovenkamp, who is probably known to most of you as -- as many things -- a professor of law at the University of Iowa, but probably better known as a co-author and a reviser of the leading treatise in the antitrust field as well as a prolific author of many, many other volumes, the most recent of which is recently out, The Antitrust Enterprise: Principle and Execution, available through Harvard University Press, with an imprint of this year.

And finally Dennis Carlton, also known to many of you in many capacities, most notably professor of economics at the Graduate School of Business at the University of Chicago, former president and still very active in Lexicon, frequent expert witness, author of many, many articles, author of I guess two of the leading economics texts in the field. I'll leave it at that. You all know Dennis Carlton.

I have several preliminary announcements that I am going to make, one of which is legally mandated. The first, which is not legally mandated but is a common courtesy, if any of you have cell phones or Blackberries, pagers, iPods, things of that nature, please do as I'm doing right now and set it into silent or manner mode, although if you do it like I just did, you just dialed 7. Okay, there we go.

Second, I have been asked to let you know that the men's room is immediately out these doors and to the left. The ladies' room is out these doors, to the other side of the elevator banks, and to the left.

And finally, the legally mandated announcement is the one that says, as a safety tip for our visitors, if the building alarms go off, please proceed calmly and quickly as instructed. If we must leave the building, take the stairway, which is to the right on the Pennsylvania Avenue side, and after leaving the building, please follow the stream of FTC people who are practiced in this evolution. We will all go to the Sculpture Garden, catty-cornered across the street at

7th and Constitution, and we will assemble there, where noses will be counted.

With that, it gives me great pleasure to turn the podium over to the Chairman of the Federal Trade Commission, Debbie Majoras.

(Applause.)

CHAIRMAN MAJORAS: Good afternoon, everyone, and thank you very much, Bill. Together with my good friend and colleague, Assistant Attorney General Tom Barnett, it is my great pleasure to welcome you to these hearings in which we will be exploring conduct under Section 2, and we are privileged to have two of our most distinguished antitrust scholars here, Professors Hovenkamp and Carlton.

Now, at the start of any new endeavor, it is important to reflect on why we are undertaking it. Beginning in 1990, the McKinsey Global Institute, led by founding director William W. Louis, undertook a 12-year study of the economic performance of 13 nations seeking to understand globalization, and more fundamentally, the disparities between rich and poor. The study showed that levels of productivity made the difference between rich and poor nations. What, though, made the difference in the levels of productivity? The answer they found was "undistorted competition in product markets."

In his book in which he reports the results of the study, Mr. Lewis says, "Most economic analysis ends up attributing most of the differences in economic performance to differences in labor and capital markets. This conclusion is incorrect. Differences in competition in product markets are much more important."

McKinsey also asked why the highly productive United States has higher competitive intensity than other nations. Mr. Lewis sums up the answer by saying that, in the United States, "Consumer is king." More specifically, he says, "[t]he United States adopted the view that the purpose of an economy was to serve consumers much earlier than any other society," and we continue to "hold this view more strongly than almost any other place." And he concludes that, in fact, "Consumers are the only political force that can stand up to producer interest, big government, and the technocratic, political, business, and intellectual."

This is why we are here. The FTC and the Antitrust Division have the responsibility to ensure that competition in U.S. markets is free of distortion and that consumers are protected not from markets but through markets unburdened by anticompetitive conduct and government-imposed restrictions. This work is critical, indeed, to the well-being of the American people. Over the past few decades, the United States has substantially deregulated critical industries, including transportation, telecommunication and energy, to the substantial benefit of the economy and consumers. As government regulators have given way to free markets, much of the responsibility for protecting consumers shifts to competition agencies and courts. While competition is distorted when governments regulate or intervene excessively, it also is true that private actors can and do distort competition.

Breaking up cartels, preventing mergers that will substantially reduce competition, and halting conduct that goes beyond aggressive competition to distorting it is vital to promoting vigorous competition and maximizing consumer welfare, and we have developed a great deal of consensus regarding appropriate antitrust policy, I think, as it relates to cartels and to mergers and other horizontal conduct, as a result of which our enforcement has become more transparent and predictable, which then, in turn, makes it easier for market participants to make decisions about their own conduct.

Unilateral or "single-firm" conduct, however, still vexes us. Even though we can find some respectable measure of consensus around principles that should apply, we find a range of opinions from knowledgeable people about how to apply those principles to enforcement in the market, and the question of the proper test that our agencies should apply and that courts should apply to conduct of the single firm with market power now has dominated our antitrust debate for several years.

We are not alone. Across the globe, over the past quarter century, economic systems in which the state owns the firms and central planners set out prices and levels of output have given way to competition where the forces of supply and demand determine prices and allocate the resources, and we have worked hard to promote the economic and political benefits of markets. With attempts to introduce market economies have come new competition authorities, today numbering around 100, when only 15 years ago, we had just 20. And even countries that for decades have had nearly total state control over their economies, like China, are now dedicating substantial resources to drafting competition laws.

Currently, the issue of how to evaluate unilateral conduct is the most heavily discussed and debated area of competition policy in the international arena. Just to give you a few examples, last week, FTC and DOJ officials attended the EC's hearing to review their policy under Article 82, which addresses conduct by dominant firms. Officials from both agencies recently held talks with our colleagues in Japan and Mexico and Canada on the issue. We recently had panels on it in the OECD. And since the International Competition Network established a working group on unilateral conduct in May, the FTC, which will co-chair that group, has received expressions of interest from more countries wanting to be involved than we have ever had in any other working group in the ICN.

So, why the strong interest? Well, first, many nations are facing the challenge of converting from state-owned or supported monopolists to markets with more than one participant, which is no small challenge, as we ourselves have learned in trying to deregulate certain markets like electricity. And, indeed, to enforcers in those nations, it then becomes companies with market power, not horizontal competitors, that are the evil that must be attacked. Second, disagreement among competition authorities about how to treat unilateral conduct produces uncertainty in national and international markets, which reduces the market efficiency and imposes costs. And third, the analysis of unilateral conduct in the identification of that which is anticompetitive presents unique challenges that are not present or at least are less present in the core antitrust concern of conduct between competitors, and by now, these unique challenges I think are familiar.

First and fundamentally -- and we discuss it all the time, but that doesn't make it less difficult -- and that is it is difficult to distinguish between aggressive procompetitive unilateral conduct and anticompetitive unilateral conduct. As the D.C. Circuit said in the Microsoft case, "The challenge for an antitrust court lies in stating a general rule for distinguishing between exclusionary acts which reduce social welfare and competitive acts which increase it," and this is tough, because as Judge Diane Wood wrote for the Seventh Circuit, "distinguishing between legitimate and unlawful unilateral conduct requires subtle economic judgments about particular business practices." So, while it's difficult, it must be done and it must be done well.

Second, the process of distinguishing between permissible and impermissible conduct must be relatively consistent and transparent so that firms are able to incorporate it into their decision-making. While there are relatively few findings of Section 2 liability, there nonetheless are a large number of different types of conduct that may raise competition concerns and would fall under Section 2.

And third, while antitrust practitioners have had substantial success devising remedies for joint conduct, devising remedies for single-firm behavior presents significant difficulties. As Professors Areeda and Hovenkamp put it, "By contrast with concerted conduct, unilateral behavior is difficult to evaluate or remedy by any means short of governmental management of the enterprise."

We have much to work with as we move forward with these hearings. Already a number of experienced experts have proposed the adoption of a single test for evaluating nearly all types of potentially exclusionary conduct. Some have argued for a test that focuses on the impact of the conduct on consumer welfare. Others support analyzing whether the conduct involves the short-term sacrifice of profits. Others support a no-economic-sense test, which asks whether the cost of engaging in the exclusionary conduct makes sense only because it serves to eliminate competition.

Judge Posner has written that the inquiry should focus on whether the conduct excludes other equally efficient rivals, and still other practitioners and scholars oppose the adoption of any single unilateral conduct test and instead favor consideration of different tests for particular types of exclusionary conduct. And then, of course, when you go out into the world, you see that there are many other opinions on the type of test or framework that should be used.

So, proponents of the various tests and approaches already have done a very good job of laying out, I think, the relative merits, and virtually all have acknowledged that their preferred approach is probably not perfect. At these hearings, I hope we can tackle this issue by starting with the conduct itself. The hearings will have panels that will focus on specific types of conduct that at least to date we know can implicate liability. We want the panels to discuss the conduct from the market perspective, from the ground up; that is, to examine why and when firms engage in certain practices, how they do it, what effects it produces for the firm, for other firms, both customers and the competition, and for consumers. And we should look at whether firms in competitive markets also engage in the same conduct, and if so, examine why that is. We want these discussions, to the extent possible, to include knowledgeable businesspeople or at least their advisers, and from these discussions, we then should endeavor to develop sign posts for when the conduct may harm competition and when it typically does not. From the sign posts, we hopefully can draw some guiding principles, and only then should we turn to examining the current state of the law as it has been applied to such conduct and then determining what workable rules can be applied to the specific conduct at issue. That way, we can then see, can we pull these together into a single test or a broader set of rules? And even if we don't produce a consensus on the universal test or tests, I'm optimistic that we can identify relative consensus on a number of principles and then on how to approach at least some fraction, hopefully a significant fraction, of single-firm conduct we encounter.

In these discussions, we need to be careful not to permit labels or semantic differences to get in the way. In some discussions I've heard on these issues, I have been worried that people are actually talking past one another. In addition, this debate must not become so academic that even if it could be resolved, it might not have much practical application in the marketplace. Indeed, last week I was speaking with a long-time antitrust practitioner about these hearings and about the debate over a proper test, and he said, that while he thought the Section 2 issues were very important, nonetheless, the search for the "holy grail" test might just be something in which only about 27 people have an interest. So, we really want to be careful about that.

I do think we start with some substantial consensus about core underlying principles and factors that should underlie any evaluation of unilateral conduct.

First, the only type of unilateral conduct that should implicate the antitrust laws is conduct that produces durable harm to competition, leading to higher prices, reduced output, lower quality or lower rates of innovation. As much as we may value the success of particular companies, the health of the companies themselves is not the concern of antitrust law.

Second, there is consensus that antitrust standards that govern unilateral conduct must not in themselves deter competition, efficiency, or innovation, and this is what we mean when we constantly say that we worry about false positives. Obviously pervasive and aggressive competition in which firms consistently try to better each other by providing higher quality goods and services at lower cost is crucial to maximizing consumer welfare. So, the antitrust laws should then never condemn market power that is obtained through the development of superior products and services, regardless of how many competitors are driven from the marketplace in the process, and that, of course, has been accepted by the courts.

Third, there is consensus that the standards for evaluating unilateral conduct must be clear and practical to administer or as practical as they can be to administer. The most analytically sound principles will provide little value to us if firms can't interpret them when they are making their business decisions. And, of course, courts have to be able to interpret and apply rules as well.

And while I want to emphasize that I am going to use the hearings to continue developing my own thinking on these issues, I do approach them, in addition to the broad principles, with a number of other hypotheses. First, any legal framework needs to avoid second-guessing business judgments that were objectively reasonable at the time they were made. An ex post facto examination of the hypothetical effects of alternative courses of conduct is likely to chill legitimate business behavior. Second, to be practical, any legal framework must be able to evaluate conduct that both generates efficiencies and produces anticompetitive exclusion. If we only had to worry about conduct for which the effects are obvious, we probably would not be here today. And third, any test or tests must account for the fact that certain types of unilateral conduct are significantly more likely to cause competitive harm than others. For example, most would agree that unilateral above-cost pricing at monopoly levels should not be condemned under the antitrust laws. Similarly, behavior that some commentators have termed "cheap exclusion," such as the use of government processes to unlawfully extend the life of a patent, is generally viewed as unlawful exclusionary conduct. And this may mean that there is no unitary test or that we simply need a broad framework that can accommodate a spectrum or perhaps a sliding scale for the levels of harm, and proposals have been made for how we might think about the distinctions that could be made, including Deputy Bureau of Competition Director Ken Glazer's proposal that we analyze conduct by distinguishing between conduct that's coercive versus incentivising.

Now, in the Microsoft case, the D.C. Circuit applied what I view as a sensible weighted balance approach to Microsoft's conduct that's largely consistent with the three principles I just discussed. Some have criticized the framework used in Microsoft as insufficiently structured or unfocused, and I understand where that comes from, but I think if we look at how it was actually applied, it may be a workable framework that incorporates the principles on which we have wide consensus. I mean, perhaps the same criticism about being unstructured could be applied to the Section 1 rule of reason and, in fact, probably is at times, but as applied to, for example, joint ventures, the balancing has been weighted I think in the right direction.

First, the Microsoft court did not attempt to substitute ex post facto its judgment for the business judgments that were made ex ante, or to determine what actions might have been better overall for consumers. For example, the Court did not base its findings on an ex post analysis of the impact of Microsoft's conduct on the prices charged to consumers.

The Microsoft court also demonstrated that to evaluate whether certain types of unilateral conduct violate the antitrust laws does require an examination of both likely anticompetitive and procompetitive effects. For example, the Court analyzed the legality of a Microsoft license provision that prohibited OEMs from modifying the initial boot sequence. Microsoft did not dispute that that restriction limited competition against IE. The Court nonetheless held that the restriction was not a violation because it concluded that preventing the Windows desktop from ever being seen at all in the boot sequence was a substantial alteration of Microsoft's copyrighted work that could produce harm that outweighs the marginal anticompetitive effect of the prohibition. The Court performed this same analysis across two dozen types of conduct, examining both the anticompetitive effects and procompetitive justifications, taking care, though, to ensure that it not chill procompetitive behavior.

And finally, the D.C. Circuit made clear that it did not consider all types of unilateral conduct to raise equal concerns under the antitrust laws. For example, the Court stated that courts need to be very skeptical about claims that a dominant firm's design changes harm competition and, by implication, violate the antitrust laws.

One final note about the hearings. I hope that our latest panels, which we will hold on remedies, will produce a productive discussion. It simply is not possible to implement sound competition policy for single-firm conduct without giving careful thought to remedies. Despite their importance, though, I think the issues relating to remedies have not received extensive attention. Take the Microsoft case, for example, which although it received and still receives a bit of notoriety, I have been stricken by how few productive discussions of the remedy and the D.C. Circuit decision that accepted the DOJ remedy while rejecting other remedies have actually occurred, and while that might have stemmed from some of the market dissatisfaction over that remedy, I think these hearings should give the Section 2 remedy issue the prominence that it deserves in our analysis. After all, if you have done these cases, you know that devising and drafting remedial provisions in monopolization cases can be more difficult than determining whether a violation has even occurred.

At bottom, through these hearings and through our work, we need to remember that antitrust is the means, not the end. Rather, the end is undistorted competition driven by "king" -- and I would say "and queen" -- consumer, and the challenge is to keep competition undistorted while not distorting it ourselves in the process.

So, I thank you again for attending the opening of these hearings, and we look forward to all of your contributions. Thank you very much.

(Applause.)

MR. BLUMENTHAL: Thank you, Chairman.

General Barnett?

MR. BARNETT: I am going to attempt to be somewhat high-tech here. We will see if it works. Ah.

I want to thank, first off, the FTC for hosting the first of these hearings on Section 2 and for their help in organizing and planning and discussing the issues that have brought us together. Both Chairman Majoras, as well as the other FTC Commissioners and the FTC staff, have all been extraordinarily helpful, and I want to thank all of you as well as the Antitrust Division staff who have worked very hard to prepare for the session today and who will continue to work hard over the months ahead.

I also want to thank Herb and Dennis for agreeing to be with us. I feel very honored to have such distinguished commentators, and feel that it is a terrific start to these important hearings.

I am going to start with the same issue that Debbie started with, which is why are we sponsoring these hearings? And I can tell you up front, much of what you are going to hear will echo some of what Debbie said, but it was done unilaterally and without consultation, and so I hope you will judge it at least under the Section 2 standard, not under Section 1.

We do feel that it is important. As Debbie said, unilateral conduct can harm consumer welfare. I think there is a consensus that the focus of the antitrust laws in the United States is to preserve and promote or prevent harm to consumer welfare and that unilateral conduct is an important element of that.

I also agree that this is the area of probably the least consensus. I think there are large areas of consensus within Section 2, but there are significant areas where I think we have room for further understanding.

These hearings, with the combination of legal, economic, business and governmental/private perspectives, provide us with a unique opportunity to advance our understanding, and I believe that that will help us to advance the development of the law. It can provide helpful guidance to the courts, guidance to the business community, and as Debbie quite eloquently put it, to the international community that is now focused on this issue.

There is a long tradition of the agencies leading the development of competition law. I need only point to Don Turner and the 1968 Merger Guidelines and the formulation by Bill Baxter in 1982 to provide an example of what has become the standard reference for analyzing mergers, not only in U.S. courts, but really around the world in many ways.

With respect to the international community, again, I do want to both echo and underscore what Debbie said. This is an issue that is at the forefront of people's minds as we talk to officials on every continent, and one example that sort of helped drive this point home a bit, I was at a conference a while ago in Budapest of Southeastern European former Soviet block countries, and we were talking about a topic that the Antitrust Division often talks about, which is the importance of cartel enforcement, and one of the officials approached me at a break and said, "I agree with you, cartels are a terrible thing. I just wish that our markets had enough participants so that they could collude together. They don't have anyone to collude with. So, we are focused on this dominant former state-owned enterprise and how we can introduce competition into this economy." It just drove home for me, at least, the importance of this issue. It is important here, but I think its importance abroad cannot be over-emphasized.

The Supreme Court, to its credit, addressed the issue of monopoly 96 years ago. That is when it decided the Standard Oil case, and while we think of it as a rule of reason case, it did talk about the three evils of monopoly. It talked about first the power to fix price and thereby injure the public; second, the power of enabling a limitation on production; and third, the danger of deterioration in quality of the monopolized article, which it deemed was the inevitable result of the monopolistic control of its production. Price increases, output reductions, quality deterioration, those are still the same three touchstones that we look to that you heard Debbie talk about that go all the way back to the Supreme Court's discussion of the issue in 1910.

As we have talked about it in the 96 years since that decision, there has emerged I would say sort of a dichotomy or two different views of monopoly. While we would all agree that they can have their evils, and this was articulated in part by John Hicks in 1935, who talked about the evils of monopoly in the terms of a quiet life. He talked about the fact that the monopolist may not be out there trying to get the highest price he absolutely can get, maximizing in the short term the most profit that he or she can get, but really, it is the lack of competitive zeal, the ability to sit back and relax, to not have to research, develop, to innovate at a frantic level. That is a major harm of monopoly, and that is something on which we are very focused in terms of preventing.

Now, at the same time, the Supreme Court just last year articulated a different view of monopoly. In the Trinko decision, the Court said, "The mere possession of monopoly power and the concomitant charging of monopoly prices is not only not unlawful, it is an important element of the free market system. The opportunity to charge monopoly prices, at least for a short period, is what attracts business acumen in the first place. It induces risk-taking that produces innovation and economic growth."

All the way back in 1942, in Capitalism, Socialism and Democracy, Joseph Schumpeter talked about a similar process called creative destruction or the gales of creative destruction, and I compliment my staff who came up with the tornado there, but I have always, since I read this in college, this -- be careful of the gale behind you -- I have always liked this image, because it talks about how the marketplace is a rough place. It involves vigorous aggressive activity, people fail, people are driven out of business, but it is through that destructive process that you get creation.

Indeed, a similar image I was thinking about recently, when somebody was talking to me about the National Forest Service, I grew up watching the commercials about Smokey the Bear and how forest fires were such a terrible thing. How could we be against forest fires? It turns out the National Park Service realizes that preventing forest fires can be a bad thing; that if you prevent them for too long, you create much bigger, larger, hotter fires that cause more permanent destruction to the ecosystem when they do occur. Periodic smaller fires are actually a good and healthy part of the process. That to me is another illustration of this basic image. Competitive, creative destruction in the marketplace is something that we want to preserve and protect, not chill along the lines that Debbie was talking about.

So, how do we reconcile these two views of a monopoly, as a bad thing that causes sloth and relaxation and a lack of competitive drive versus the benefits of creative destruction, the opportunity to get to a monopoly? Well, this somewhat conflicting view was illustrated in a book written in 1964, and this was R.W. Grant expressing some frustration about the treatment of monopolies, and I will read this to you in a moment, but the basic story here is of a man named Tom Smith who invents a bread machine. It will produce terrific bread, it will slice it, it will wrap it, all for less than a penny a loaf, and as you can imagine, he very shortly owns the market for bread in the United States and is making large sums of money. He is ultimately, however, brought low by the men of antitrust who bring an antitrust case against him for making too much money on the backs of consumers and driving everybody else out of business, and he crafts a poem here to illustrate this frustration.

"You're gouging on your prices
if you charge more than the rest
But it's unfair competition
if you think you can charge less!
A second point that we would make
to help avoid confusion:
Don't try to charge the same amount!
That would be collusion.
You must compete -- but not too much
for if you do, you see
then the market would be yours --
and that would be monopoly!

It's very similar in many ways to the admonition of Learned Hand in the Alcoa case who said that the successful competitor, having been urged to compete, must not be turned upon when he or she succeeds.

So, having expressed that frustration back in the 1940s and 1960s, where are we today? One of our esteemed both I would say academics and judicial members of the antitrust community, Richard Posner, Judge Posner, remarked just last year, "Antitrust policy toward 'unilateral abuses of market power' is 'the biggest substantive issue facing antitrust today.'"

And if I can, if you will excuse me, preempt Herb possibly, last year Herb is quoted or wrote, "Notwithstanding a century of litigation," 96 years since the Standard Oil decision, "the scope and the meaning of exclusionary conduct under the Sherman Act remain poorly defined."

Now, there are areas where I think there are relatively easy answers. Doug Melamed has written about the concept of naked exclusionary practices. I mean, if you blow up your competitor's factory, few of us would find that to be defensible conduct. That's a fairly easy case for not finding liability. I also think there are some fairly easy candidates for safe harbor provisions. If you engage in conduct that merely reduces your cost of production, that seems to me beneficial to consumer welfare.

The difficulty lies in cases, as Debbie referenced, that have the potential for both beneficial cost reductions, innovation, development, integration, and at the same time potentially anticompetitive exclusion. How do we deal with those situations?

Well, some relatively recent Supreme Court decisions have shown progress in this direction. In the

Brooke Group case, which is, of course, a predatory pricing case, it dealt specifically with the issue of recoupment and holding that Liggett in that case had not shown the opportunity or the ability to recoup, but the case in my view, at least, stands for more than that and discusses, for example, specifically how harm to a competitor does not demonstrate harm to competition. There was little doubt in that case that there were discount programs aimed at and/or that had a harmful effect on Liggett, but the Court was quite clear that as long as that does not harm competition, that is not an antitrust problem.

Second, the Court also talked about the practical ability of a judicial tribunal to regulate a problem and avoid chilling legitimate price cutting. It's recognizing the limitations of the body that is administering the law. I would expand that to include the limitations of agencies as well as courts, but it's certainly a relevant consideration, and recognizing that aggressive price cutting can be beneficial for consumers and we do not want to chill it. Thus, it created effectively a safe harbor against predatory pricing claims where the prices were above some appropriate measure of cost.

And the Court expressly acknowledged in creating the safe harbor that there was at least the theoretical possibility that there could be harm to consumers, harm to consumer welfare, from some above-cost pricing, but recognizing it was likely to do more harm than good to try to ferret out those individual cases.

More recently, in the Trinko decision, the Court obviously had a somewhat more limited holding but discussed on a broader basis some of these same similar Section 2 issues. It underscored the need for administrable rules, clear objective standards. It talked about the fact that being able to craft a remedy that is both clear and administrable by the Court is very important, endorsing Professor Areeda, in that no court should impose a duty to deal that it cannot explain or adequately and reasonably supervise, and implicitly, at least, that not all problems may have antitrust solutions.

While I think there are many areas of consensus, there are many areas where we have a lot to learn. As Debbie indicated, our panels are going to focus on different aspects of conduct. We will start on Thursday with a panel discussing predatory pricing and predatory buying. Brooke Group answered a lot of questions. It did not answer, among other things, what is the appropriate measure of cost? Is it marginal cost? Is it average cost? Is it average avoidable cost? Is it average total cost? There has been a lot of discussion about that, and we are looking forward to hearing people's views on that.

The question on predatory pricing or remedy, are you going to enjoin lower pricing? Weyerhaeuser is a case with which you may be familiar. There's a cert petition pending before the Supreme Court right now. It involves a predatory bidding situation. The Solicitor General's Office has filed an amicus brief on this front encouraging the Court to take cert and to examine it. I view it, at least, as an opportunity for the Court to reaffirm in the Section 2 context that clear and objective standards are extraordinarily important. There's a jury instruction at issue in this case that talks about prices that are unfair or unnecessarily high. This is an opportunity for the Court to make clear that a jury's post hoc determination of what it believes was unfair is not the appropriate criteria for determining whether or not there should be Section 2 liability.

Refusals to deal will follow. Again, this raises very significant issues. When, if ever, should a firm be compelled to deal with a competitor? If you are compelled to deal, under what terms and conditions?

Will the Court be able to administer it? A range of issues which we are, again, looking forward to hearing the experts' views on it.

Loyalty discounts, another area that we will be looking at. A couple of years ago, the United States urged the Supreme Court not to take cert in the LePage's case. That involved bundled discounts. That was not because we necessarily agreed with the Third Circuit's decision or analysis. Indeed, if you parse that decision, I think it is very difficult to come up with a clear standard of liability. There has been, in the wake of LePage's, a flurry of attention by academics, by legal scholars, on this issue of bundled discounts, loyalty discounts, and we are looking and hoping to see whether or not any consensus has developed on any of these issues.

Should it be viewed as a predatory pricing tactic, as exclusive dealing, as a tying tactic? Are there safe harbors that can be developed even if we cannot develop a single, clear answer for all cases? Tying and exclusive dealing, Debbie mentioned that you sometimes, when you see things in a competitive market, that ought to make you question whether or not there are benefits associated with it. Tying and exclusive dealing can have anticompetitive effects. Look at our

Dentsply case as a recent example. By the same token, we see these practices in competitive markets, and we need to better understand what benefits there are and when there are not.

Towards the end of the year, we expect to turn toward some more general principles. Is there an overarching standard for Section 2 cases and liability? We all agree that consumer welfare is an appropriate standard. Trying to operationalize that in a particular case with particular conduct is more challenging, and there is less agreement on that. Debbie outlined the range of potential tests. The Antitrust Division in a number of recent cases looked to the no-economic-sense test. As I have talked with people about that, one issue that I find is that people have different ideas of what the test is. So, over and above discussing what the appropriate test ought to be, there is some confusion about what is meant in terms of what are you going to look at and what the rules are. That may be part of the semantic difference that Debbie was referencing. Clarifying some of those things as well as the underlying substantive issues I think can be beneficial.

We may look at the issue of whether there are different duties or different criteria for tying claims under Section 3 of the Clayton Act versus Section 1 or Section 2 of the Sherman Act.

Here, I have two reasons for putting this up. As you can see, this associate is responding to a request, "I'll be happy to give you innovative thinking. What are your guidelines?" An example of having too cabined an approach, too narrow a guidelines can be the antithesis of innovative thinking, can restrain the benefits that you may achieve through your innovation and development. That is part of the creative destruction that we want to encourage, not discourage, as this cartoon suggests may be happening. So, I raise that to say that while I am now going to talk about six possible principles to inform our discussions, I do not mean them to cabin or prevent a wide-ranging, open and frank exchange of ideas.

So, first off, individual firms with market monopoly power can act anticompetitively and harm consumer welfare, and we should seek to identify and prosecute such conduct. This is an important first principle. If it were not true, we could just abolish Section 2. That is not what we are here to do. We are here to better focus and identify those instances where there really is harm to consumer welfare.

Second, mere size, mere market share, does not necessarily demonstrate competitive harm. It can demonstrate superior acumen, effort, zeal, et cetera.

Third, injury to competitors does not demonstrate competitive harm, a point that has been talked about in a number of contexts.

Fourth, the need for clear, objective and administrable rules, so that businesses, at the time they are taking actions, can understand where the lines are and can conform their behavior so they are not deterred from engaging in procompetitive activity, so that courts are not asked to do things that are beyond their competence, and that agencies can do the same.

Fifth, avoid chilling procompetitive conduct, and certainly an interrelated point, self-explanatory.

And finally, the remedy must promote competition. A remedy that harms competition can be worse than no remedy at all, an important point worthy of bearing in mind.

Again, I want to thank the FTC, our panelists for agreeing to kick off these hearings. We will continue again on Thursday. We very much are interested in a free, open and wide-ranging discussion of these issues and are excited about the prospect.

With that, I will turn it over to Herb.

(Applause.)

DR. HOVENKAMP: Thank you. I am very grateful and appreciative of being invited here, with particular thanks to Chairperson Majoras and General Barnett for extending this invitation.

In keeping with the thrust of this opening meeting, which I believe is quite general, what I would like to do is give kind of an overview of where I think the fault lines and concerns in Section 2 lie. In the future, future hearings, you are going to hear about specific practices such as predatory pricing or refusals to deal in considerable detail, and I am not going to do that today. I am going to go through them rather quickly and just point out where I think work needs to be done and where the FTC and the Antitrust Division and private litigants can use some clarification and understanding.

I am going to divide my talk into three parts, though the parts are not equal in size. First, a very short one on market power or monopoly power, then a rather long one on conduct issues, and then finally, a much shorter one again on remedies.

With respect to power, the Merger Guidelines, in particular the 1992 Merger Guidelines, the series of guidelines that began with 1984, did a remarkable job of rationalizing and simplifying the approach to market delineation and assessment of the potential for collusion or other types of anticompetitive behavior that grow out of mergers. Some portions of the Merger Guidelines market delineation sections are relevant to Section 2 enforcement, but many are not, because the question that one asks in a Section 2 case is fundamentally different from the one that one asks in a merger case.

In a merger case, we generally start out with the presumption that a market is more or less competitive, it may be oligopolistic or moderately competitive prior to the merger, and what we really want to know is whether the quality of competition is going to deteriorate as a consequence of the merger. In keeping with that, the SSNIP test, small but significant nontransitory increase in price test, considers whether a further increase in price would cause new entry or other situations that would make this future price increase unsustainable.

In a Section 2 case, by contrast, the opening presumption is that the defendant or the firm under examination is already a monopolist, is already charging monopoly prices, and as a result, the SSNIP test is really not the appropriate one in most circumstances, although it certainly could be relevant in certain cases like those involving an attempt to monopolize where the defendant is not a monopolist at the time the conduct is being assessed.

I do not have a solution to propose here. Those of you who are familiar with this area know that this involves something that in monopolization law we call the Cellophane fallacy or the fallacy of inferring that a firm lacks power because there is high cross-elasticity of demand with the products of others at current market prices, and, of course, if you multiply that examination by asking what the response would be to a yet further increase by a firm that is already a monopolist, you might very well conclude that the firm lacks this type of market power, because in response to a yet further price increase, there would be so much substitution away from the dominant firm's product that the price increase would be unprofitable.

Well, if you took that approach, you would be committing an error; namely, you would be ignoring the fact that that firm is already a monopolist and presumably already charging its profit-maximizing price. So, I think one of the things that ought to be of concern to the agencies as they go through these hearings is to pay some special attention to the formulation of usable presumptions that single firms can use for assessing whether they have individual market power and thus can be made liable to a Section 2 inquiry.

Let me just add to that, that that may involve certain approaches that we have more or less given short shrift to or rejected in the past. For example, it may mean that we will not look at residual elasticity of demand, which looks at the existing power that firms have. We may have to look at things like price-cost margins or rates of return. Some of these approaches have been discredited in the past, but that does not mean that they cannot be rehabilitated.

Okay, I want to spend a little more time on monopolizing conduct. I am going to open by giving the definition of monopolizing conduct from The Antitrust Law Treatise that I am privileged to write, because it is very general, has a number of flaws, but nevertheless, I happen to like it for reasons I will explain in a little while. The Antitrust Law Treatise defines exclusionary conduct as conduct that is, number one, reasonably capable of creating, enlarging or prolonging monopoly power by impairing the opportunities of rivals; and two, that either does not benefit consumers at all or is unnecessary for the particular consumer benefits that the acts produce; or three, produces harms that are disproportionate to the benefits; and finally, the assessment of the conduct must be within the administrative capacity of the antitrust tribunal.

Like I say, that test is very general. It is not particularly helpful to assessing particular instances of exclusionary conduct if it is the only thing you have. You certainly would not want to give a jury that test as an instruction and shut them up with no further instruction and ask whether the defendant's conduct was exclusionary, but the test was never intended that way. It was, in fact, designed to be a basic principle to be used in conjunction with specific rules for specific types of antitrust cases, and it is my view that that is fundamentally what Section 2 conduct jurisprudence needs to do.

I think there are very, very helpful general tests. I like Greg Werden's no-economic-sense test. I think there is much to be said for it. I think it produces a few false negatives. Nevertheless, it's a very, very good starting point. I like Judge Posner's test that Chairperson Majoras mentioned in her talk, which is conduct which under the circumstances is capable of excluding an equally efficient rival. Once again, I think it produces a few too many false negatives, but they are good starting places.

However, none of them is a substitute for the formulation of good technical rules covering individual types of conduct; namely, pricing, abuses of the intellectual property system, refusals to deal and so on, okay?

In the few minutes I have, I cannot do any more than scratch the surface, but I would like to give you just a few observations about where we are in various areas involving specific exclusionary practices and where I think some of the problems lie.

With respect to predatory pricing, I believe that both the Areeda-Turner test, as it was formulated in 1975 and has later been incorporated into The Antitrust Law Treatise, plus the elaboration of the recoupment requirement in the Brooke Group case in 1993, fundamentally set predatory pricing law on the right track. I am a strong believer in the view that prices must be below some measure of cost. Furthermore, they must be below some measure of incremental cost; that is, pricing is driven by concerns for variable costs, not principally by fixed costs. That does not mean that there are not a few problems.

One problem that I think needs to be assessed is the problem of predatory pricing in oligopoly industries by nondominant firms. That was, in fact, the facts of Brooke Group. Strictly speaking, that may not be a Section 2 issue. In fact, it may be an issue where the Justice Department might reconsider its long-standing opposition to bringing Robinson-Patman Act suits since the late 1970s report on the Robinson-Patman Act and create an exception for primary line enforcement given the premise that with respect to primary line enforcement, the principles that the Court follows are basically the principles that are laid out in the Sherman Act, and as a result, all of the overreaching that applies to secondary line enforcement of the Robinson-Patman Act need not apply here.

The problem with predatory pricing and oligopoly is that victims have a different set of incentives than they do in monopoly. Predatory pricing as a Section 2 problem involves predatory pricing designed to destroy a rival. That is a very, very difficult thing to do. The rival clearly has incentives to resist.

On the other hand, predatory pricing and oligopoly frequently is used simply to enforce or bring the oligopoly back into order so that the noncompliant firm will once again raise its price to the oligopoly levels; that is, the set of incentives that the target of predatory pricing and oligopoly has are incentives to rejoin, start making profits once again. As a result, I believe predatory pricing in oligopoly industries is fundamentally a more plausible strategy than strict monopoly predatory pricing, and I think it needs to be given somewhat closer scrutiny.

The other problem has to do with the measurement of relevant costs. As I said before, I think the proper measure of cost is incremental cost, which can mean short-run marginal cost, short-run marginal cost with some kind of additional factor for depreciable long-term assets. It can mean average variable cost, as it was in the Areeda-Turner formulation. The average variable cost tests or the marginal cost tests simply don't work very well in certain kinds of markets that have very high fixed cost components and particularly in markets that are characterized by a lot of intellectual property or certain kinds of public utility or transportation markets, such as the airline industry.

I think Ken Elzinga's analysis in the Spirit Airlines case last year in the Sixth Circuit was a very good first step, but the Government shouldn't be losing predatory pricing cases in the airline industry. It is the one industry where predatory pricing claims seem plausible, and some attention needs to be paid to modifying or, if necessary, rejecting and adopting a different cost test for such industries.

On the Weyerhaeuser case and predatory buying, I am one of the critics. I hope the Supreme Court sees fit to follow the SG and grant cert. I think the instruction that General Barnett described that permitted a jury to find simply that predatory buying occurs when the defendant pays too much or more than a fair price is an atrocity. I think few people fully appreciate how frequently such situations can come up; that is, buying of inputs during times of scarcity. This is not going to be an idiosyncratic situation. This kind of case will come up a lot if the Ninth Circuit's decision is permitted to stand.

Now, having said that, the question is what kind of test to come up with. Well, in the Weyerhaeuser case, where first of all the timber at issue accounted for some 60 or 70 percent of the value of the finished hardwood, and secondly, where at least according to the jury, the hardwood was resold in a competitive market, I think an average variable cost test might work quite well; that is, buying is predatory if it forces the defendant's resale prices to below its costs.

I am a little troubled by the use of an average variable cost or marginal cost test, however, in a situation where, number one, the defendant may sell in an oligopoly, and number two, where the input on which predatory buying is claimed is a relatively low proportion of the value of the finished product, because in that case, the variation in purchase might actually fall within the margins that the firm charges, that it is going to be too hard to detect predatory buying in cases where the value of the purchased input is only a tiny proportion of the value of the finished product.

In all cases, however, I believe that there should be a recoupment requirement equivalent to that in Brooke Group and that the Ninth Circuit erred not only in its failure to require a showing of prices below cost, but also in its failure to require a fairly strict showing of recoupment.

With respect to patents, there is too much to say and too little time. I just want to make one fairly general observation. Mr. Barnett mentioned Joseph Schumpeter's Capitalism, Socialism and Democracy, this very, very important book in 1942 which opined in the chapter on creative destruction that the amount of welfare contributed to the economy through innovation is far, far greater than the amount contributed by moderate movements from oligopoly to competitive industries. I mean, Schumpeter basically looked at the prior half century or so of development as a result of the second industrial revolution, of the theorizing of economists like Edward Chamberlin and Joan Robinson, who were very upset about oligopoly and imperfections in the economy, and said, "You'd think to listen to these people that American consumers were much, much impoverished compared to their position in the 1870s, and, in fact, nothing could be further from the truth."

Well, where do all those gains come from if we are now in this oligopolistic era? And one of the things Schumpeter concluded is that they came from innovation. Schumpeter's premises were formalized and given empirical support in Robert Solo's work in the 1950s in which Solo himself concluded that as much as 80 percent of economic gain comes from innovation rather than simple improvements in price-cost relationships.

Now, neither Schumpeter nor Solo was talking about IP law. They were talking about innovation, and, of course, there is this enormous lingering question out there of whether the IP laws we have are sufficient to facilitate the optimal amount of innovation or whether they, in fact, may hinder innovation. Fundamentally, that is not antitrust's problem. The antitrust laws need to accept the existing IP laws, warts and all, and I personally believe there are a fair number of warts.

One thing, however, that that work suggests is that antitrust needs to be much more concerned with restraints on innovation. We have generally measured harm in the antitrust laws by looking at price-cost relationships, deviations from marginal cost pricing. Harm to innovation is always included kind of as an afterthought, but it has never been very well formalized into our models of harm, and actually, there are pretty good reasons for that. We have very good rules for determining when prices deviate from marginal costs and what the price elasticities facing firms are. Predicting the consequences of restraints on innovation is far more difficult, because innovation always takes us by surprise.

We will never know, for example, what the consequences were of Microsoft's successful attempts to get Intel to stop developing a Java-enabled chip. How good would it have been? Would it have done all the things that Bill Gates feared in commoditizing the platform market and so on? Those are very hard things to predict, and for that reason, I believe courts are rightfully skeptical when they turn away private plaintiffs who claim that the injury that they suffer is an injury caused by a lack of innovation.

So, I believe this is one area where the Government should move into the fore, because they do not need to prove damages, they do not need to prove causation in the strict private plaintiff sense. I think restraints on innovation are something that need far more development in Section 2 law than they have received in the past.

With respect to vertical exclusion, I just have a couple of comments. First of all, there has been a not so subtle move over the last four or five years in government enforcement to move away from Section 1 of the Sherman Act and Section 3 of the Clayton Act and towards Section 2 of the Sherman Act as a device for enforcing laws against tying or tying-like practices and exclusive dealing, and I believe that is the correct movement. Fundamentally, tying and exclusive dealing ought to be regarded as dominant firm exclusionary practices. They are rarely anticompetitive at nondominant levels, and fundamentally, they do not depend on agreement in any meaningful sense of the word. Unlike resale price maintenance or Sylvania-style restraints, they are typically not the product of bargaining and traditional agreement between dealers and manufacturers.

No, most tying and most exclusive dealing is imposed by manufacturers unilaterally on dealers. The dealers generally do not like it, but they accept it as the price of a dealership. It ought to be treated as an exclusionary practice, number one. The agreement requirements really get in the way of appropriate analysis of tying and exclusive dealing in most situations. And finally, the market power requirement should be equivalent to those that we assess in monopolization cases.

So, I laud the increased scrutiny of tying and exclusive dealing under Section 2 of the Sherman Act. Microsoft included both, but the Government won on its Section 2 tying claims. Dentsply, of course, the exclusive dealing case that the Government won a year or two ago, was a Section 2 case.

On bundled discount -- you are going to have a big hearing on these, right? You are going to talk about bundled discounts a lot? Are they predatory pricing or are they tying? I think they are a little bit of both, and I think the way to analyze them is by asking two questions in two different stages.

The first question you ask is, are two goods subject to a bundled discount bundled together? Well, what does that mean? Well, it means that an equally efficient firm that offered only one of them could not match the bundled offer. How do you get there? Well, as several papers have shown, you basically attribute the entire discount to the product upon which exclusion is claimed, and then you ask whether the price of that product, subject to the full discount, has fallen below a relevant measure of cost, whatever cost measure you would use in a predatory pricing case, okay?

That gets you to bundling; that is, that predatory pricing test gets you an answer to the question, are the two firms -- are the two products bundled together? And if the answer is that no equally efficient firm that offered only one of the products can match the price, then they are bundled together, but that is only the beginning rather than the end of the inquiry. Tying is explicit bundling of products together, and yet most tying is perfectly legal. So, once we have decided that two products are bundled together, we have yet a further set of questions to ask about whether there is foreclosure, whether the foreclosure is justified under the circumstances by cost reductions, improvements in consumer satisfaction, quality control, in many instances price discrimination, and so on.

Finally, on conduct, on refusals to deal, my suggestion is that the Government simply get out of the business of enforcing the law against simple refusals to deal. Now, conditional refusals are something else.

Conditions usually mean exclusive dealing or tying. Lots of things, including price fixing, can amount to conditional refusals to deal, but if we are talking about simple refusals to deal in the Trinko or Aspen sense, I think the administrative problems are so horrific, the disincentives created to competitive behavior are so substantial, that the best thing that the Government can do is stay away, and, in fact, that is pretty much what they have been doing, even going so far as to support the defendants in the Trinko case.

Okay, then let me turn finally and very briefly to the subject of remedies. Both General Barnett and Debbie Majoras spoke at some length about the importance of remedy. I simply want to underscore what they said. In fact, I would go a little bit further and say that every Section 2 action that the Government brings ought to begin with an exit strategy, right? We have talked about Iraq, we have talked about exit strategies, and now we have discovered that whatever exit strategy we have, we probably could have had a better one, and the same thing applies to Section 2.

Section 2 has no moral content. The only purpose in bringing these cases is to make the economy work better, and if you do not have a clear picture of the kind of remedy you want when you go in, then you really have to wonder whether it is worth bringing the action to begin with.

For a long, long period of our history, beginning with Standard Oil and through the 1960s, the preferred remedies were structural or mandatory breakup of firms. For relatively good reasons, those kinds of remedies have fallen into some disrepute. Many of them were very, very poorly designed. For example, the remedy in the United Machinery case, which may have ruined the firm, although there was some good evidence that USM's technology in its Beverly, Massachusetts plant was pretty obsolete already to begin with, or remedies like the one in Grinnell, which didn't really break up the monopoly at all, but just divided up the market into a whole bunch of little monopolies.

Today, we operate in a regime in which structural remedies in Section 2 cases appear to be disfavored; conduct remedies are preferred. Unfortunately, I think the record that we are developing with respect to conduct remedies is not much better than the record we developed with respect to structural remedies in the 1960s and earlier. I think the verdict is still out on the Microsoft remedy, largely because of the two-year extension, but once that time period has run, we have to look back and say, "Well, exactly what did we accomplish here in terms of making this market more competitive? And to the extent the market is more competitive, to what extent was it owed to the remedy?"

I would like to see some more serious attention be paid once again to structural remedies or at least modified structural remedies, things like compulsory licensing, as mechanisms for restoring competition. Compulsory licensing is a dirty word in the United States when we are talking about general forcing of firms to share their patents, but that is not what we are talking about here. We are talking about proven antitrust violators who are frequently forced to give up their plants and other kinds of hardware. Compulsory licensing under that set of circumstances is a perfectly viable remedy, and I would like to see us use it much more seriously than we have in the past.

I am afraid I have gone over my time, and so I will turn the floor over to Professor Carlton. Thank you.

(Applause.)

DR. CARLTON: Okay, thank you. It is a pleasure to be here, and I express my appreciation to the organizers for inviting me, and I am honored to sit with such distinguished panelists.

Exclusionary conduct is an important policy topic. There is a great amount of debate as to what is an exclusionary act and how to deal with it. There is much less consensus on what bad acts are and how to adjudicate them in the context of Section 2 claims, than, for example, what cartel behavior is or how to handle cartl claims. The real problem is that competition harms rivals just like exclusionary behavior, and it is sometimes easy to confuse the two.

As a general matter, it is very hard to study what should be the optimal policy for exclusionary conduct. The reason, one reason, is that the biggest effect of any antitrust policy is likely to be, not on litigants in litigated cases, but rather, on firms that are not involved in litigation at all but are forced to change their business behavior in contemplation of legal rules. That means that although it is definitely informative for economists and lawyers to study the outcome of individual cases and you can learn a lot -- did the court get it right, did they get it wrong -- that is not really a study of antitrust policy.

To appropriately do a study of antitrust policy, you have to look at either times when the antitrust laws were adjudicated differently, that is, there was a different policy, or perhaps you have to look at different countries, and that is hard to do. Looking at litigated cases will give you a biased view. They are very self-selected cases and really will not allow you to focus on what may well be the biggest costs of an antitrust policy, and that is, the chilling effect it has on the behavior of nonlitigants.

Since this is an introductory panel, one of the advantages you get is you can yell out these hard questions, and then when they are not answered by the end, you can say, "See, you didn't answer my question," so I am not suggesting I have a simple answer. I am just saying here that this is actually a quite important problem and definitely deserves some research time.

What I will talk about today and on which I think I do have some answers are two topics. One has to do with the profit sacrifice test, or its variant, the no-economic-sense test, and the other has to do with market definition. Each of those is used or proposed to be used as a tool to uncover Section 2 violations.

Now, it is important to distinguish a tool from an objective. The objective is to maximize consumer welfare, and whether when I say consumer welfare, I mean consumer plus producer surplus or just consumer surplus, that is a debate we can hold for another time. It does not matter to the remarks I am going to make.

The tools you choose are used to identify acts that harm welfare. Now, the use of tools necessarily entails errors. You are going to have false negatives and false positives. It is going to happen because, one, you do not always have perfect information. Even if you are the smartest economist, you make errors, and if you are a juror who knows no economics, you might make errors, and second, the tools are not quite the same as the objective. So, the tools will differ from the objectives sometimes, so there definitely will be errors, and the real question is whether and when tools should be used.

From an economic point of view, the question of whether a particular act harmed consumers is a very well-posed question that I could, for example, assign to a Ph.D. student writing his thesis, and that person could go about trying to answer it with economic tools and econometric tools. Now, it is true it sometimes may be hard for that person to reach an answer, especially if there is both an efficiency effect and an exclusionary effect on rivals, but sometimes it will not be so hard, okay, but it is a well-posed question.

Now, from a policy perspective, the DOJ and the FTC, with their staffs of knowledgeable economists and attorneys, should be focusing on answering the direct question, is there harm to welfare, and not on the use of possible tools, though obviously they need, especially if they are going to think about litigation, they need to worry how judges and juries will use whatever tools they are told to use when a case is litigated.

Now, matters change as the inquiry shifts away from the government agencies to courts with judges and juries who may have less economic sophistication, and their simple but imperfect rules may be better than an unstructured inquiry, but simple rules should not be viewed as anything but simple rules, crude guides that sometimes work for some acts, but not all. It can be dangerous to use a simple rule that could ultimately subvert the goal of maximizing welfare.

Now, let me turn to first the profit sacrifice test and then to market definition. The profit sacrifice test, or a close relative, the no-economic-sense test, asks would the act make sense but for its exclusionary effect? And that test may work fine in the hands of some of its accomplished proponents, and in particular, I have in mind Greg Werden, who is sitting here in the audience. My hunch is if I sit down with Greg and we are talking about an exclusionary act, we are going to reach agreement nine times out of ten, and he is aware of the limitations of the test and would carve out exceptions so it would not be misused.

What I worry about is when there is someone implementing the test who is not as smart as Greg. Suppose they have a judge or a jury who is not an economist? What worries me about the test is that it raises all the danger signs associated with possibly confusing competition with exclusionary conduct. Let me try and explain why, and I will give you two or three reasons.

First, all strategic behavior -- and every business school teaches this -- all strategic behavior is designed to improve one firm's position relative to the other one. It is relative position that matters, and that is what is going to often determine the outcome of a competitive battle. Investments in advertising, investments in R&D, price discounts, all of these could mistakenly and easily be condemned by jurors convinced that the firm engaged in the act could have been more accommodating, less exclusionary. That "but for" standard -- that is, would the act make sense but for the exclusionary effect -- that hypothetical thought experiment is actually quite a difficult one to implement. That does not mean if you are measuring harm to consumer welfare that you can necessarily get around it. Maybe it is unavoidable sometimes, but I am worried when you are postulating the "but for" the exclusionary conduct, what hypothetical world will you be proposing, and what worries me is there could be a very high error rate associated with application of that rule.

The second reason I am worried about it is because of the way it is formulated: Does it make economic sense to engage in this behavior? Now, Ronald Coase, one of my colleagues at the University of Chicago, always fond of explaining how little economists know about business and that businessmen really know a lot about business, and just because an economist cannot understand an action or a jury cannot understand an action, he said why should that create antitrust liability for the poor firm? And that I think is a serious concern.

The profit sacrifice test may sometimes work and may be appropriate for some actions, but I think it is dangerous to enshrine it as a general proposition. It strikes me as much more appropriate to devise tests and screens that fit particular exclusionary acts, especially because under Section 2 we have a range of such widely different behavior that people have attacked as exclusionary, so many different acts fall under Section 2, and with each act, I would be concerned as to how the legal treatment of the act is creating special risks for chilling competitive behavior, and that is going to differ from act to act to act.

So, for example, to pick up on what Herb was saying, let us suppose you are looking at an industry that is undergoing rapid technological change, and there is an exclusionary claim that the way the product was designed is a problem. Well, you have to worry in that instance whether you are depriving consumers of a new product if you attack the firm for its product design, and that can lead to large losses. So, in that situation, I might want to give more weight to the firm's efficiency claim for fear of causing a large dead weight loss than in other situations.

Let me give you a second example. Let's talk about the Areeda-Turner test for predatory pricing. Basically that's a test that says if your price is below some measure of cost, unless it is, I am not going to worry. So, the implicit idea is that if you see price below some measure of cost, that is a big enough deviation from what we usually think of as profit maximization that there is something fishy, and the reason they chose price below a cost as the predation standard rather than above-cost pricing is because they were very worried about chilling competition that drives price down. So, they were specifically worried in the context of predatory pricing of erroneous behavior, of erroneous condemnation, which then would chill competition, very specialized to the predatory act, okay? Not a general principle.

If you misread it, what the Areeda-Turner test said, you could misread it as follows: You could say, ah, price below cost, the firm is not profit-maximizing. If the firm is not profit-maximizing, there is something fishy going on, that's a violation. Now, if you read it that way, which would be an incorrect way to read it, that is saying that any deviation from profit-maximizing behavior would be an antitrust violation, and that would make me nervous. That is the concern I have about a profit sacrifice test, because if you are not maximizing profit, your failure to maximize profit is a sacrifice of profit, and I do not want get into the situation in which I claim that firms must be maximizing profit as I see it or it is an antitrust violation.

Now, you could remedy that. You could say, all right, I will not say you have to be exactly, I will give you a margin of error, but that is really my concern with the test, not that it is not in some situations useful, but that I would not want to enshrine it as a general principle.

Let me now turn to a market definition, which I was going to say I am sure you have heard a lot about and probably do not want to hear more about, and I was glad, though, that Herb did talk about it, because at least it confirmed in my view that someone else thinks it deserves still more thought.

But for the antitrust laws, industrial organization economists would not pay all that much attention as to how you define a market. I think it is fair to say that the reason it receives so much attention is precisely because it has been used as a screen or a requirement under our antitrust laws, and that is what gives it prominence.

Now, my own view is it is a very good but crude tool, and it has this intuition behind it that if there are lots of rivals, do not worry, and I think that is a very good common sense rule, but it is hard to apply in the non-merger context, and there have been attempts to apply it in the nonmerger context that at least sometimes strike me as odd. So, what I have seen in a number of cases is the application of the Merger Guidelines, and it goes something like this.

Define a market so that a hypothetical monopolist of those products can raise price 5 percent above the competitive level, the competitive price. In a merger case, it would be the current price, but since this is not a merger case, we say above the competitive price. Well, that is a very well-posed question, and in order to answer it, I have to say, "Okay, well, what is that competitive price?" Well, I do not know what the competitive price is. If I knew what the competitive price is, I could look and see, is the current price above the competitive price? And if it was, I would say, yes, it is above. I would not then have to define a market, take market shares and say, "Ah, you know, based on all this analysis, you know, 10 is above 5 when I started, and still, the market shares are so high now, I conclude 10 is above 5." So, there is a circularity to it that I find a little troubling. So, you cannot really directly answer the question, because the competitive price is not available. So, then, what do you do?

I think there are several alternatives. Herb mentioned some of them, and none of them I would say are completely satisfying. One alternative is to ignore the problem and simply say, "I am not going to use the competitive price, I am going to use the existing price," and Herb sort of indicated that this leads to the well-known what is called Cellophane fallacy in which it is possible that you will not find any market power at the current price, but you do have market power because you have already raised the price above the competitive level. That is one thing you can do, with its problems.

The second thing you can do is you could say, "Okay, let me ask the following: Is price above marginal cost where marginal cost I will use as my proxy for the competitive price?" Of course, that kind of replaces one question with the other, what is marginal cost? Well, maybe you can go out and try and measure marginal cost. If you had access to firm information, you could try and sift through accounting information, you could econometrically try and estimate a cost curve. It's difficult, okay?

Moreover, suppose you do find prices above marginal cost. You have to face the realistic possibility that most markets are not perfectly competitive. In most markets, price will not equal marginal cost; therefore, and what you presumably must mean, is that price deviates a lot from marginal cost if you are worried about such a deviation. The amount of deviation, the deviating a lot from marginal cost, has actually never been articulated that I have seen in a quantitative way.

Okay, suppose you do not like marginal cost. Is there something else you can do? Well, I think there is. Another thing you can do is you can ask, "Is the rate of return a firm is earning above the competitive rate?" We know what the competitive rate of return is. Is the rate of return the firm is earning above the competitive rate? This can be a difficult accounting exercise, or better put, this can be a difficult economic exercise using accounting data. You would have to ask over what period of time, how does my answer change depending on risk, not easy to do necessarily, likely to create a lot of controversy.

Finally, you could estimate the demand curve facing the firm, and the benefit of estimating the demand curve is you could determine the elasticity and the cross-elasticities that the firm is facing, and that I think gives you useful information about certain types of competition. It raises issues over what time period you estimate the demand curve, but all of those strike me as things you might be forced to do because the question you are trying to answer is really a very difficult one and does not admit a very simple answer.

Since time is running a little short, and I know we want to leave time for discussion, I will just mention two topics, and maybe we can come back to it in the panel discussion. What is the distinction between market power and monopoly power? And then second, what does it mean to have individual market power in an oligopoly?

Well, let me just conclude, screens can help but can also become a danger if one loses sight of the ultimate goal of maximizing consumer welfare. You should create rules to fit the act, paying special attention to how the rules applied to this particular act will chill competition.

The profit sacrifice test worries me a bit for the reasons I have explained, and I would use it sometimes but certainly not regard it as a general principle. With regard to market definition, I still think it is a useful discipline, especially when you get to court, for judges and juries to go through, because it helps structure the analysis, but there is an inherent lack of precision in its application in Section 2 cases that might be worrisome, and there may well be cases where its use could be misleading.

Thank you.

(Applause.)

MR. BLUMENTHAL: Well, thank you to the panel for very, very interesting perspectives. We have about 20 minutes for panel discussion, and because of airline schedules, we are going to have to end promptly at the appointed hour of 4:00, but I guess let me turn to the first two speakers, who are agency speakers, and ask whether you have any comments you would care to offer on the thoughts from either of the two professors.

CHAIRMAN MAJORAS: Wow, I have a lot that I could comment on. I thank both of them, because those were very thoughtful presentations, as we expected, and I very much appreciate that.

One thing that I was curious about is Herb's advice that the agencies should step in a bit more in looking at restraints on innovation, and I was wondering, Herb, if you had any particular hypothetical or context involved or if you can be even more critical of what we have not done in the past, if that is easier for you, in terms of where we could be looking for such a thing, because it is true that we constantly talk about promoting innovation and how important that is to our work and how important it is that we not inhibit it, but I find not only in enforcement but in forming policy and explaining to courts, it is very difficult for people to get their arms around it, because it is such an amorphous concept, and I am not sure we are very good at it.

DR. HOVENKAMP: It is an amorphous concept. In part, though -- and I think this is an important principle -- it is the one place where the IP laws and the antitrust laws tell the same story. We always talk about this tension between innovation and competition. It is hard to defend restraints on innovation when they are defined properly, and the fact is that the enforcement record has not given us cause for much hope. I can think of -- right now, off the top of my head, I can think of three situations.

One is the air pollution cartel cases of the 1970s. I suspect some of you have not been around long enough to remember those, but those were challenges by farmers, class action, brought by agricultural groups to an alleged agreement among the major automobile producers for restraining the development of engines that produce less pollution, and what they wanted to collect as damages was harm to their crops that accrued as a result.

Well, just stating it tells you why that antitrust case is not going to go anywhere, right? You would have to determine what was lost, you would have to determine what the impact of these more fuel-efficient engines would have been, how the farmers might have evaded it. It would be totally impossible for private plaintiffs to collect damages in such a case.

Another one is the series of cases, a fairly large number of cases, that made it to the circuits against the cigarette companies in the late 1990s alleging various cartels to refrain from developing healthier cigarettes. To the best of my knowledge, every single one of those cases was dismissed, at least the ones that went to the circuits, were dismissed on grounds of standing, causation, provable injury, maybe a couple of other reasons, but they all had to do with ability to prove injury.

Then, of course, there is the conclusion in Judge Jackson's Microsoft opinions, affirmed by the D.C. Circuit, that Microsoft's attempts to force Intel not to develop a Java-enabled chip, a chip that could have spoken multiple-processor languages, something that Bill Gates feared at the time, was unlawful, and that complaint allegation has actually been included in a few of the indirect purchaser cases against Microsoft, and to the best of my knowledge, not a single plaintiff has ever collected a dollar for those failures of innovation.

So, one of the problems is that restraints on innovation are very likely extraordinarily harmful if they occur. If so much of our economic growth comes from innovation, then restraints on innovation could, in fact, be very harmful.

Number two, because of the nature of innovation, because you can never predict where it will go, how much value it will produce, how much people would be injured by such a restraint, it is not good grist for private damages actions under Section 4 of the Clayton Act.

I do not know if that is a satisfactory answer, but it is just an area where I would like to see more attention paid.

CHAIRMAN MAJORAS: Well, it does help, because the other difficulty we have, not only in antitrust but in forming just good economic policy, is how you balance innovation incentives generally. I mean, this is the classic case that I was just discussing earlier with some folks in the consumer protection arena about pharmaceutical companies and their incentives to innovate and how this group of folks just came back from Europe and said, "Okay, now we need to push in the United States what other countries are doing," and I said, "Well, what is going to happen to the incentives to innovate if every country in the world put caps on pharmaceutical prices?" But because the harm to innovation from that is so hard to measure in the policy arena, people do not necessarily, I think, take it into account.

MR. BARNETT: Well, I guess a couple of

reactions. First, I am extraordinarily pleased with the contributions that the two of you made. They not only frame some interesting issues and pose some hard questions, but in some instances, also provided suggested answers or even policy directions, which is a great way to start off the hearings, and we very much appreciate hearing it.

I think, Herb, it is interesting to hear your views on refusals to deal, whether we should be involved in that or not, and I guess I was going to ask you, you have touched on a little bit the issue of innovation, and given its importance, does that mean we should be more or less aggressive in intervening in the sense that is there a greater risk of deterring innovation if you get involved in some of these areas? I do not know the answer to that. I just raise it as a thought.

Let me, if I can, pause and ask a -- well, I will ask you one question, though, before I get to that. I have always been of slightly two minds. I mean, I quoted Capitalism, Socialism and Democracy, the Joseph Schumpeter discussion of monopolies, and I have been taken with this gales of creative destruction imagery. Now, there is a lot in there that sort of apologizes for and/or justifies monopolies as good in and of themselves, and I guess some of hearing your remarks and all caused me to want to clarify that I do not agree with everything that is in that book in terms of monopoly, but I do agree with the importance of innovation and not losing sight of that.

But talking about this, you just made a comment about remedies and a distinction, I think, between damages and the Government. I would be interested to hear more of your views on that point, if you think that would be a good idea, to draw such a distinction.

DR. HOVENKAMP: The distinction between?

MR. BARNETT: Different remedies for governmental ver -- well, for I would say maybe injunctive versus damages type relief.

DR. HOVENKAMP: It has always been my opinion, which the Supreme Court has rejected in California versus American Stores, that structural remedies should be the prerogative of the Government. That is not the law, let's make sure everybody's clear about that. In California versus American Stores, where the plaintiff was the Federal Trade Commission, so it's a private -- I'm sorry, was the State -- was the Attorney General of the State of California, so it was a private party in this rather unusual way we treat states attorneys general in antitrust, but I believe structural remedies ought to be something that only the Government ought to do, because they have such extraordinary spillovers.

I mean, we have some confidence that the federal antitrust agencies, because of their diversity, the diversity of the industries that they represent, and because of the high quality of the people that run them, they are not captured industries, by and large, that we may not have that level of confidence about industry-specific agencies.

The one thing we know about private plaintiffs is that they are always captured, right? Private lawyers serve their clients. Their clients are completely self-interested, and as a result, they do not take overall effects into account, and as a result, my own view is that structural relief, such as divestiture, should simply be denied to private plaintiffs.

Is that an answer to your question?

MR. BARNETT: I just was interested in your perspectives, so thanks.

MR. BLUMENTHAL: Herb, Dennis had spoken after you did, so I guess I would ask whether you had any rejoinder to any of Dennis' comments.

DR. HOVENKAMP: No, and I mean, Dennis knows a million times more about this market definition stuff than I do, and so I am very elated that he actually agreed with me about most of it. I think you can develop a few presumptive rules for dealing with market power issues. For example, where the defendant, the firm under investigation, faces competition from other firms that use the same technology and apparently have the same cost structure, then I think the inference of competition, competitive pricing, is higher than in a case like Cellophane. I think what makes the Cellophane case so extraordinary is that the defendants, DuPont, plus Sylvania as its licensee, produced Cellophane, but the stuff that the Government ended up throwing into the market was brown wrapping paper, tin foil, glassine -- I'm not even sure I know what glassine is -- but these were things that used different raw materials, they almost certainly used different technologies for producing them, and simply to conclude that such things are in the same market simply because of high observed cross-elasticity of demand is a very serious error. It's an error courts continue to make.

There are several cases, for example, that have concluded that rental videos, films shown in movie theaters, and films shown on television are all in one relevant market simply because they make the obvious observation that if you look at any particular person, sometimes she goes and rents a video, sometimes she goes to a theater, sometimes she watches a movie on television, without asking the question whether any one of those technologies is sufficient to hold the other ones to cost.

I would rather hear Dennis talk about this.

DR. CARLTON: I agree, but I will talk about something about innovation, if that is all right, because I think that is an important topic.

It is absolutely right, our standard of living has increased because of technological change. The question about what the implication of that is for antitrust I think is easy to state. It is very hard to implement. Part of the reason it is hard to implement is because what we know about innovation and the market structure that induces innovation is a lot less than what we know about concentration and the effect of concentration on raising price.

The evidence, I think most economists would say, that competition is good for innovation. On the other hand, if you pushed them and said, "Do you think four to three makes a big difference when firms are innovating," you know, it is pretty hard to find evidence, I think, and moreover, innovating in what? The idea of, for example, an innovation market I think is not particularly helpful except maybe in rare exceptions like drugs where you can redefine it to be not an innovation market, but rather, a future product market. In drugs, you can look at the pipeline, and you know what is coming out. So, it is not really an innovation market as much as it is a prediction of future products.

It is much harder when you are looking at just firms doing R&D in a general area to say, "What are they doing R&D on? Is it even on similar products?" And if you ever go back and do an experiment, like if you look at major product introductions, who did them, sometimes the people doing them are often outside the industry, and no one predicted they would come in. So, I think the difficulty in this area, when antitrust tries to deal with it, is the difficulty that you have -- that anyone would have -- in predicting who is going to be the innovator. That is why I think it is very hard.

The other reason why I think it is very hard is innovation markets inherently involve intellectual property. People want to protect their intellectual property. There are a lot -- if you look at, you know, just -- there are some very interesting articles on the Internet, who has exclusivity rights on certain types of information that is generated. Restrictions, vertical restrictions on intellectual property, who can use them, who cannot use them, are very widespread, and therefore, if you do have a big success, that will complicate some antitrust enforcer's life, because they will say, "Well, look, a big hit in the vertical restrictions, I am a little worried," but you have got to go back and step back and say, "Well, the whole idea of innovating was to get the returns from this intellectual property, and they would not have done it if they could not put the restrictions on it."

So, I think it is a very difficult area. I think it is made more difficult by our intellectual property laws, and the problem that I really see arising is that because so many patents are given for products that may not be all that valuable, you create the problem that the property right in a truly valuable innovation is not that valuable, because now you have to get cross-licenses from lots of other people, and that is I think creating a lot of the antitrust problems, and maybe the best way to fix it is not just through antitrust but through reforming IP.

CHAIRMAN MAJORAS: As long as we are on the subject of innovation, in the two minutes we have left, does either of you have an opinion on the recent phenomenon that we are seeing in the patent area known as patent trolls, people who go out and buy up what some people might term useless patents -- I don't know if you can go that far -- and some of those people doing it, in fact, as I understand it are plaintiff's lawyers, and then wait until somebody creates an invention, and that bundle of patents might look, you know, like it could have been infringed, maybe it is, maybe it isn't, and then pounce and say, "Okay, now you owe me really high royalties."

And there are obviously many different variations on this theme, you know, those that have zero interest in ever making anything or innovating I think are the ones that people refer to as patent trolls. Do you have any comment on whether that is injuring competition or something that any of us should be worried about?

DR. HOVENKAMP: Well, my reaction to that is that whether it's good or bad, it is fundamentally not an antitrust problem. I mean, in order to be an antitrust problem, it either has to monopolize the market or create a dangerous probability of doing so or else it has to be an agreement that restrains trade, and simply surprising people with a patent and claiming high royalties in and of itself does not do that.

Now, that does not mean if it were not used in conjunction with some other practice, it couldn't sum up to an antitrust violation.

DR. CARLTON: I would just add, I basically agree with what Herb said. I think that it is a problem for reform of the patent laws, and there are at least two thoughts I have. The first is that one of the things that gives a troll great power is the ability to get an exclusion right, and you might want to encourage the courts to give the surprised infringer time to invent around the patent if that is possible, and that can get rid of sometimes a lot of the pressure.

The other question you can ask is, are they ever intending to use this themselves and implement it, and that may influence how you treat them.

Having said that, you know, an economist always has two sides to a story. A patent -- you may call them a patent troll, but the flip side is I'm an inventor, maybe I want to give my invention to someone else to figure out, you know, all the licensing problems. So, I mean, there is a flip side.

CHAIRMAN MAJORAS: Yes.

MR. BARNETT: Can I just ask quickly if based on your remarks, Dennis, if you would be willing to get into a locked room with Greg Werden for a session with a tape recorder and we could solve nine out of every ten Section 2 problems.

DR. CARLTON: I would be delighted.

MR. BLUMENTHAL: Dennis, if I could I guess ask one last question in the two minutes we have, you had thrown out a teaser at the end about the distinction between market power and monopoly power, an issue that was of some interest to the staff, although we had not quite posed it, and I might add, it was something I recalled George Stigler having denied as a distinction in the Data General case about 20 years ago, although the Ninth Circuit disagreed with that view. So, perhaps there is a distinction after all.

Did you have in mind something more than just quantum? Is it a character of the difference or --

DR. CARLTON: Yes, actually, it is in my textbook, so I know it very well. One definition of market power could simply be that price is in excess of marginal cost. That is a logical definition. Whether you want to use it in a court, you know, I think that is a different question. You might want to define it by how much before you say it is something that triggers some action, but you can distinguish market power from monopoly power by saying monopoly power is not just price in excess of marginal cost, but also, profits in excess of the competitive rate of return. So, that is at least a logical distinction.

I should say in the third edition of my book, I dropped that paragraph, because no one seemed to pay attention to it. Now, I change a lot of things when I revise my book, and most people never comment, but on this, I did get some comments, and people said, "We thought it was useful," even though I had never seen anyone -- I was unaware anyone had cited it, and I think it is useful, so I have put it back in. Now, so, that is an answer.

Now, whether that should be what courts use when they are deciding on an exclusionary act is a slightly different question, because I think courts really should be asking a slightly different question, which is, let us suppose you are talking about exclusive dealing. I don't really care about what the rate of return is, I don't think. I think what a court is saying is if you are engaged in an act and there are other characteristics of the market that make that act have a greater effect than if you didn't, say, have as large a market share, then I am going to be worried about that, and that really does not have to do with rates of return.

So, you know, I can see why courts could be asking are the characteristics of the market that make the exclusionary act under discussion much more a competitive concern than not, whether that -- I don't know that that necessarily corresponds to the distinction I gave you. The distinction I gave you does strike me as a sensible economic distinction.

MR. BLUMENTHAL: Well, thank you, and with that, we are out of time. Let me ask you to join me in thanking the panel for a great presentation.

(Applause.)

MR. BLUMENTHAL: We look forward to receiving your comments in the months ahead. We hope to see you Thursday and in the hearings to come. Thank you all.

(Whereupon, at 4:00 p.m., the hearing was concluded.)

C E R T I F I C A T I O N   O F   R E P O R T E R

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CASE TITLE: SECTION 2 HEARING

DATE: JUNE 20, 2006

I HEREBY CERTIFY that the transcript contained herein is a full and accurate transcript of the notes taken by me at the hearing on the above cause before the FEDERAL TRADE COMMISSION to the best of my knowledge and belief.

DATED: 7/5/06

SUSANNE BERGLING, RMR-CLR

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I HEREBY CERTIFY that I proofread the transcript for accuracy in spelling, hyphenation, punctuation and format.

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