

FTC/DOJ Hearings on Section 2 of the Sherman Act: Single-Firm Conduct as Related to Competition¹

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(As reported by Amanda Wait of the Federal Trade Commission)

The joint Federal Trade Commission and Department of Justice Hearings on Section 2 of the Sherman Act: Single-Firm Conduct as Related to Competition continued on March 8, 2007, in Washington, DC, with a morning panel exploring monopoly power. Thomas J. Klotz, Attorney, Policy Studies, in the Office of General Counsel at the Federal Trade Commission, and Gregory J. Werden, Senior Economic Counsel at the Antitrust Division of the U.S. Department of Justice, moderated the panel.

Each panelist provided a short presentation then Mr. Klotz and Mr. Werden led a brief roundtable discussion. The panelists' written materials are available on the FTC's website at <http://www.ftc.gov/os/sectiontwohearings/index.htm>.

Mr. Klotz opened the panel by noting that the program began on March 7, 2007, with two panels addressing monopoly power. The hearings continued with a third panel discussion of monopoly power. Mr. Werden added that this session will focus on technology markets, in all of the various forms of that term. He also noted that the sessions continue a process of hearings that began last June on the law and policy of single-firm conduct under Section 2 of the Sherman Act.

Richard Schmalensee

Dick Schmalensee is the John C. Head III Dean and Professor of Economics and Management at the Sloan School of Management, Massachusetts Institute of Technology.

He noted that his remarks would be a set of disconnected comments on markets experiencing rapid technological change. He outlined that in markets with rapid technological change ("RTC markets"), we would expect to see market power because market power is a reward to technological innovation. He suggested that the primary issue in a finding of monopoly power is durability, which, typically, is when the power lasts long enough to be an issue. He said that we can address durability by looking at entry barriers, but that the difficulty is that, in RTC markets, entry may take a different

¹ This document is intended to summarize the FTC/DOJ Hearings on Section 2 of the Sherman Act: Single-Firm Conduct as Related to Competition and is not intended as a primary source document. Although the author strives for reporting accuracy, this summary is based on the author's own notes and impressions from the hearings. Any errors or misrepresentations are inadvertent and deeply regretted. For a complete transcript of the hearings and the panelists' written materials, please visit the FTC's website at www.ftc.gov/os/sectiontwohearings/index.htm.

form than incumbent's product. In such markets, the key to market performance is competition to innovate. He cautioned that by ignoring the special features of these markets one will find durable market power where it really is transient.

First, in addressing the difficulty of thinking about rapid change of a disruptive sort, he said that the tricky part is determining whether disruptive change is likely. If dynamic competition occurs, then the short run market power is less of a concern. A problem, however, is that dynamic competition often comes in bursts. He gave the example of the automobile industry, which faced many new innovations early on but by the 1950s became fairly static. He also noted that predicting the direction and source of disruptive innovation is difficult. For example, the walkman was made obsolete by innovation on disk drives. He suggested that one way to find innovation is to look at who is spending money on innovation, but cautioned that this focus on research and development may miss radical innovation.

Turning to a discussion of network effects, Professor Schmalensee noted that network effects can lead to high shares in RTC markets. He cautioned that snapshots of these markets can be consistent with both vigorous competition and its absence. Professor Schmalensee pointed out that network effects build large shares and dominant positions through expectation: the firm has a large share because everyone expects that firm to have a large share. He noted that increases in shares happen rapidly, but its hard to predict pace of disruptive change.

The third point of discussion for his remarks concerned multi-sided platform businesses. He noted that many businesses fit the multi-sided platform business paradigm, including any business that brings disparate customer groups together. He said that the term "technology market" is a misnomer because it is not necessarily a characteristic of a market, but really is a business model. He said that currently RTC markets are a live research area and that these models apply to a wide variety of industries. He suggested that one natural industry for application of these models is the windows platform application developers and users. Making a few comments on these business models, he said that one surprising feature is how often in practice pricing is asymmetric—all the money is made from one of the groups. He also said that a platform can compete with other two-sided, one-sided, or intersecting (A-B; B-C) businesses. These patterns complicate the assessment of market power. If market shares are based on sales, but sales primarily are attributable to another group of customers, then the assessment will be incorrect. He also commented that we need to consider competition from different models. For example, satellite radio is single-sided business, but deals with the same listeners as radio, which is a two-sided business (because it also deals with advertisers).

To determine market shares in multi-sided platform markets, Professor Schmalensee denounced using a price/cost margin because of the problem of asymmetric pricing. He also noted that the *Merger Guidelines* approach is difficult in these industries. For example, when the majority of a firm's profits are derived from a different group of consumers, thinking about price reductions and increases for the other product is difficult. The problem is the feedback effect: if you sell to A and B and go through price increase to A, that reduces demand from A, but if you also face a

feedback effect, the platform also will be less attractive to B. He commented that these externalities are difficult to think about in practice and the *Merger Guidelines*' approach is not well-suited to this analysis. One key feature of multi-sided industries is that the firm has to keep both sets of parties interested. If the firm spends significant money to get one side to buy its product but the other side does not buy the other product, then the lack of patronage can eliminate profits.

Professor Schmalensee concluded by noting that his presentation was not intended to provide answers, but rather to raise questions.

Michael A. Williams

Mike Williams is a Director at the ERS Group.

Mr. Williams noted that he would focus on markets for intellectual property, not on markets for widgets or software. He stated that his takeaway from the prominent cases is that there have been a number of them, and there probably will be more. Another takeaway is that many cases deal with intellectual property for high technology industries, but many cases also have involved very mundane things like toothpaste tubes.

He considered that a technology market consists

of the intellectual property that is licensed ... and its close substitutes—that is, the technologies or goods that are close enough substitutes significantly to constrain the exercise of market power with respect to the intellectual property that is licensed.

IP Guidelines, Sec. 3.2.2. This language suggested to him that we generally think about intellectual property as patents, but it can include other technology, including know-how and goods.

He noted that the demand for intellectual property is derived demand from the demand of the final consumer good. The Hicks-Marshall law of derived demand is a useful tool to organize our analysis of intellectual property markets. He said the key question is whether demand is inelastic. The intellectual property guidelines make it clear that an intellectual property market is a new construct, but Mr. Williams argued that traditional market definitions still apply.

Considering the practical problems in defining a market for technology, Mr. Williams first noted that firms do not license patents individually. Generally a firm will license a whole portfolio containing complementary and substitute patents. He suggested that for a full analysis we really would want to see each patent licensed separately and at an explicit price, but he noted that we do not usually get either one of those. He said that this lack of patent-specific information poses a huge challenge in defining markets.

Assuming, however, that one can manage to define a market, Mr. Williams then noted that one has to assign market shares as an indicator of the firm's future competitive significance. He commented that assigning market shares is a challenge because most of the time we do not have information on patent-specific royalty payments because we cannot disentangle the royalties for a single patent in portfolio. He also said that the notion of basing market shares on capacity or shipments does not make sense when dealing with intellectual property. He noted that two approaches exist to assigning market shares: using the $1/n$ approach or using the "mirror image" approach. One advantage to the $1/n$ method is its simplicity. This method, however, turns on the determination of the number of firms in the market (n). In technology markets, Mr. Williams noted that " n " can include patents, know how, and physical products. He suggested that using the $1/n$ method is useful when a firm could develop close substitutes to the product at a comparable cost. He also noted that using the $1/n$ method is good because it assigns the same future competitive significance to each firm in the market. This method is disadvantageous, however, when different patents in the patent portfolio are not as equally valuable to downstream firms. He noted that patent portfolios likely are highly differentiated. Another disadvantage to the $1/n$ approach is that intellectual property suppliers provide more than just ideas—some firms also work with the licensed firm to create the product to implement the idea. He noted that intellectual property firms can vary in their ability to work with downstream firms to turn ideas into real products.

Under the "mirror image" approach to assigning market shares, one considers how manufacturers have voted with their dollars to pick among patent portfolios. Looking at what they have picked and which intellectual property firms have been successful in the marketplace is one way to determine how technology is played out in the marketplace. An advantage to this method is that it captures the differentiated nature of the portfolios. A disadvantage, however, is the difficulty of assigning shares when a manufacturer licenses technology from two different intellectual property providers.

Mr. Williams then considered how to measure monopoly power in technology markets. He suggested two ways to think about this: structural measures and performance measures. The structural perspective provides some measure of market concentration and then you consider barriers to entry. He noted that entry takes different methods in technology markets. For example, an entrant may have to indemnify against patent infringement claims from an incumbent. Another way to think about measuring monopoly power in technology markets is to study the performance of the market to see if one firm appears to have monopoly power. He suggested that we can consider change in royalty rates or changes in circumstances under which intellectual property is licensed as evidence of monopoly power.

Andrew Chin

Andrew Chin is an Associate Professor at the University of North Carolina School of Law. He noted that two of his recent articles are available on his website: www.andrewchin.com.

He emphasized that we can use the *Merger Guidelines* to delineate relevant software markets. He cautioned that describing the software correctly and at the right level of abstraction makes delineating market share tricky. He noted that the district court in *Microsoft* found liability based on market share for “platform level browsing software for Windows,” but the circuit court reversed based on this market definition. He said that the approach of using the browser market was doomed because the software product was defined as the software code and nothing else.

He suggested that another approach available to the D.C. Circuit was buried in the findings of fact. In those findings, the court discussed defining the market as the market for web browser functionality. He noted that the D.C. Circuit did not cite to these findings, but also failed to enter detailed findings regarding the web browser market.

Although antitrust law requires a description in detailed and explicit terms about what the market is, Professor Chin suggested that we do not need such a high level of detail in our market definitions. He said that all antitrust requires, in the language of *DuPont*, is to identify whether the software product is reasonably interchangeable from the user perspective. He gave the example of two products that support the same user purpose: one is a program that converts binary to BCD, and the other that can duplicate the functionality through a Windows button. He noted that the functionality of the two products is interchangeable. If we complete a deeper analysis, however, the two products operate on different code, have different interfaces, may appeal to different consumers, run on different operating systems, and have different platform preconditions—but still have high overlaps. On the supply side, we can identify structural barriers to entry, but what we may need more information regarding the appropriate level of abstraction and user purpose.

The “essential use” is another way to describe the functionality of a software product. This is a high level of abstraction. There are so many ways to describe a web browser that the design choices and code do not matter. The only thing that matters is user intention. That is the appropriate level of abstraction.

Professor Chin explained that Windows competes in at least two products (which he explained technically were end-use segments): platform software, and legal and technological support for web transactions. In a real sense the service conception of software products is already there, but network-centric approach not there yet.

He concluded his remarks with a comment about price discrimination markets. He said that we can extend price discrimination analysis to the quality adjusted price discrimination markets. The benefits of his approach are to end up with the best software for each essential use case. Professor Chin said this better meets user intentions. Markets characterized by strong network effects lead to the recognition of harm to competition in form of shortening of a product’s competitive windows, which leads to a software developer-centric view of freedom to innovate.

Robert H. Lande

Bob Lande is the Venable Professor of Law at the University of Baltimore School of Law.

Professor Lande began his remarks by noting that market power without a large market share could indicate imperfect information or other market failures. He said that market power can result from market share and also from market failures. “Consumer protection” market failure can create market power even resulting in harm to competition in some markets giving rise to an antitrust violation. Professor Lande said that the purpose of his remarks is to urge a larger role for consumer protection market power in modern day antitrust.

All market power requires a market failure. When we say market power we almost always mean market share-based market power. Even if a firm has a large market share, it only has the power to raise price if entry is hard and other market conditions exist. Imperfections in the marketplace give a firm the power to charge supracompetitive prices.

A firm can obtain the ability to raise prices by coercion, undue influence, asymmetric information, and overly complicated information—all of which are consumer protection market failures. Consumer protection problems occur inside the head of the ultimate consumers. By contrast, however, corporate officials can also be victimized by this imperfect information, even if the firm does not have a monopoly market share. We prosecute firms for fraud, and we should do the same thing when consumer protection market failure equates an antitrust violation.

Professor Lande noted three cases, each of which involved an act that would have been considered a traditional consumer protection-type act, in which the firm did not have a large market share but whose acts resulted in anticompetitive harm. First, in *Kodak*, the consumer protection act was a change in Kodak’s policy when consumers were unable to anticipate such a change and, therefore, were vulnerable due to their imperfect information. Professor Lande noted that even businesses can have imperfect information. Second, he mentioned the *Rambus* case. He said that *Rambus* was similar to *Kodak* but involved standard setting organizations. He noted that a firm that was about to secure a patent could misrepresent the existence of a patent and, thereby, induce reliance on the patent and increase its value. The FTC case alleged that Rambus illegally monopolized the relevant markets, even though Rambus had no market power before the deception. Professor Lande noted that determining the market power at the time of the deception is difficult because Rambus’ patent could have been crucial or worth nothing depending on the actions of the standard setting organization. Finally, Professor Lande discussed *Jefferson Parish*. He noted that this case raised the possibility that market power can flow from consumer protection-type violations. The court found that a thirty percent market share was insufficient for market power. He suggested that this case may stand for the proposition that a thirty percent safe harbor exists, but that it also established that market failures, other than imperfect information, can be crucial to the court’s decision.

Turning to a discussion of the implications of these cases for Section 2 analysis, Professor Lande said that imperfect information is everywhere, but the real question is how significant that imperfect information has to be to raise concerns about anticompetitive effects. If antitrust took imperfect information more seriously, we would see profound effects on market power, market definition, and entry analyses. He also noted that considerations of imperfect information may result in different market definitions. If imperfect information keeps some customers from turning to potential substitutes, then considering this market failure may result in more narrowly defined markets. Professor Lande suggested that we should ask what information was available to customers at the time of the purchase in order to determine the relevant substitutes for that good or service. He also noted that consideration of imperfect information could significantly affect entry analysis. When we compute the entry period, we should not assume that entrants always will know the best time to enter. He suggested modifying the five to ten percent test, because entry should only count if entry was the result of increased costs due to increases in market power. For example, if entrants believed that a price increase was the result of increased input prices, the higher price may not induce new entry to counteract the anticompetitive effects.

In conclusion, Professor Lande pointed out that no plaintiff has won an antitrust case before the Supreme Court in over a decade. He also noted that the potential for consideration of consumer protection concepts in Section 2 jurisprudence has not been forgotten, citing the recent *Rambus* case as an example. He suggested that we should take the potential of consumer protection market power more seriously. As the agencies contemplate future dominant firm cases, they should give more attention to consumer protection market failures even for defendants with relatively modest market shares.

Alan H. Silberman

Alan Silberman is a Partner at Sonnenschein Nath & Rosenthal LLP.

Mr. Silberman noted that he would represent the lawyer view on the panel. In that capacity, he suggested that labels in antitrust private litigation are being used and misused, resulting in costs to litigants and overall costs to the system. He said it was his sense that we have this problem because all of our high level discussion of monopolization, market share, and market power fails to be organized into a coherent analytical structure that can be understood by “ordinary” people. This organization is a key public policy goal, because the ordinary perception of monopolization is “it’s bad if you’re too big,” which is incorrect.

Mr. Silberman used his remarks to highlight some examples in Section 2 jurisprudence that he finds troubling. First, he noted that he is troubled by cases involving unfairness and deception that have exclusionary effects, giving *Conwood* as an example. He noted that this case provided an example of terrible firm behavior, which definitely made a case under Section 5 of the Federal Trade Commission act, but perhaps also could have been a case under Section 2, because the data in *Conwood* suggested that competition was ongoing.

A second group of cases that Mr. Silberman found troubling are those cases in which market share does not indicate exercisable market power. He gave a simple example of this as follows: a distribution system in which the wholesaler has ninety-five percent of the sales, and then either buys up the other five percent or enters into exclusivity contracts to gain market share. What if, then, that wholesaler has market share, but does not have market power. In another example, a market faces no entry barriers and entry is possible within six months, but does not happen. Customers are big companies. The company selling the product does a good job and customers like it. Mr. Silberman suggested that this situation is not a problem because some other factor must be disciplining the exercise of market power.

A third set of situations that Mr. Silberman suggested are troubling are those in which we challenge conduct as of today when we expect that competitive forces would have been played out sometime in the past. He gave the example of the franchise situation of lock-in as a substitute for market power. He said that the franchise contract creates market power and, therefore, the antitrust question is whether the formation of the contract was subject to competitive forces. If the formation of the contract is subject to competitive forces, then we should not be worried about market power today. He suggested that we can apply this reasoning to *Kodak*, but that Kodak could not argue that appropriate competition existed at the time of contract formation.

Finally, Mr. Silberman noted confusion about relevant markets in measuring market power for franchises. He said that buying a widget franchise does not necessarily make widgets the relevant market.

Mr. Silberman suggested that a coherent way to organize our analysis of these situations is to recognize a semi-safe harbor. He also said that we need to identify and articulate the constraints upon which we rely in each set of circumstances by asking what constraints will prevent the undue exercise of power in the future. After addressing this question, we can test whether the conduct at issue affects that constraint. If the conduct at issue does not affect that constraint, then the constraint does not pose an antitrust problem. He advocated the development of a decision tree that antitrust lawyers can use for Section 2 analysis. He also asked the antitrust agencies to continue their advocacy, including amicus briefs in federal district court, to help guide judges through complicated issues.

He concluded by noting that he does not want to chill the scope of any Section 2 inquiry, but suggesting that antitrust practitioners and policy makers reflect on how to frame the analysis of single firm conduct under Section 2 of the Sherman Act.

Panel Discussion

After the individual presentations, Mr. Klotz and Mr. Werden led a brief roundtable discussion.

Mr. Werden asked Professor Schmalensee to comment on the potential use of safe harbors in Section 2 analysis. Professor Schmalensee said that error costs are high and errors are likely, but we can reduce these errors by minimizing the extent to which judges and juries have to decide difficult questions by using safe harbors and burden shifting approaches. Professor Schmalensee said that an unstructured rule of reason analysis is frightening and that he prefers either clearer rules or more structured analysis. He commented that some areas exist in which he does not know how to create clear rules or a more structured analysis, but noted that in developing such rules or analysis he would consider a firm engaged in spending solely to displace a market leader. He conceded, however, that evidence of such spending is not always available. He also cautioned, however, that the DOJ and FTC should not avoid intervention simply because the analysis is difficult.

Mr. Werden then asked whether a market will self-correct for a technology bubble. Professor Schmalensee responded that a judge facing this type of market can assume that the world as he or she sees it will persist and can deal with that market on its face. He continued that this probably is a better assumption on average than the opposite presumption that bubbles are fleeting and will dissolve since they have done so in the past. Mr. Silberman added that dueling advocates hurt both the client and the economy and suggested that Section 2 analysis should remove tricky questions from courts. Mr. Werden characterized Mr. Silberman's suggestion as a conduct-based safe harbor. Mr. Silberman noted that such a safe harbor would avoid the semantic gamesmanship of describing the conduct. Professor Schmalensee indicated skepticism that developers of safe harbors could know which innovations are procompetitive in advance, noting that drawing the lines between pro- and anticompetitive innovations is difficult. Mr. Werden noted, however, that the court in *Microsoft* distinguished between product design and new products.

Mr. Werden asked Mr. Williams to explain why assigning market shares is necessary to the analysis of monopoly power in technology markets. Mr. Williams provided the example of *Gemstar*. He explained that Gemstar allegedly had monopoly power in the technology for interactive program guides, and, although its market share was not 100%, its exact market share was unclear. Mr. Werden asked about the meaning of the intellectual property right and suggested that knowing whether another technology is infringing on that right is difficult. Mr. Williams said that Gemstar claimed that making a product without violating its patents was impossible. He said the real question in that case was what property rights was Gemstar protecting.

Mr. Werden asked Professor Chin whether price discrimination market analysis applies the same way in both monopolization and merger cases, noting that it is not often applied in monopolization cases. Professor Chin responded that he intended to ground his prior remarks in the existing approach. He said that the agency support for price discrimination markets should counter the intuition that seeing the same product in two relevant markets might be improper. Professor Chin gave the following example: A web browser has two features: (1) ancillarity to the choice of the operating system, and (2) a role in providing meta information to web content. Professor Schmalensee responded that Professor Chin's example points to the absurdity of tying law, particularly as applied to product design. Professor Schmalensee said that he is very nervous of using tying law as a way to let courts drive product design decisions. Although product design has

been an exclusionary device, tying law is not a good way to address this occasional exclusionary use. Professor Schmalensee suggested that the law should not distinguish between melding two products together through tying and similar melding through contract.

Mr. Werden asked Professor Lande (1) whether a distinction exists between market power in Section 1 and Section 2 cases, and (2) whether he thought the concept of monopoly power would give rise to a Section 2 violation. Professor Lande said yes, all market power must be durable in order for it to rise to the level of violating Section 2. If not, then the market power is *de minimis*. Professor Lande also said that imperfect information can give rise to a durable market power problem, both under Section 1 and Section 2. Mr. Klotz asked whether this imperfect information should factor into the competitive effects analysis. Professor Lande said that if we are trying to determine who competes and the likelihood of entry, then these consumer protection issues will play a role in the analysis. Mr. Schmalensee cautioned, however, that we should not make our analysis too broad because not all consumers have to be informed for prices to be affected—perhaps only a small number of consumers have to be informed to effectuate a price change if the firm can price discriminate.

Mr. Werden noted that Mr. Silberman pointed out earlier that franchising cases have held almost uniformly for the defendant. He noted that the contracts define rights if the parties willingly entered into the contracts. Mr. Silberman said that the courts got the law right on this point, but suggested that courts require a party or third party to disclose information at the time of contracting. He continued that if a competitive process existed at the time of contracting, we should not worry about the competitive effect today, but rather should force contracting parties to deal with relational power issues at the inception of the contract.

Propositions

Mr. Klotz and Mr. Werden then posed propositions to the panelists and asked whether consensus for the propositions exist.

Proposition 1. Innovation is a powerful force in enhancing the well being of consumers.

Mr. Werden noted that none of the panelists dissented from this statement and, so, asked whether antitrust analysis should be concerned about protecting the innovation process. All of the panelists agreed that antitrust should be concerned about protecting the innovation process.

Responding to how to protect the innovation process through antitrust, Mr. Silberman said that we should not put barriers in front of people attempting to innovate by second guessing innovation after the fact. He suggested that the principle should be that where the evidence shows innovation, we should presume that competition is working. If it turns out that this presumption is wrong, we should only be concerned about innovation when it has a collateral effect that harms competition. Professor Schmalensee said that we should avoid obvious pitfalls—the competitor who is urged to compete should not be turned upon when he wins. Professor Lande distinguished

between firms that innovate for themselves and firms that prevent other firms from innovating. He said that if “you are just running faster, then good for you,” but cautioned that we must be careful in making the distinction between innovating and blocking others’ innovations. Mr. Williams highlighted that a firm does not violate Section 2 if it knows its patent covers another firm’s business and remains silent until the competing firm has incurred sunk costs, but noted that this type of conduct seems anticompetitive from an economic perspective. Mr. Werden opined that all the panelists would agree that the conduct described by Mr. Williams is “not nice,” but cautioned that determining what is or is not “nice” is not part of the business of antitrust law. Mr. Silberman suggested that the conduct suggested by Mr. Williams would result in a tort remedy in most states.

Proposition 2. A competitive foremarket precludes monopoly power in the aftermarket.

Mr. Werden noted that this proposition probably is more controversial than the first proposition. He said that the *Kodak* court rejected this argument as made by Kodak, but suggested that some commentators think the court got it wrong. Mr. Silberman said that the discussion of this issue in *Kodak* was framed by the district judge’s saying that Kodak’s argument could never be proven, which was incorrect. Mr. Silberman suggested that Kodak’s position was correct and the issue could have been more clear on appeal. Mr. Werden added that the plaintiff was able to outline this theory in opposing summary judgment, but failed to do so and, instead, raised the issue before the Supreme Court. As a result, no court made a determination of what the relevant markets were.

Professor Schmalensee suggested that a competitive foremarket creates a strong, but rebuttable, presumption that monopoly power is precluded in the aftermarket. In order to rebut this presumption, one could enter evidence to show monopoly power. He also noted that durability of market power is a consideration, but did not express a view on where to draw the durability line. Professor Lande commented that the consideration of durability depends on how much market power we consider to be *de minimis*. Although noting that reasonable people can disagree, he suggested that durability for two years at a ten percent market share was reasonable.

Mr. Werden asked the panelists whether Section 2 cases should face a higher standard of proof than cases brought under Section 1 or Section 7, noting that the Supreme Court suggested that a difference should exist between Sections 1 and 2. Professor Lande said that merger cases are supposed to have a lower standard than cases brought under Sections 1 and 2.

Conclusion

Mr. Werden and Mr. Klotz then adjourned the hearing. The next series of panel discussions in these hearings are scheduled for March 28-29, 2007, and will discuss the issue of remedies under Section 2.