TWENTY YEARS OF RAISING RIVALS' COSTS: HISTORY, ASSESSMENT, AND FUTURE

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INTRODUCTION

This paper begins with a discussion of the historical context in which the research underlying the original Raising Rivals' Costs ("RRC") papers was conducted. We then go on to evaluate the contribution of the RRC (or "non-price predation")[2] literature to economics and to antitrust policy, and to discuss how the literature has evolved. We end with a discussion of two specific recent monopolization cases.

I. HISTORY[3]

The work that formed the foundation of what became my contribution to the original RRC articles began in 1980, during my first "stint" at the Federal Trade Commission ("FTC"), which began in 1979. My work was heavily influenced by what was going on at the FTC and in antitrust and industrial organization during that time. During the 1970s, and continuing into the early 1980s, the FTC undertook a number of major monopolization cases and investigations, including cases like *In re E.I. DuPont de Nemours & Co*.[4] (allegations of predatory capacity expansion), *In re General Foods Corp.*[5] (allegations of predatory pricing and marketing), and *In re Kellogg Co.*[6] (allegations of predatory product proliferation). Additionally, in the

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2 We will use "RRC" as the shorthand for non-price predation or vertical conduct that injures rivals.

3 This section expresses the opinions of Dr. Scheffman.

4 *In re* E.I. DuPont de Nemours & Co., 96 FTC 653, 655 (1980).

5 *In re* Kellogg Co., 99 FTC 8, 16-17 (1982).

6 *Id*.

1970s and into the 1980s, there were a number of papers on predatory pricing, non-price predation, and "strategic" industrial organization models.[7]

A notable event from the perspective of non-price predation was the FTC conference held in June 1980, which was organized by Steven Salop.[8] Salop assembled leading industrial organization economists, business school academics, experimental economists, and lawyers. The conference was well balanced, with advocates of aggressive new approaches to price and non-price predation and advocates of caution and/or great skepticism. During the conference, the FTC's *In re DuPont de Nemours & Co*. case was awaiting the administrative law judge's decision.[9] The case was litigated vigorously. This was a very important matter for the viability of an aggressive non-price predation enforcement program. The FTC Administrative Law Judge's decision was issued after the conference, but in time to be included in the conference volume.[10]

It is interesting to note that Michael Spence, who is probably the father of modern strategic conduct-focused industrial organization literature (and whose paper provided an apparent theoretical foundation for the *DuPont* case) was one of those urging a cautious approach.[11] Clearly, "non-price" predation was "in the air" and was an explicit focus of the Conference.[12] However, the Conference did not provide a unifying conceptual framework. I would argue that the RRC article[13] provided the outline of a unifying conceptual framework.[14]

In published work concerning industrial organization economics from the 1980s to the present, there appears to have been little recognition or even memory of the big monopolization cases of the 1970s.[15] This is unfortunate, since those cases involved top government and "outside" lawyers

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7 *See*, *e.g.*, Phillip Areeda & Donald F. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 75 HARV. L. REV. (1975); Frank H. Easterbrook, *Predatory Strategies and Counterstrategies*, 48 U. CHI. L. REV. 263 (1981).

8 STRATEGY, PREDATION, AND ANTITRUST ANALYSIS 1-3 (Steven Salop ed., Federal Trade Commission 1981).

9 *See DuPont*, 96 FTC 653.

10 STRATEGY, PREDATION, AND ANTITRUST ANALYSIS, *supra* note 8, at app. 1-51.

11 *Id*. at 45-88.

12 *Id.*

13 Steven C. Salop & David T. Scheffman, *Raising Rivals' Costs*, 73 AM. ECON. REV. 267 (1983) [hereinafter Salop & Scheffman (1983)].

14 In his introduction to the 1981 FTC volume, Salop summarizes some of our then ongoing work that resulted in the RRC papers. *See* STRATEGY, PREDATION, AND ANTITRUST ANALYSIS, *supra* note 8, at 1-42.

15 *See*, *e.g.*, Janusz Ordover & Garth Saloner, *Predation*, *Monopolization*, *and Antitrust*, *in* HANDBOOK OF INDUSTRIAL ORGANIZATION 537-596 (Richard Schmalensee & Robert D. Willig eds., Elsevier Science B.V. 2000) (summarizing the non-price predation literature) [hereinafter Ordover & Saloner].

and economists. These cases created substantial records resulting in very detailed opinions.[16] In litigated cases that an economist would call strategic conduct cases,[17] the government did not prevail. Typically, the district or appellate court judges concluded that the challenged conduct was not anticompetitive.[18] Of the major cases that were closed or settled, only *AT&T* resulted in a victory for the government.[19] Economists appear not to have paid much attention either to the fact that the deficiencies in the government's cases did not lie in the government's economic theories or to the implications of this fact on the contours of a useful role for economics in antitrust litigation and policy. Rather, in these cases, the government was unable to put forward evidence that led to a conclusion that the challenged conduct was anticompetitive.[20] A particular problem was the inability to credibly distinguish between "competition on the merits" and anticompetitive conduct.[21] The fact finder in these cases had to deal with the richness and complexity of "real world" competition, about which the modeling of competition in economic theory then, and still today, provides only limited assistance. I will return to this issue below.

Despite all my criticism of theorizing, contributions to economic theory can be important. However, theorizing would be much more productive if it was based on greater knowledge of facts and institutions. Unfortunately, there is probably too little in Ph.D. programs, and in published economics articles, about the actual functioning of "real" markets and companies to help in this regard. Although my own published work in this area has been largely theoretical, my thinking about non-price predation was from the beginning and continues to be heavily influenced by empirical realities.[22]

My work on what became the RRC papers[23] began with my assignment as an FTC staff economist for the FTC's shared monopoly oil indus-

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16 One of the more notable contributions was a full airing of arguments as to whether profits, measured somehow, could be used as an indicator of market power. Those contributions have greatly fenced in potential mischief that can be created by using evidence on profitability to try to establish the existence of market power.

17 Because of the regulatory "hook," we do not classify *AT&T* as a strategic conduct case.

18 Of the major cases that led to a court decision, the government prevailed in what is probably the more typical reason for plaintiffs to lose monopolization cases, *i.e.*, relevant product and geographic market. Thus, what is particularly notable is that the fact finder rejected the government's case based on a finding that the challenged conduct was not anticompetitive. Such findings go the heart of limited applicability of RRC theories (that *assume* market definition and market power generally).

19 United States v. AT&T, 552 F. Supp. 131 (D.D.C. 1982).

20 *See generally In re* E.I. DuPont de Nemours & Co., 96 FTC 653 (1980); *In re* Kellogg Co., 99 FTC 8 (1982).

21 *See generally DuPont*, 96 FTC 653; *Kellogg*, 99 FTC 8.

22 *See generally* Salop & Scheffman (1983), *supra* note 13.

23 *Id.*

try case (*Exxon*).[24] Briefly, an important allegation in that matter was that the respondents, who were major marketers of gasoline ("majors"), were involved in conduct intended to create a "vertical squeeze" of the independent (i.e., non-major) gasoline marketers ("independents").[25] As best as I can now recall, the claim was that the majors were "overbuying" crude oil, thereby raising the price of gasoline at wholesale while at the same time squeezing the margins of the independent gasoline wholesalers and retailers. I was assigned to determine whether we could develop an economic theory that would make such allegations viable.

I benefited greatly from conducting my research in the context of this actual antitrust investigation. I still vividly recall presenting the theory to the FTC attorneys, explaining to them what evidence we needed to support the theory, and having them provide me with the relevant documents and information. It quickly became obvious that the basic facts did not fit the theory in this case.[26] Although the majors' documents were filled with concern about the independents and hints of thinking about how to "foreclose" the independents, the facts/data on the industry showed that the independents were growing, including in share, during this period. This was, in significant part, because the majors were selling to the independents the majors' increasingly "excess" production. A vertical squeeze theory did not make much sense when the allegedly squeezed sector was growing because of increased sales to this sector by the alleged predatory cartel.[27] I was taught an important, but not new, lesson as a relatively young antitrust economist—begin by thoroughly checking the basic facts and understanding the institutions.[28] Of course, if the basic facts on the increased sales to the independents had not been so inhospitable, FTC staff would still have had to develop many other facts to support the allegations in the case (with one major stumbling block being that the case alleged the eight largest oil companies, which at that time had a share of around 50%, were engaged in some, probably tacit, collusion to engage in this vertical squeeze strategy). So I learned from the outset in this, and many other matters, that the important issues are generally going to be factual rather than theoretical. This lesson was reinforced many times during Michael Pertshuk's term as FTC

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24 *In re* Exxon Corp. et al., 98 FTC 473, 473-81 (1981).

25 *See id.* at 473.

26 According to my recollection, the respondents' counsel was not very helpful in this regard, arguing that it did not make sense that their clients would have engaged in conduct that raised their own costs.

27 Since, as will be explained further below, RRC theory shows that many things can happen, as a matter of *theory*, an RRC allegation would not fail simply because the independents were growing, due in part to increased sales by the alleged predator.

28 Although much of my academic work was theoretical, much of my work as an academic arose in a policy context in which the institutions and facts were very important.

Chairman, with respect to both the antitrust and consumer protection missions.

I end this section on history with a summary of my assessment of the significance of the RRC papers[29] as contributions to the academic literature. In retrospect, it is obvious that a strategy by a dominant firm that not only raised its rivals' costs, but also increased its own costs, could be profitable. However, it did not seem obvious at the time, and it took several months of thinking through the analysis to get the first results. Many critics of the RRC literature have pointed out that there were earlier articles, or assertions, that pointed to this result.[30] Indeed, for the propositions they can embrace, some Chicago-school lawyers have credited Chicago-school thinking for the basic recognition that cost-raising strategies might, in some cases, be profitable.[31] However, the contribution of the RRC articles has stood the test of time, with a myriad of citations and follow-on literature to the original RRC articles. None of the earlier work really laid out the model and results. Next we will discuss these results and their implications in more detail.

II. ASSESSMENT

A. *Overview of the RRC Analysis*

We begin with an overview of the basics of RRC analysis. RRC can work for a dominant firm ("predator")[32] because raising costs of other competitors is likely to shift their supply curves or reaction functions back (i.e., at each price they sell less, or at each set of competitor prices they set higher prices). If this is so, this shifts out the demand facing the predator.[33] There is nothing remarkable in this—having rivals with higher costs, other things being equal, is likely to be beneficial. What is more interesting is

29 *See* Salop & Scheffman (1983), *supra* note 13.

30 Most of these articles were cited in the RRC papers. *See*, *e.g.*, Aaron Director & Edward H. Levi, *Law and the Future: Trade Regulation*, 51 NW. U. L. REV. 281 (1956) [hereinafter Director & Levi]; Richard R. Nelson, *Increased Rents From Increased Costs: A Paradox of Value Theory*, 65 J. POL. ECON. 287 (Oct. 1957); Oliver Williamson, *Wage Rates as a Barrier to Entry: The Pennington Case*, 82 Q. J. ECON. 85 (Feb. 1968).

31 *See* Director & Levi, *supra* note 30.

32 As discussed below, RRC can even work for firms without "traditional" market power.

33 *See generally* David Scheffman, *Comments on 'An Economic Definition of Predatory Product Innovation,' in* STRATEGY PREDATION, AND ANTITRUST ANALYSIS 39 (Steven Salop ed., 1981) (providing a simple, non-technical explanation, although it does not focus on a dominant firm model) [hereinafter Scheffman, *Comments*].

that actions that raise rivals' costs will generally increase the instigating dominant firm's own costs. Some kinds of cost-raising strategies can obviously be very cost-effective (i.e., actions that lead to governmental actions that exclude your rivals, or impair their ability to compete with you).[34] Of more interest, as a theoretical matter and for antitrust, is when the cost increase imposed on rivals has a similar effect on the instigator—(i.e., raising the price of an input used by both rivals and the instigator through overbuying the input, which was the *Exxon* theory, discussed above).

The logic of profitable RRC is straightforward.[35] A RRC strategy will be profitable if, by raising rivals' costs, the dominant firm can raise the market price at the current level of output by more than the firm raises its average cost (keeping output constant).[36] For example, in a homogeneous product industry, an increase in the incremental costs to rivals will shift up the rivals' supply curves by the amount of the increase in their incremental costs. Then, if the rivals have very elastic supply curves, assuming the dominant firm keeps its output constant, the market price will shift up by the increase in the rivals' incremental costs. The dominant firm's profits will increase if its average costs increase by less than the increase in rivals' incremental costs (which in this case is the increase in market price, with the dominant firm's output held constant).[37] This simple example demonstrates the power and superiority of RRC strategies over predatory pricing. With a very elastic supply by a fringe number of competitors, a predatory pricing strategy cannot work (without substantial re-entry barriers), but a RRC strategy can be very effective.

Raising rivals' costs or exclusion is not necessarily anticompetitive. As stated by Krattenmaker and Salop, "A firm that raises its rivals' costs has not necessarily gained anything. It may have harmed one or more of its competitors, but has it harmed competition? Competition is harmed only if the firm purchasing the exclusionary right can, as a result, raise its price above the competitive level."[38] In fact, much of "competition on the merits"

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34 *See*, *e.g.*, Steven C. Salop et al., *A Bidding Analysis of Special Interest Regulation: Raising Rivals' Costs in a Rent Seeking Society*, *in* THE POLITICAL ECONOMY OF REGULATION: PRIVATE INTERESTS IN THE REGULATORY PROCESS (Federal Trade Commission: Law and Economics Conference ed., 1984) [hereinafter Salop, Scheffman & Schwartz 1984].

35 In my view, the best simple explication is Scheffman, *Comments*, *supra* note 33.

36 As a technical matter, this is a *sufficient*, but not *necessary* condition. The condition is not necessary because, although the condition may fail at pre-predation price and output, RRC may nonetheless be profitable at another output level.

37 If rivals' supply curves are not very elastic, then the elasticity of their supply curves, their share of total sales, and the elasticity of market demand impact how any increase in their incremental costs impacts the market price. *See generally* Salop & Scheffman (1983), *supra* note 13.

38 Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 YALE L.J. 209, 242 (1986) [hereinafter Krattenmaker & Salop (1986)].

in concentrated industries involves strategies and tactics that disadvantage rivals but is not anticompetitive.[39] The specifics of cost-raising strategies under various scenarios, including overbuying inputs to drive up rivals' input costs and some initial results on RRC through vertical integration, are covered by Salop and Scheffman.[40] Their paper expanded the RRC framework to RRC through use of the government and also dealt more thoroughly with the issue of whether counter-strategies by rivals could thwart a predator's attempts at RRC.[41] Finally, Scheffman applies the logic of RRC to horizontal restraints cases (i.e., trade association and standards cases).[42]

B. *Strengths of the RRC Analysis*

The RRC framework has a number of virtues. The analysis is pretty straightforward, and you do not need to be an economic theorist to grasp the basic logic. In some senses, the results are theoretically powerful. since a RRC strategy will often be profitable "nearly" from the outset, RRC makes clear that cost-raising and exclusionary strategies are generally, if not always, going to be superior (for an instigating dominant firm) to predatory pricing or other strategies that require recoupment. Put differently, the RRC analyses (and the literature on predatory pricing) make clear that a dominant firm's cost-raising and exclusionary strategies should be the predominant antitrust concern about a dominant firm's behavior.[43]

A further strength, at least as a matter of theory, of some of the RRC literature, particularly Salop and Scheffman,[44] Salop, Scheffman, and Schwartz,[45] and Ordover and Saloner,[46] is that empirically "testable" conditions are derived. These conditions are probably too cryptic for most lawyers, but they are conditions amenable, at least in principle, to application by economists in specific fact situations.

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39 *See* Charles A. Holt & David T. Scheffman, *Strategic Business Behavior and Antitrust*, *in* ECONOMICS AND ANTITRUST POLICY 39, 82 (Robert J. Larner & James W. Meehan, Jr. eds., 1989) [hereinafter Holt & Scheffman].

40 *See generally* Steven C. Salop & David T. Scheffman, *Cost-Raising Strategies*, 36 J. INDUS. ECON. 19 (1987) [hereinafter Salop & Scheffman (1987)].

41 *See generally* Salop, Scheffman & Schwartz (1984), *supra* note 34.

42 Scheffman, *Comments*, *supra* note 33.

43 *See generally* Krattenmaker & Salop (1986), *supra* note 38.

44 Salop & Scheffman (1987), *supra* note 40.

45 Salop, Scheffman & Schwartz (1984), *supra* note 34.

46 Ordover & Saloner, *supra* note 15.

C. *Limitations of the RRC Analysis*

Both the original RRC article,[47] and later articles,[48] make clear that as a matter of economic theory, the effects of cost-raising strategies are ambiguous. The fact that a dominant firm engages in cost-raising strategies does not prove, by itself, as a matter of economic theory, that such strategies are anticompetitive. It is important to understand this theoretical ambiguity, particularly in light of the many papers, written since the RRC paper, that focus on the potential for vertical mergers to be anticompetitive (a topic I will discuss in more detail below).[49]

The analyses in the RRC papers largely focus on a situation with a dominant firm that is assumed to have significant market power, independent of any cost-raising strategies.[50] Although it appears pretty simple, the model is actually quite complex in generating general results, as are all general models that involve market power short of monopoly. Thus, as is pointed out clearly in Salop and Scheffman's 1987 paper, as a matter of theory, cost-raising strategies by a dominant firm may raise or lower price, raise or lower total welfare, and even raise or lower the profits of the "victims."[51]

The ambiguity in the effects of cost-raising strategies arises from a number of sources. The most straightforward reason is that, in the models, the dominant firm prices according to the elasticity of demand that it faces. A cost-raising strategy shifts out the demand faced by the dominant firm, but it is possible that it also makes the demand more elastic—sufficiently more elastic that the profit maximizing price falls. Again, RRC theory lays out, in principle, testable conditions under which, in a specific situation, cost-raising strategies are likely, from an economic perspective, to be anticompetitive.

A more serious limitation of the RRC analysis is that it does not provide guidance on how to distinguish cost-raising strategies from "competition on the merits," or pro-competitive strategies that shift business from rivals.[52] As a matter of simple theoretical modeling, in principle the RRC models could tackle this by having the cost-raising strategy also impact market demand and/or the production costs of the dominant firm (to incor-

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47 Salop & Scheffman (1983), *supra* note 13.

48 Salop and Scheffman (1987), *supra* note 40, at 24, 26.

49 *See*, *e.g.*, Michael A. Salinger, *The Meaning of* '*Upstream*' *and* '*Downstream*' *and Implications for Modeling Vertical Mergers*, 37 J. INDUS. ECON. 373 (1989) (discussing a model of vertical mergers) [hereinafter Salinger, *The Meaning*].

50 *See generally* Salop & Scheffman (1983), supra note 13.

51 *See generally* Salop & Scheffman (1987), supra note 40.

52 *See generally* Holt & Scheffman, *supra* note 39.

porate the possibility that the strategy that increases rivals' costs makes the dominant firm more efficient). Needless to say, such changes greatly increase the ambiguity of the competitive effects of cost-raising strategies.

D. *Empirical Support for RRC*

The big monopolization cases and later important decisions, including *Microsoft*, have made clear that a firm with market power still has broad latitude to engage in conduct that is typically also engaged in by firms without market power (adding capacity, introducing new products, competing aggressively in marketing tactics against rivals).[53] The important lesson that was largely ignored, at least in the ensuing economics literature, was that lawyers and the judicial system could not be convinced that economics could suitably draw the line determining when a firm with market power was doing "too much" of what are otherwise normal competitive strategies and tactics, particularly with respect to product innovation and introduction, expansion, and pricing. The subsequent literature has not contributed much to drawing that line credibly. Instead, at their core, the major cases, including *Microsoft*, have focused on alleged overtly exclusionary conduct.[54] I believe that the RRC literature has contributed to the analysis of such cases, but the core focus of the RRC literature (raising competitors' costs by manipulating their input markets—other than overt exclusion, and vertical mergers) has had little impact on law or policy.[55]

In a more perfect world, industrial organization economists' reaction to the outcome of the monopolization cases and further development in the case law would have been to place a greater emphasis on empirical research that would have contributed to a determination of what sort of evidence could lead a fact finder (i.e., not just a Ph.D. economist) to conclude that conduct undertaken by a firm with market power was anticompetitive. What happened instead was that economists (myself included) largely devoted their efforts to developing new theories of monopolization.[56] One notable exception was Krattenmaker and Salop who attempted to show that a number of past monopolization cases provided evidence supporting RRC

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53 *See generally* United States v. Microsoft Corp., 87 F. Supp. 2d 30 (S.D.N.Y. 2000); Transamerica Computer Co. v. IBM Corp., 459 F. Supp. 626 (N.D. Cal. 1978).

54 *See generally* Janusz A. Ordover, Garth Saloner & Steven C. Salop, *Equilibrium Vertical Foreclosure*, AM. ECON. REV. 127 (1990); Michael H. Riordan & Steven C. Salop, *Evaluating Vertical Mergers: A Post-Chicago Approach*, 63 ANTITRUST L.J. 513 (1995); Salinger, *The Meaning*, *supra* note 49.

55 *See generally* Salop & Scheffman (1987), *supra* note 40.

56 *See generally* Ordover & Saloner, *supra* note 15.

theories. [57] However, their arguments have been widely critiqued, based on additional facts or differing interpretations of the facts in the cases.[58] I think that a fair assessment of the debate has been that for most of the cases they discuss, the Krattenmaker and Salop's interpretations are not proved. Another important paper that attempts to provide empirical support for RRC is Granitz and Klein,[59] who develop evidence supporting a RRC-type theory interpretation of the *Standard Oil* case, which has thus far stood up to review.[60] However, their research demonstrates the need for a very extensive empirical analysis to support an RRC-type theory.

RRC-type theories are logically valid, given their assumptions. There are cases that careful research appears to indicate fit the theories.[61] However, with one exception, the proponents of RRC-type theories have not made the case that RRC-type monopolization cases should have a significantly greater market share in enforcement policy (or a larger winning percentage in private litigation). The one category of cases that deserves (and, at the FTC under Chairman Muris, has received) more resources and attention are cases in which a dominant firm or collusive group misuses legal or governmental processes to anticompetitively exclude competitors or entrants.[62] We discuss this further below.

In any event, since RRC-type cases almost always involve complainants, the agencies do not have to spend scarce resources searching for them. Rather, the resource issue is separating the wheat from the chaff. Complainants also have the option of private litigation. Economics can make important contributions with more empirical work designed to help determine whether allegations of anticompetitive RRC in a specific case actually are anticompetitive.

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57 Krattenmaker & Salop (1986), *supra* note 38.

58 *See*, *e.g.*, Malcolm B. Coate & Andrew N. Kleit, *Exclusion*, *Collusion*, *or Confusion? The Underpinnings of Raising Rivals*' *Costs*, 16 RES. IN L. & ECON. 73 (1994); Herbert Hovenkamp, *Post-Chicago Antitrust: A Review and Critique*, 2001 COLUM. BUS. L. REV. 257 (2001); John E. Lopatka & Andrew N. Kleit, *The Mystery of Lorain Journal and the Quest for Foreclosure in Antitrust*, 73 TEX. L. REV. 1255, 1278-80 (1995); John E. Lopatka & Paul E. Godek, *Another Look at Alcoa: Raising Rivals*' *Costs Does Not Improve the View*, 35 J.L. & ECON. 311 (1992); Scott E. Masten & Edward A. Snyder, *United States versus United Shoe Machinery Corporation: On the Merits*, 36 J.L. & ECON. 33 (1993); Timothy J. Muris, *The FTC and the Law of Monopolization*, 67 ANTITRUST L.J. (2000) [hereinafter Muris, *The FTC*]; David Reiffen & Andrew N. Kleit, *Terminal Railroad Revisited: Foreclosure of an Essential Facility or Simple Horizontal Monopoly?*, 33 J.L. & ECON. 419 (1990).

59 Elizabeth Granitz & Benjamin Klein, *Monopolization by* '*Raising Rivals' Costs: The Standard Oil Case*, 39 J.L. & ECON. 1 (1996) [hereinafter Granitz & Klein].

60 Fichorn v. AT&T Corp., 248 F.3d 131, 137 (2001) (citing Standard Oil Co. of N.J. v. United States, 221 U.S. 1 (1911)).

61 *See generally* Granitz & Klein, *supra* note 59.

62 *See generally* Timothy J. Muris, *Looking Forward: The Federal Trade Commission and the Future Development of U.S. Competition Policy*, 2003 COLUM. BUS. L. REV. 359.

III. POLICY IMPLICATIONS OF RRC

Many commentators have been very skeptical about the viability of RRC-type cases. For example, Granitz and Klein state "our analysis provides no support for a new antitrust policy which would condemn a vertical relationship without the presence of a horizontal conspiracy."[63] This leaves, at best, unclear their view of vertical relationships for which at least one party has substantial market power and is able to anticompetitively exclude rivals or entrants. Judge Easterbrook states that "[m]y recommendation is that for the foreseeable future, we leave raising rivals' costs to the academy."[64] We are not as skeptical. To begin, we suspect that both Klein and Easterbrook would support going after anticompetitive exclusion through manipulation of governmental or legal process. However, we advocate enlarging the focus of potential governmental or legal process abuse cases.

In the modern economy, barriers-to-entry, or effective competition, increasingly do not arise from bricks-and-mortar or economies-of-scale. In any event, we have learned from cases like *DuPont*, *Kellogg's*, and *Microsoft*, that "predatory" capacity expansion, or product innovation or introduction, are not likely to be a fruitful lines of pursuit. In the modern economy, often the traditional sources of competitive advantage have been eroded by globalization and technological advances.

Competitive advantage increasingly involves intangibles such as intellectual property. Such intangibles are often more manipulable than are bricks and mortar. Thus, we would argue that the sound policy basis for concern with non-price predation by a dominant firm has increased over time. Certainly, manipulating the government and the patent system are fruitful areas of concern with potentially anticompetitive conduct. Two recent Federal Trade Commission cases, *Rambus*[65] and *Unocal*,[66] are examples. More difficult to reach are what appear to be anti-consumer (but may be more difficult to reach as anticompetitive) activities by "patent vultures," and the use of patent thickets (sometimes combined with high stakes (for the defendant) actions at the International Trade Commission).[67]

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63 Granitz & Klein, *supra* note 59, at 45.

64 Frank H. Easterbrook, *When Is It Worthwhile to Use Courts to Search for Exclusionary Conduct?*, 2003 COLUM. BUS. L. REV. 345, 357 [hereinafter Easterbrook (2003)]; *see also* Frank H. Easterbrook, *On Identifying Exclusionary Conduct*, 61 NOTRE DAME L. REV. 972 (1986).

65 *In re* Rambus Inc., File No. 011 0017, Docket No. 9302 (2002), *available at* http://www.ftc.gov/os/caselist/d9302.htm (last visited Sept. 3, 2004).

66 *In re* Union Oil Co. of Cal., File No. 001 0214, Docket No. 9305 (2003), *available at* http://www.ftc.gov/os/caselist/d9305.htm (last visited Sept. 3, 2004).

67 October 2003 FTC Patent Report, *available at* http://www.ftc.gov/os/2003/10/innovationrpt.pdf (last visited Sept. 3, 2004).

Of course, we do not mean that conduct involving patents should be challenged because patents sometimes create market power. Rather, we think it is appropriate to be aggressive about patent misuse, involving patents inappropriately obtained, and misused, for example, in standard setting contexts.[68] The recent FTC/DOJ hearings on intellectual property[69] highlighted widespread concern with patent quality, (concern that patents may too frequently be granted inappropriately). The solution to this problem, if it exists, lies with the Patent and Trademark Office and, perhaps, legislation in intellectual property law. But, in limited circumstances, the antitrust, and perhaps other, laws can (and should) attack anticompetitive use of patents.

In any event there is little reason to use many enforcement resources to search for suitable and significant potentially anticompetitive RRC cases. The "beauty" of RRC is that it is likely to leave its fingerprints on a disadvantaged rival, whether or not the conduct is anticompetitive, and disadvantaged rivals are not shy about suing and/or complaining to enforcement agencies. The problem is sorting through what are mostly complaints about competition and competitive advantage to find the few nuggets. More empirical research is needed to develop reliable empirical analyses that facilitate the evaluation of the nuggets.[70]

The great weakness in trying to apply RRC is that there are so many false positives. Competition on the merits often injures rivals and potential rivals. It cannot be stressed enough that allegations of injury to rivals and potential rivals should not "pass go" unless there is a credible concern that the result is anticompetitive. We agree with Tim Muris that credible anticompetitive effects must be required for any viable RRC-theory case.[71]

This is another area in which economic research could be helpful. Unfortunately, most economic models of competition have, at their core, market power and the creation or enhancement of market power, and its effects are the focus of the papers using these models. But the models are much too simplistic to be able to provide much guidance on real world competition.

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68 *See generally* Rambus, Inc. v. Infineon Techs. AG, 318 F.3d 1081 (Fed. Cir. 2003).

69 Federal Trade Commission for the Consumer, Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy, *at* http://www.ftc.gov/opp/intellect/index.htm (last visited Sept. 3, 2004) (providing access to FTC/DOJ hearings on intellectual property).

70 Judge Easterbrook stresses the inherent difficulties in evaluating situations that appear to be procompetitive in the short run but potentially anticompetitive in the longer run. *See* Easterbrook (2003), *supra* note 64, at 347. We agree that we are a long way from having any research that could provide significant assistance in complex cases involving product innovation, etc. However, many cases, discussed below, do not involve such tradeoffs. *See*, *e.g.*, the allegations in JTC Petroleum Co. v. Piasa Motor Fuels, Inc., 190 F.3d 775 (7th Cir. 1999) and in Conwood, Co. v. U.S. Tobacco Co., 290 F.3d 768 (6th Cir. 1990). These types of cases also often involve conduct that is, at best, complex to analyze (see our discussion of *Conwood* below), and empirical economic research could have quicker payoffs for this more modest task.

71 Muris, *The FTC, supra* note 58.

Much more economic research that develops models of competition that demonstrate that conduct that harms rivals is generally not going to be anti-competitive would be a big advance. Only with such models is it possible to try to seriously address as a matter of theory distinguishing competition on the merits from anticompetitive conduct.

IV. RRC "IN ACTION"[72]

Between my stints at the FTC, I was involved in several private monopolization cases. In this section I will briefly discuss two of them. These two were notable because they, for various reasons, had high visibility. The purpose of this discussion is to highlight the role of economics and RRC in these cases. I believe there are lessons to be drawn from these two cases that have broader implications.

The two cases are *JTC Petroleum Company v. Piasa Motor Fuels, Inc.*,[73] and *Conwood Company, L.P. v. United States Tobacco Company.*[74]

A. JTC Petroleum Company v. Piasa Motor Fuels[75]

I served as an economic expert for the plaintiff in this case. This is an interesting case because it involved allegations of horizontal and vertical conspiracies aimed at raising prices at one or both levels and foreclosing competition through various cost-raising strategies.[76] It is also interesting because Judges Posner and Easterbrook sat on the appellate court panel, reversing a district court decision that the plaintiffs lacked standing.[77] The Court looked favorably upon what was a relatively complex RRC theory.[78] Briefly, the case involved allegations that applicators of road surface emulsion (crudely speaking, road sealant) conspired among themselves to divide markets and rig bids and that they also conspired with (or coerced) suppliers of emulsion to deny supply of emulsion to the plaintiff, who attempted to enter and bid for business in emulsion application.[79] Of course, a key

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72 This section is based on Dr. Scheffman's opinions about these cases in which he served as an expert.

73 190 F.3d 775 (7th Cir. 1999).

74 290 F.3d 768 (6th Cir. 2002).

75 *JTC Petroleum*, 190 F.3d at 775.

76 *Id.* at 777.

77 *Id.* at 779. The defendant emulsion suppliers had settled out, so the remaining defendants were competitors of the plaintiff. *Id.* at 777.

78 After the plaintiffs won the appeal, the rest of the defendants settled.

79 *JTC Petroleum*, 190 F.3d at 775.

issue was why the emulsion suppliers would act to defend the alleged cartel of their customers. As explained in the opinion:

> So what JTC has tried to show is that the applicators enlisted the producers in their conspiracy, assigning them the role of policing the applicators' cartel by refusing to sell to applicators who defied the cartel--such as JTC, which has bid for jobs that the cartel had assigned to other applicators. JTC, a maverick, was a threat to the cartel--but only if it could find a source of supply of emulsified asphalt. The claim is that the applicators got the producers to deny JTC this essential input into its business, and as a result injured it. The producer was the cat's paw; the applicators were the cat.
>
> *Matsushita Electric Industrial Co. v. Zenith Radio Corp*, however, teaches that an antitrust claim which makes no economic sense can on that ground be dismissed on summary judgment. And it might seem to make no sense from the producers' standpoint to shore up a cartel of their customers. Cartels, as we have pointed out, raise price above the competitive level and by doing so reduce the demand for their product. The less asphalt the members of the applicators' cartel sell (perhaps because the higher, cartel price induces municipalities to defer road maintenance), the less they will buy, and so the producers will be hurt. But if the producers have nowhere else to turn to sell their product, as may be the case here because of the specialized character of their plants and the limited radius within which they can ship their product from the plant, the applicator defendants may be able to coerce them into helping to police their cartel by threatening to buy less product from them or pay less for it . . . .
>
> Alternatively, and more plausibly (at least on this record), the cartelists may have been paying the producers to perform the policing function, rather than coercing them, by threats, to do so.[80]

This case involved striking circumstantial evidence consistent with a conclusion that the applicators were involved in bid rigging and market division.[81] One of the lessons I have drawn from this and other cases is that strong evidence pointing to "bad acts" is a key element for a plaintiff to prevail in a complex monopolization case. The other lesson is that, as discussed above, as a matter of theory alone, this case could not, as an economic matter, be conclusive. Any *general* economic model of the combined horizontal/vertical conspiracies would have ambiguous results. But theory demonstrates that it is possible for the alleged vertical conspiracy to be rational, and, with the richness of facts available in a case, the theoretical modeling can be much more specific and determinate. Of course, as always, the facts are critical. There was not (in my opinion) strong evidence directly bearing on agreement between the applicators and suppliers. The 7th Circuit opinion points to the relevance and importance of quantitative evidence indicating that the applicators benefited from the conspiracy.[82]

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80 *Id.* at 778 (internal citations omitted).

81 Applicators located near to one another generally did not bid against one another, and, for most county bid occasions, there was generally a single bid.

82 *JTC Petroleum*, 190 F.3d at 779.

B. Conwood Company, L.P. v. United States Tobacco Company[83]

This case is notable, among other reasons, because of the size of the judgment. I was the economic expert for the defendant. Market definition and the existence of monopoly power were not an issue in the case.[84] The case involved allegations of widespread tortious behavior including allegations that the defendant removed its competitors' products and point-of-sale merchandise from retail locations and that this conduct was widespread.[85] The core theory of the plaintiff was that point-of-sale displays ("POS") (i.e., product racks and signage) are very important in the wet snuff industry because of restrictions on advertising, and that defendant USTC sought to exclude plaintiff's ability to use effectively its POS materials.[86] The other allegations involved vertical conduct that would and should have been very difficult to assess under the rule-of-reason (i.e., convincing retailers to use exclusive racks,[87] inappropriate use of category management,[88] promotional

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83 Conwood, Co. v. U.S. Tobacco Co., 290 F.3d 768 (6th Cir. 1990).

84 *See id.* at 782-83 ("In the instant case, USTC does not challenge that it has monopoly power; nor is there an issue as to the relevant product (moist snuff) and geographic markets (nationwide).") (footnote omitted).

85 *See id.* at 773.

86 *See id.* at 774, 784.

> The parties agree that POS in-store advertising is critical in the moist snuff industry because unlike with other products, such as soft drinks or snacks, tobacco advertising is restricted. Tobacco products cannot be advertised on TV or radio, and some places have restrictions on other forms of advertising outside of a retail store, such as on billboards. Further, the number of people who use smokeless tobacco products is relatively small in relation to those who consume other tobacco products . . . . It is undisputed that POS advertising and a manufacturer's ability to sell its moist snuff from its own racks are critical to success in the moist snuff market.

Id.

87 *See id.* at 775.

> Kroger's Steven Luckett testified that while his store permits each moist snuff company to have its own rack, an advantage of allowing only one rack to store all similar products is uniformity. It also allows retailers to stack products in a manner that looks more attractive and neat. According to Alan Hart, a former USTC salesman, less than 10 percent of stores carried USTC racks exclusively, and of those that did, "most all of them" did so because the store authorized it. Several retailers testified that they requested exclusive racks . . . . USTC also points out that in 1996, Wal-Mart asked it and other moist snuff manufacturers to design a rack for the store to use for its moist snuff products. Conwood decided not to participate in the contest. USTC's design won. Swisher also won similar competitions for exclusive rack systems in K-Mart and Tom Thumb stores.

Id. at 775 n.1.

88 *See id.* at 775, 777, 786.

> During the 1990s, many retailers adopted the practice of category management . . . . Manufacturers support the efforts of retailers by presenting to them products or a combination of products that are more profitable and "plan-o-grams" describing how, and which, products should be displayed. At Wal-Mart, Swedish and USTC were involved with category management, which entailed suggesting which items should be on the racks. Swisher at one point was also involved in the process . . . . Larry Luckett, who decides which moist snuff products will be sold at Kroger Company, testified that any supplier trying to use category manage-

programs offered to retailers),[89] especially since the defendant's share fell, market output increased, and there was successful introduction of new products by competitors.[90]

It is difficult to judge whether, absent the allegations of tortious conduct, the judge would have let the matter go to a jury and whether the jury would have found liability. One would hope that the jury would see through allegations that involved claims that the defendant manipulated large sophisticated retailers, many if not most of which were much larger and more sophisticated than the defendant, to the detriment of those retailers. However, the judge allowed the experts great latitude, much broader than is typically allowed of economic experts, to interpret the documents as to intent and competitive implications.[91] The judge also allowed the jury great latitude in performing what was required—at best, a highly complex rule-of-reason analysis of the non-tortious conduct.[92] At a minimum, without the

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> ment practices to control competition, in his store anyway, would be "committing suicide." USTC points out that no retailer testified that the company required shelf space allocations equal to its market share. Apparently, Wal-Mart rejected such a request from USTC . . . . There is also documentary evidence that USTC sought to use its position as category manager to control and limit the number of price value products introduced in stores and to control the merchandising and POS placements in stores . . . . Conwood does not appear to challenge USTC's role as category manager per se, but rather the manner in which it used its position as a monopolist providing category management services, i.e., to exclude it from competition.

Id.

89 *See* Conwood Co. v. U.S. Tobacco Co., 290 F.3d 768, 778 (6th Cir. 1990).

> In 1998, USTC introduced its Consumer Alliance Program ("CAP"), which entails granting retailers a maximum discount of .3% for providing USTC with sales data, and participating in USTC promotion programs, and/or giving the best placement to USTC racks and POS. According to Conwood, however, CAP is another means by which USTC excludes competition. For example, in "a monthly competitive letter" dated March 27, 1998, a USTC employee stated that the CAP "has become a great incentive in securing space for our vendors and for the elimination of competition products." . . . There was testimony that the CAP can be used to exclude competitive POS advertising, and that USTC was extremely successful in signing up retailers to enter into these agreements. In the first couple of months of the program, USTC was able to sign 37,000 retailers to the CAP, which represents 80 percent of its overall volume in moist snuff sales.

Id.

90 *See id.* at 773-74.

91 *Id.* at 786 n.3.

> USTC complains that Conwood was allowed to rely on numerous hearsay documents that detailed conduct that is routinely rejected as not being very probative of anti-competitive intent and that showed nothing more than statements about competitive objectives. However, experts are entitled to rely on documents, even hearsay documents that are otherwise inadmissible.

Id.

92 *See id.* at 787 n.4.

> To the extent that USTC complains that evidence of its unlawful anti-competitive conduct, and its lawful conduct to take advantage of scale of economies, offer category management services or engage in other promotional activity in general were commingled, the district court properly instructed the jury that USTC could not be held liable for conduct that was

allegations of tortious conduct that was on its face, if true, harmful to the plaintiff (if not anticompetitively exclusionary), the case would have been very difficult. My reading of the appeals court decision is that what they viewed from the limitations of an appeals court perspective as unrebutted allegations of widespread tortious conduct, at a minimum, made the case much easier to uphold for the plaintiff.

In any event, *Conwood* is consistent with our view that a viable (if not correct) RRC case likely must have, at its core, an allegation of market power and allegations of relatively egregious conduct that harmed the plaintiff, not allegations of subtle cost-raising strategies (for example, raising input prices without overt exclusionary conduct). If these two conditions are present, a court (and juries and appeals courts) may be willing to bundle other conduct that would otherwise be difficult to properly assess under the rule of reason into a bundle of conduct viewed as exclusionary. If this is right, this is not a prescription for correctly decided cases, because the focus, and perhaps determinative factor, is an allegation of injury to competitors (that do not need the antitrust laws to resolve) rather than injury to consumers. This is another area in which more economic research could be helpful.

> part of the normal competitive process. The jury is deemed to have followed these instructions.

Id.