



2005

## Anticompetitive Overbuying by Power Buyers

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72 Antitrust L.J. 669-715 (2005)

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February 2010

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## ANTICOMPETITIVE OVERBUYING BY POWER BUYERS

STEVEN C. SALOP\*

Today there is a growing interest in buyer-side exclusionary conduct—whether undertaken by a group of firms or a single firm with buyer-side market power. Anticompetitive “overbuying” conduct by power buyers involves increasing the purchases of a particular input with the purpose and effect of gaining (or maintaining) either monopsony power in the input market or market power in the output market, or both. Two types of single-firm overbuying are analyzed in this article. *Predatory overbuying* consists of overbuying inputs as a predatory strategy to cause buyer-side competitors in the input market to exit from the market or permanently shrink their capacity in order to gain monopsony power in the input market. *Raising Rivals’ Costs (RRC) overbuying* consists of overbuying inputs as an exclusionary strategy to raise rivals’ input costs and thereby gain market power in the output market. In most cases, the additional input purchases are used to produce output. However, in unusual cases a firm may engage in *naked overbuying*, that is, purchasing an input solely to deny it to rivals and then simply discarding the input.

While antitrust enforcers and courts have had considerable experience dealing with buyer-side market power involving conduct by groups of firms,<sup>1</sup> there also have been a number of similar cases involving firms

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\* Professor of Economics and Law, Georgetown University Law Center; Senior Consultant, Charles River Associates. I would like to thank Jonathan Baker, Andrew Gavil, Warren Grimes, Thomas Krattenmaker, Serge Moresi, Arman Oruc, Mark Patterson, John Woodbury, and editors of this Journal for helpful comments. I have been consulting with Weyerhaeuser and other clients on overbuying issues. All opinions expressed in this article are my own and do not necessarily reflect the views of others. Any errors are solely my own.

<sup>1</sup> Buyer-side cartel cases have arisen throughout the history of antitrust, including *American Tobacco Co. v. United States*, 328 U.S. 781 (1946), and *Mandeville Island Farms v. American Crystal Sugar Co.*, 334 U.S. 219 (1948). The recent Competitor Collaboration Guidelines analyze cooperative buying arrangements. Federal Trade Comm’n and U.S. Dep’t of Justice, Antitrust Guidelines for Collaborations Among Competitors (2000), available at <http://www.ftc.gov/os/2000/04/ftcdojguidelines.pdf>. With respect to exclusionary conduct, certain group boycott cases can be seen as the exercise of exclusionary conduct by a group of input buyers. A recent opinion by Judge Posner in *JTC Petroleum*

with single-firm buyer power. For example, in *Klor's*<sup>2</sup> and *Toys "R" Us*,<sup>3</sup> a single firm induced input suppliers to refuse to supply or discriminate against its downstream rivals.<sup>4</sup> Examples of potential overbuying situations have surfaced in the courts. For example, *Alcoa* included allegations that Alcoa engaged in overbuying with respect to bauxite, to make it more expensive for its aluminum rivals.<sup>5</sup> *Socony Vacuum* involved a variant of collusive overbuying.<sup>6</sup> The *Beef*<sup>7</sup> case and *Cargill*<sup>8</sup> also involved overbuying allegations.

An economic and legal analysis of overbuying leads to several conclusions. First, overbuying inputs can lead to consumer harm under well-defined conditions and, therefore, states a logical and economically justifiable antitrust claim under standard Sherman Act jurisprudence. Second, the economic analysis of overbuying distinguishes between two different types of overbuying because of their different target markets and potentially different consumer impacts. Third, overbuying should be evaluated with a four-step rule of reason analysis under the basic consumer welfare standard. Fourth, the legal analysis of the two types of overbuying should be differentiated. In particular, plaintiffs in predatory overbuying cases should be required to satisfy the below-cost pricing test, in addition to other steps of the rule of reason. However, that test should not be required for RRC overbuying allegations.

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provides an interesting example: in that matter, members of a highway contractor cartel allegedly induced their asphalt suppliers to refuse to supply a maverick contractor that was disrupting their cartel in the output market. *JTC Petroleum Co. v Piasa Motor Fuels, Inc.*, 190 F.3d 775 (7th Cir. 1999).

<sup>2</sup> *Klor's, Inc. v. Broadway-Hale Stores, Inc.*, 359 U.S. 207 (1959).

<sup>3</sup> *Toys "R" Us, Inc. v. FTC*, 221 F.3d 928, 937 (7th Cir. 2000).

<sup>4</sup> Of course, these particular cases were litigated under Section 1, not Section 2, of the Sherman Act as a result of the agreements, despite the fact that the concerted conduct was exclusionary.

<sup>5</sup> *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 432 (2d Cir. 1945).

<sup>6</sup> In *Socony Vacuum* the large oil companies ("majors") coordinated excessive purchases of distress gasoline from independent refiners. The goal of this overbuying was to stabilize the spot price of gasoline, which was used as an index for the price at which the majors sold to jobbers under their long-term contracts. However, if one views the jobbers and independent retailers also as downstream distribution rivals of the majors, then the conduct also raised the costs of competitors. For a diagram emphasizing this vertical structure, see ANDREW I. GAVIL ET AL., *ANTITRUST LAW IN PERSPECTIVE: CASES, CONCEPTS AND PROBLEMS IN COMPETITION POLICY* 91 (2002).

<sup>7</sup> *In re Beef Indus. Antitrust Litig.*, 907 F.2d 510 (5th Cir. 1990). This case also contains conspiracy allegations.

<sup>8</sup> *Cargill, Inc. v. Monfort of Colo., Inc.*, 479 U.S. 104 (1986).

## I. ECONOMIC ANALYSIS OF MONOPSONY AND OVERBUYING

Overbuying generally occurs in input markets in which a firm has some monopsony power. There are two types of overbuying conduct: *predatory overbuying* and *raising rivals' costs (RRC) overbuying*. Both strategies involve a type of price-cost squeeze. However, the two strategies differ in their target markets and in their likelihood of consumer injury. The target for predatory overbuying is buyer-side market power in the input market. The target for RRC overbuying is seller-side market power in the output market. The two strategies also differ in their likelihood of consumer injury, which supports the application of somewhat different legal standards to each.

In particular, successful predatory overbuying does not necessarily harm consumers. During the predatory period when the firm is overbuying the input, consumers generally benefit if the firm uses its increased input purchases to produce more output. During the recoupment period, consumers may be harmed, but only if total market output declines from the overbuying while output prices rise, relative to the market absent overbuying. Moreover, higher output prices from the overbuying are not necessary for the monopsonistic firm to successfully recoup its overbuying investment. The net present value effect on consumer welfare involves balancing the effects in these two periods. Even if consumers are harmed during the recoupment period, that harm may not offset the benefits received during the predatory period.

A firm engaging in successful RRC overbuying of inputs raises its rivals' input costs and gives the firm the market power to raise or maintain a supracompetitive price in the output market. If rivals must pay more for inputs, they will have the incentive to reduce their input purchases and production of output. In this way, the overbuying firm may be able to charge a higher output price and reduce consumer welfare. Of course, the overbuying also increases the firm's own costs, which implies that profitability of the strategy is not inevitable. For example, holding the firm's output constant, a RRC overbuying strategy only would be profitable if the firm is able to raise its price by more than the strategy raises its own average cost.<sup>9</sup> Similarly, there is no consumer injury unless prices in the output market are increased relative to the proper competitive benchmark.<sup>10</sup>

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<sup>9</sup> If the firm can increase its output, then the profitability condition is more complicated. See Steven C. Salop & David T. Scheffman, *Cost-Raising Strategies*, 36 J. INDUS. ECON. 19 (1987).

<sup>10</sup> Steven C. Salop, *First Principles Approach to Antitrust, Kodak, and Antitrust at the Millennium*, 68 ANTITRUST L.J. 187 (2000) [hereinafter *First Principles*].

## A. CLASSIC MONOPSONY CONDUCT

Monopsony power in an input market is the buyer-side analogue to market power in the output market.<sup>11</sup> Monopsony conduct involves “underbuying” an input to profitably reduce its price.<sup>12</sup> Suppose that a firm accounts for a large share of input purchases in an input market with competitive input suppliers, and the market supply of the input is rising in price (i.e., not perfectly elastic).<sup>13</sup> The monopsonist does not treat the market price of the input as beyond its control. Instead, a monopsonistic input purchaser has the incentive to restrict its input purchases below the competitive level. The monopsonist reasons that by decreasing its input purchases, it will be able to reduce the unit price for the remaining input it purchases. This can lead to a significant cost saving that more than offsets the profit that would have been earned on the output. During this process, the firm typically would reduce its output as well.<sup>14</sup>

If the monopsonistic input purchaser sells into an output market with a downward-sloping market demand curve, the output reduction would cause higher prices and consumer injury. This outcome occurs even if the firm takes the price of output as given in making its market decisions. This situation is illustrated in the left-hand panel of Figure 1, which pictures the output market and which assumes that a unit of the input is transformed into a unit of output.<sup>15</sup> Instead of purchasing the competitive input level  $L_c$ , the monopsonist restricts its input purchases to only  $L_s$  units and produces that level of output. By restricting purchases to the intersection of the MFC and D curves, the input price is pushed

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<sup>11</sup> For other reviews of the economics of monopsony, see Roger D. Blair & Jeffrey L. Harrison, *Antitrust Policy and Monopsony*, 76 CORNELL L. REV. 297 (1991).

<sup>12</sup> Monopsony power that reduces input purchases also should be distinguished from bargaining power that increases input purchases. Suppose that sellers in the input market have market power and, as a result, set supracompetitive prices and restrict their production. If a buyer (or group of buyers) somehow gains countervailing bargaining power, the equilibrium outcome may involve a higher production of the input and a lower input price, closer to the competitive level. Buyers could gain bargaining leverage in a variety of ways, including a cooperative buying agreement.

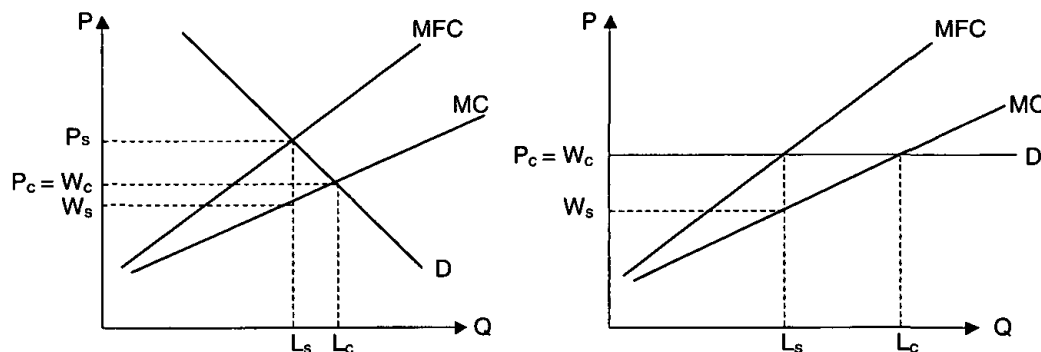
<sup>13</sup> In contrast, if the input supply is perfectly elastic, then a reduction in input purchases does not result in a price decline. In these circumstances, monopsony power cannot profitably be exercised.

<sup>14</sup> Alternatively, a firm might find it more profitable to substitute less efficient inputs for its marginal production.

<sup>15</sup> In a sense, the monopsony diagram is just the monopoly diagram turned upside down. The input supply curve in the monopsony problem is analogous to the demand curve in the monopoly diagram. The marginal factor cost curve is analogous to the marginal revenue curve for a firm with market power in the output market. The demand curve in the monopsony problem is analogous to the firm's marginal cost curve in the monopoly diagram.

down to  $W_s$ , below the competitive level  $W_c$ .<sup>16</sup> This is because the supply of the input is upward-sloping so reduced purchases leads to a lower unit price. This input restriction harms input suppliers, and also leads to a reduced output level, equal to the input purchases  $L_s$  in this example. Assuming that the monopsonist takes the output price as given, this leads to a higher output price  $P_s$ , and results in consumer injury.<sup>17</sup>

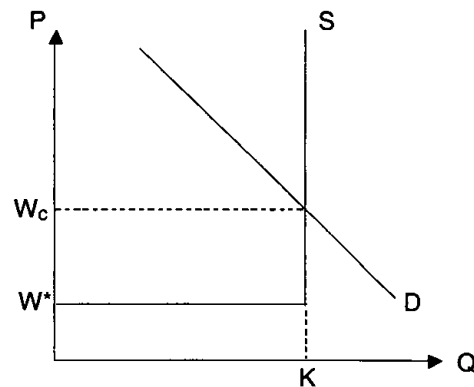
The exercise of monopsony power reduces economic efficiency but does not necessarily harm consumers. The profitability of exercising monopsony power can come solely from reducing input costs. In particular, when the monopsonist is a perfect competitor in a broad output market in which other suppliers have perfectly elastic supply at the current price, the monopsonist would reduce its input purchases and its output, but the other competitors would expand by an equal amount. This situation is illustrated in the right-hand panel of Figure 1. In this situation, the output demand curve  $D$  is perfectly elastic at the price  $P_c$ . In this case, the input restriction does not lead to a higher output price, only a lower input price  $W_s$  and lower input purchases and output  $L_s$  by the monopsonist. Market output remains the same because other competitors (purchasing in other input markets) take up the slack.



**Figure 1. Output Market: Basic Monopsony Analysis**

<sup>16</sup> At this point, the monopsonist is setting its output price equal to its marginal factor cost (MFC), which represents the firm's incremental (i.e., marginal) cost of increasing output with this input. The MFC exceeds the firm's (conventionally defined) marginal cost (MC), as indicated on the diagram. This is because the MC does not take into account the impact of additional purchases on the unit price of the input. This article often refers to the MC as the "conventionally measured" marginal cost to distinguish it better from the MFC.

<sup>17</sup> If the monopsonist also recognizes its ability to control the output price by restricting its own output, then the outcome will involve even lower output and an even higher output price. This outcome would be characterized by the marginal factor cost in the input market being set equal to the marginal revenue in the output market. This scenario is not pictured in Figure 1.



**Figure 2. Input and Output Markets: Perfectly Inelastic Supply**

At the monopsony outcome, the firm's output price strictly exceeds its (conventionally measured) marginal cost. This outcome does not occur primarily because the firm intends to raise the output price. Instead, it arises because the firm restricts its input purchases and therefore its output production, resulting in a lower marginal cost. Indeed, even if the monopsonist is a perfect competitor in the output market and the output price is fixed, the monopsonist still produces at a point where the market price exceeds the (conventionally measured) marginal cost. Price is set equal to marginal factor cost. This is illustrated in the right hand panel of Figure 1.

One other situation deserving attention is where the maximum input supply is fixed and perfectly price inelastic. Because of the assumption that one unit of input is converted into one unit of output, this fixed input supply also limits the output capacity accordingly. In this situation, monopsony conduct may not lead to reduced input purchases or output, only a lower input price. This is illustrated in the output market diagram in Figure 2. The input (and output) supply curve is perfectly elastic at a price of  $W^*$  until it reaches a full capacity level  $K$ , at which point it becomes perfectly price inelastic. In this diagram the competitive input price would be  $W_c$ , but a monopsonist would push that input price down to  $W^*$ , without significantly reducing purchases. If the monopsonist also controls the output price and the initial output price were  $W_c$ , it would have no incentive to reduce the output price.<sup>18</sup> In fact, such a monop-

<sup>18</sup> The monopsonist would recognize that it has to pay no more than  $W^*$  to get  $K$  units of the input. As a technical matter, the monopsonist would trivially reduce its input purchases just slightly below  $K$ , which would cause excess supply, leading the input price to fall to  $W^*$ .



sonist also might choose to restrict purchases further and raise the output price above  $W_c$ .<sup>19</sup>

It should be noted that a firm may achieve monopsony power without engaging in any exclusionary conduct, just as a firm may achieve monopoly power by accident or through superior skill, foresight, or industry. For example, the largest purchaser of labor in a small town could have monopsony power in an input market that has a rising supply curve. Similarly, an innovative firm might find a use for a natural resource that was not valued previously.

Achieving monopsony power by legitimate means and exercising legitimately achieved monopsony power is not illegal. But, if monopsony power is achieved with illegitimate conduct that harms consumers, then the Sherman Act would apply. For example, buyer cartels violate Section 1 of the Sherman Act. The antitrust laws also would be violated if a monopsonistic purchaser achieves or maintains monopsony power by engaging in exclusionary conduct towards its buyer-side competitors in the input market.

#### B. PREDATORY OVERBUYING: OVERBUYING TO GAIN MONOPSONY POWER IN THE INPUT MARKET

Predatory overbuying to achieve or maintain monopsony power in the input market is analogous to predatory pricing to achieve monopoly power in the output market. Suppose that a monopsonistic buyer in an input market, in response to increased competition on the buyer side of this market, stops restricting its purchases and instead outbids its buyer-side input competitors, thereby significantly increasing its input purchases. This overbuying could cause the rival purchasers to lose money and exit from the market or permanently reduce their capacity. That effect, in turn, could allow the firm to regain or solidify monopsony power. At that point, the overbuying firm, again, could engage in monopsony conduct, restricting its purchases in order to reduce its input costs. This predatory strategy could increase the firm's profits. In fact, its profits could rise whether or not the firm achieves (or maintains) market power in the output market, because the strategy reduces its input costs.

For example, a large meat packer with several packing plants could face bidding competition at a single plant for purchasing cattle from smaller packers with plants nearby. The meat packer may reckon that

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<sup>19</sup> That issue would depend on whether the firm's marginal revenue curve would cut the vertical versus the horizontal portion of the supply curve.

if some of these smaller packers were driven out of business, then it could acquire cattle more cheaply. To achieve this goal, the firm might purchase more cattle than it needs to drive up (input) prices at the auctions where the small bidders participate. At the same time, the overbuying firm would not raise (output) prices for its packaged beef but rather would sell the extra beef produced from the extra cattle purchased, leading to lower output prices. This strategy could squeeze the profits of the fringe packers and, for that reason, is sometimes called a "price-cost squeeze." If the rivals were not well-financed, this strategy could lead them to exit from the market, permanently reduce capacity, or forgo expansion. At that time, the meat packer then could get the benefit of a lower price of cattle for this plant.

Although predatory overbuying is analogous to predatory pricing, the target market differs and likelihood of consumer harm from predatory overbuying is smaller. A monopolist engaged in predatory pricing in the output market hopes to recoup its investment directly from consumers. In contrast, predatory overbuying may or may not harm consumers. In fact, consumers may even gain from the conduct through lower prices and increased output. Alternatively, in the above example, suppose that the packaged beef were sold in a worldwide market. In this situation, there may be no effect on the price of packaged beef during either the period in which the large packer is overbuying or afterwards, when the fringe packers exit from the market.

To see why consumer harm is not inevitable, it is necessary to trace through the dynamics of predatory overbuying conduct and its impact on suppliers, competitors, and consumers. As suggested by the analysis of predatory pricing, it is useful to distinguish between the "predatory" period and the subsequent "recoupment" period. During the predatory period, the predating firm purchases more of the input than it would otherwise. The higher price of the input raises the cost of the firm's buyer-side competitors and causes them to exit or permanently reduce their capacity. During this period, consumers gain from lower prices. But, after rivals exit, the predating firm faces less buyer-side competition in the input market. During the recoupment period, the firm exercises monopsony power in the input market and pays less for the inputs it purchases. This predatory strategy is profitable if the overbuying firm's lower profits during the predatory period are outweighed by its higher profits during the recoupment period.

Although predatory overbuying may not harm consumers, successful overbuying clearly hurts the defendant's competitors in the input market. They face artificially higher input costs during the predatory period and

reduce their output as a result. They are unable to offset these harms during the recoupment period because they permanently exit from the market or permanently reduce their capacity.<sup>20</sup>

The impact of the conduct on input suppliers varies over time: during the predatory period, the input suppliers benefit from the increased demand and higher prices.<sup>21</sup> During the recoupment period, the input suppliers are harmed and face a reduced demand for their inputs for two reasons. First, some of the competing input buyers have exited from the market or cut back their capacity. Second, and as a result of the first reason, the defendant now exercises monopsony power by reducing its own input purchases in order to reduce the price it must pay for the units it continues to buy. Consequently, it is not clear whether input suppliers are benefited or harmed on balance by a successful predatory overbuying strategy.

Of course, the overriding concern of antitrust is the impact of the overbuying conduct on consumers, not competitors or suppliers. The impact on consumers also is complex because, during the predatory period, consumers likely gain in the form of lower output prices and increased output. Although the defendant's competitors reduce their output, the defendant likely increases its output by more.<sup>22</sup> Selling more output generally involves price reductions.

During the recoupment period, output prices are higher than during the predatory period; however, they may remain below the price level that prevailed before the predation was commenced. Consumers can be harmed only if the output price rises above the pre-predation level, which may not occur. As some input competitors exit and the monopsonist shrinks its input purchases (i.e., underbuys) to reduce the unit price

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<sup>20</sup> If input market competitors did not irreversibly reduce their capacity but instead re-entered the input market during the recoupment period, or if they were replaced by other equally large and efficient entrants, then the predatory overbuying strategy would be unprofitable for the defendant. The defendant would pay higher input costs during the predatory period but would fail to gain the benefits of monopsony power during the recoupment period. This is similar to predatory pricing, where the strategy fails if the competitor/victims re-enter the market, or other entrants replace them, during the recoupment period.

<sup>21</sup> If the supply of inputs is perfectly inelastic, there is no effect on quantity, only price. If the supply of inputs is perfectly elastic, then overbuying cannot succeed.

<sup>22</sup> Although it is theoretically possible that the overbuying firm could choose to dispose of the excess inputs, it generally would be more profitable for the defendant to produce more output. Once the input is purchased, it has a lower opportunity cost. However, if the firm sells in multiple output markets, it might sell the "excess" output during the predatory period in one output market and raise price while decreasing output during the recoupment period in a different output market. In this situation, consumers in the latter output market would be harmed.

of the input, the monopsonist produces less output. Unless this reduced output is fully offset by increased output from other producers, output prices will rise.

Consumers surely gain from *failed* predatory overbuying because they get the benefits of lower prices during the predatory period but do not pay higher prices (than absent any predatory overbuying strategy) during the recoupment period. Consumers also are not harmed when the defendant successfully gains monopsony power in the input market but the price of output does not rise. Except in these two scenarios, the net consumer impact from successful predatory overbuying requires balancing benefits against harms.

As shown by the meat packing example presented earlier, the existence of competition in the output market is not foreclosed by monopsony power in the input market. Where sufficient output competition exists, the output reduction by the defendant during the recoupment period would be compensated by increased production from other output market competitors (who purchase inputs in another input market and would not be affected by the overbuying). Thus, there would not be an output price increase during the recoupment period and, as a result, no consumer harm. Of course, in this scenario, consumers also would not gain during the predatory period. This is because increased output by the defendant would be offset by compensating output reductions from other output market competitors who are not input market competitors.

A similar result occurs in the case of an input with a fixed (i.e., a perfectly price inelastic) supply. For example, suppose that farmers grow a fixed amount of tobacco each year and one large cigarette company engages in predatory overbuying targeted towards the fringe buyers. In this case, total market purchases would not rise during the predatory period. Therefore, there could be no price-reducing effect to benefit consumers. However, there is unlikely to be any consumer harm during the recoupment period, even if the predator causes these input rivals to exit.<sup>23</sup> The cigarette company also would purchase all the tobacco during the recoupment period and so might produce the same quantity of cigarettes. This would certainly be the case if the cigarette company faced a perfectly elastic demand for cigarettes.

A predatory overbuying strategy may fail for a number of reasons. For example, during the predatory period the share of the input accounted

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<sup>23</sup> It is theoretically possible that the input supply is perfectly inelastic with respect to price increases, but very elastic with respect to input price decreases, as in Figure 2. However, this would be an unusual situation.

for by the defendant may be too small or the supply elasticity too large to trigger any significant input price increase. There also may be good substitutes for any particular input. During the recoupment phase, the attempt by the predator to force input prices lower may invite entry to take advantage of the lower prices. But, even if the overbuying strategy is profitable, output prices need not rise over the level that would have prevailed absent the overbuying. And, unless output prices rise above this level, there can be no consumer harm from predatory overbuying.

### C. RRC OVERBUYING: OVERBUYING TO GAIN MARKET POWER IN THE OUTPUT MARKET

As a substitute or complement for predatory overbuying, a firm might overbuy inputs to achieve market power in the output market. Through Raising Rivals' Costs (RRC) overbuying, a power buyer significantly increases its input purchases to increase the input prices faced by its rivals in order to gain market power in the output market. If its output market rivals have materially increased input costs, then they would have the incentive to reduce their output or raise their output prices.<sup>24</sup> Either way, the reduced competition would permit the firm to increase both the price it charges for its output and its market share.

The basic economic analysis of RRC overbuying is straightforward. If the firm's pricing is not fully constrained by other output market competitors whose costs are not raised, then the firm would gain the power to raise its own price in the output market.<sup>25</sup> Consumers would be harmed by the higher output prices. For example, the meat packer in the earlier example could overbuy to drive up the price of cattle, causing fringe firms to face higher costs and raise their packaged beef prices. In that case, the overbuying firm could raise its packaged beef price, too.

RRC overbuying also can involve a type of "price-cost squeeze" that results in the firm increasing its market share. The price-cost squeeze results when the overbuying leads to higher costs for the input-market competitors while the output price does not rise by as much, leading to

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<sup>24</sup> Note that monopsony power is not necessary for successful RRC overbuying. RRC overbuying involves expanding purchases to push up input prices, not reducing purchases in order to profitably push down input prices.

<sup>25</sup> It is not necessary that the overbuying firm have classical market power in the output market, that is, the ability to raise price by restricting its own output. Even if the firm is a price-taker, there can be a price effect in the output market if the demand curve is downward-sloping and competitors' supply is not perfectly elastic. Of course, in this situation, the firm also may have some classical market power. See Thomas G. Krattenmaker et al., *Market Power and Monopoly Power in Antitrust Law*, 76 GEO. L.J. 241 (1987).

a reduced price-cost margin facing competitors. However, it is important to emphasize that this squeeze involves an increase in the output price. Unlike the initial phase of predatory overbuying, it does not involve the combination of higher input costs and lower output prices. Instead, the firm uses the overbought inputs to increase its market share, while rivals decrease their output despite the higher output price.

Given that the overbuying firm also suffers from increased costs as input prices rise, the question arises as to whether the firm would profit from an RRC overbuying strategy. Increased costs might make the strategy unprofitable even if the firm gains the power to raise the output price. However, this cost-raising strategy can be profitable when technologies differ across firms or marginal costs are rising faster than average costs.<sup>26</sup> In these cases, the overbuying may increase rivals' costs (and the price of output) by more than they increase the costs of the overbuying firm. Alternatively, the overbuying may increase the market price by more than it increases the unit costs of the overbuying firm and its output market rivals. There are several conditions under which one of these outcomes would occur.

First, rivals may be more vulnerable to the input price increase because they use relatively more of the input in their production process than does the firm engaged in the overbuying strategy. For example, suppose that an overbuying coal-mining firm has a more capital intensive production process than its smaller rivals. In that case, an increase in the wage rate of the coal miners would inflict a larger increase on the rivals' marginal costs than on the costs of the overbuying firm. If the price of coal were to rise by the increase in other firms' marginal costs, the overbuying firm's profits would rise, even if the firm did not increase its own output.<sup>27</sup> A more extreme case occurs if the firm begins purchasing an input that it does not use in its production process—what might be called “naked” overbuying.

Second, rivals may be more vulnerable to input price increases because the overbuying firm is partially vertically integrated into the relevant input. In that way, when the input price increases in the merchant market, the overbuying firm's costs do not rise as much because it relies partially on its own “captive” production. For example, if an overbuying aluminum firm were to produce half of its bauxite input needs internally,

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<sup>26</sup> See, e.g., Steven C. Salop & David T. Scheffman, *Raising Rivals' Costs*, 73 AM. ECON. REV. 267 (1983); Steven C. Salop & David T. Scheffman, *Cost-Raising Strategies*, 36 J. INDUS. ECON. 19 (1987).

<sup>27</sup> See Oliver E. Williamson, *Wage Rates as a Barrier to Entry: The Pennington Case in Perspective*, 82 Q.J. ECON. 85 (1968).

then an increase in the market price of bauxite would increase its costs by half the increase in its rivals' costs. Thus, if the output price were to rise by the same amount as the increase in the marginal costs, the overbuying firm's profits would rise, even if it did not increase its own output.

Third, for certain production technologies it is possible that the profits of both the overbuying firm and its rivals could rise, if the input price increase would increase every firm's marginal cost by more than its average cost.<sup>28</sup> For example, this could occur if the relevant input is used by all firms only for producing output at the margin. It also could occur if the input becomes less productive as a firm's output is increased, that is, if the firms' technologies exhibit significant decreasing returns to scale. In either situation, if the output price rises by the increase in marginal costs, and the firms' increases in their marginal costs exceed the increase in their average costs, and demand is sufficiently inelastic, then profits could rise. In this situation, the rivals are not injured on balance, but consumers are harmed. Thus, such conduct would violate the antitrust laws.<sup>29</sup>

Of course, anticompetitive overbuying strategies may fail. There are several constraints on the profitability of RRC overbuying, including the possibility that the above conditions may not be present. Other constraints, such as several types of input market conditions, also may make it impossible to materially raise rivals' costs.<sup>30</sup>

Conditions in the output market similarly may prevent significant price increases, even if rivals' costs are raised. First, in the input market, rivals may be able to rely on close substitutes for the input or rivals may be able to backward integrate and produce the necessary inputs themselves without suffering a cost disadvantage. If so, rivals' costs might not be raised. Second, the supply of the key input may be highly price elastic. This would mean that even significant increases in the firm's demand for the input would not have a substantial increase in the price of the input. As a result, rivals' costs would not be raised significantly. Third,

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<sup>28</sup> See Michael T. Maloney et al., *Achieving Cartel Profits Through Unionization*, 46 S. ECON. J. 628 (1979); 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 1984); James A. Langenfeld & John R. Morris, *Analyzing Agreements Among Competitors: What Does the Future Hold*, 36 ANTITRUST BULL. 651 (1991).

<sup>29</sup> Where this could be established by the defendant firm, a plaintiff-competitor might not be able to claim damages from lost profits and might face an attack on its standing.

<sup>30</sup> See Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 YALE L.J. 209 (1986).

the overbuying firm and its rivals may purchase inputs in separate input markets. The clearest example of this is the situation where the firms purchase inputs in separate local geographic markets. The same basic analysis would apply where the firms use different technologies, with different inputs, to produce the same output.<sup>31</sup> Fourth, the overbuying firm may not be a significant enough purchaser to drive up the input price substantially. Even a dominant seller in the output market may not be a significant buyer in the input market. Input markets often are comprised of buyers who sell non-competing products.

In the output market, if overbuying does not raise rivals' costs by much, then output prices may not be raised enough to make the overbuying strategy profitable.<sup>32</sup> Simply raising rivals' costs does not by itself benefit the overbuying firm or harm consumers. The overbuying firm may lack market power in the output market and continue to face sufficient competition that prevents the output price from rising in response to its overbuying. This could occur if the firm only raises the costs of a subset of its rivals and the other competitors have the ability to take up the slack by expanding their production without suffering a cost penalty. It similarly could occur if there are close market substitutes for the output produced by the firm and the rivals whose costs have been raised. It also could occur if the input is only a trivial contributor to the rivals' marginal costs. For example, doubling the price of spark plugs would not materially increase the price of an automobile. Finally, it could occur if output demand is highly price elastic. In that case, a fairly small price increase could lead to such a large reduction in sales for the overbuying firm, whose costs also have increased, that its profits would fall from the strategy.

Under all these conditions in the input and output markets, overbuying may not lead to sufficiently higher output prices to make the overbuying strategy profitable or harmful to consumers. A rational firm would attempt RRC overbuying only if a profitable outcome were anticipated. Moreover, unless the price of output rises, consumers would not be harmed.

#### D. PROCOMPETITIVE JUSTIFICATIONS FOR INCREASED INPUT PURCHASES

Of course, not all increases in input purchases are part of an anticompetitive overbuying strategy. The increased purchases could be driven

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<sup>31</sup> However, as discussed *infra* Part I.E., where the firms purchase in separate input markets, the firm could attempt a naked overbuying strategy, entering rivals' input markets with the sole purpose of raising their costs.

<sup>32</sup> Krattenmaker & Salop, *supra* note 30.



by an increase in demand for the firm's product or a new business plan that involves market share growth. Or they could be driven by the firm adopting a new production process that uses the input more intensively. Increased purchases also could reflect changes in inventory policy, such as where the firm chooses to hold more inventories to reduce the likelihood of shortages or to hedge against future input price increases. It is also possible that a one-time instance of seeming overbuying would occur from a mistake regarding input needs, perhaps because the firm overestimated the demand for its product.<sup>33</sup>

Increased purchases also may reflect a firm's loss of monopsony power. As a result of increased competition for inputs or a change in supply conditions, the firm may lose the ability to control the input price. Without monopsony power, the firm would not have the incentive to restrict its input purchases.<sup>34</sup> This could lead to higher input purchases by the firm and a higher market price for the input.<sup>35</sup> A similar analysis would apply to a loss in monopoly power in the output market that makes the firm's input demand more elastic.

#### E. NAKED OVERBUYING AND WAREHOUSING

Overbuying typically involves purchasing additional amounts of an input that are then used in the firm's production process to increase output. Naked overbuying involves purchasing an input that the firm does not use in its own production process but is used by its output market competitors. Naked overbuying reduces the overbuying firm's profits because the inputs are purchased but not used, either in the present or the future. The most obvious reason why a firm would purchase an input that it does not use in its own production process would be to interfere with its competitors. By purchasing such inputs, the firm would raise its rivals' costs, leading them to reduce their output and raise their output prices. Thus, naked overbuying potentially could be a profitable RRC strategy. However, it is not a rational predatory overbuying strategy

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<sup>33</sup> In the case of a differentiated product like a TV series shown by cable networks, the buyer may purchase more episodes than it exhibits in order to deter free riding by competitors on its promotion. Competitors may do likewise. This rationale can raise a line-drawing issue between legitimate deterrence of free riding and rent seeking.

<sup>34</sup> Note also that overbuying offsets the restricted input purchases that flow from monopsony power. Thus, modest overbuying increases economic efficiency, even if it has an anticompetitive motive. This issue is discussed in more detail below in the legal policy section, *infra* Part II.

<sup>35</sup> This situation creates two conflicting forces. On the one hand, the loss in monopsony power leads the firm to increase its purchases. On the other hand, a higher input price from an increase in rivals' input demand leads the firm to decrease its purchases. Both lead to a higher input price.

because the firm would gain no benefit from achieving monopsony power over an input that it does not use.

Warehousing involves inputs that are used by the firm. A firm following a warehousing strategy purchases a higher quantity of the input than it uses to produce output and then disposes of the rest. Buying inputs that are not used raises suspicions because it suggests that the firm is deliberately sacrificing profits to raise the costs of rivals and deny them access to needed inputs. Warehousing conduct could be part of either a predatory or RRC overbuying strategy.<sup>36</sup> However, as discussed in Part II.D., behavior that looks like warehousing could have a legitimate, pro-competitive explanation.<sup>37</sup>

Another interesting scenario involves a bidding market for inputs where the firm would not have been the highest bidder. A firm could attempt to bid up the price that its rivals pay for an input but still lose out on the bidding. In this case, the rivals' marginal costs would increase at no expense to the firm.<sup>38</sup> Of course, this strategy requires a delicate bidding strategy, as one must be aware of "the danger of making one bid too many."<sup>39</sup> This strategy also may be difficult to implement perfectly because at the higher marginal cost level, the rivals likely would cut back their production, which would lead the firm to end up purchasing some of the overpriced input.

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<sup>36</sup> This might be particularly relevant with respect to fixed inputs that an entrant needs for its survival.

<sup>37</sup> Purchasing exclusive access to an input can raise foreclosure concerns that are similar to RRC overbuying. Exclusive purchasing agreements can raise rivals' costs and give the firm power over price in the output market. Exclusive purchasing agreements also can lead to higher input prices as the rivals bid up the price of the remaining available input supplies. However, the economic analysis of exclusive purchasing agreements is somewhat different because the purchase of an exclusivity right is distinct from the purchase of the input. That is, in addition to purchasing inputs for its own use from a supplier, a firm purchases the right to deny its competitors access to that supplier's production. In fact, a firm that does not purchase any inputs from a supplier in principle could purchase a *naked* exclusionary right. Because of these differences, analysis of exclusivity agreements is beyond the scope of this article. For further analysis of exclusive access to inputs, see Krattenmaker & Salop, *supra* note 30; Krattenmaker et al., *supra* note 25; Steven C. Salop, *The First Principles Approach to Antitrust, Kodak, and Antitrust at the Millennium*, 68 ANTITRUST L.J. 187 (2000).

<sup>38</sup> See *Reid Bros. Logging Co. v. Ketchikan Pulp Co.*, 699 F.2d 1292, 1297 (9th Cir. 1983).

<sup>39</sup> *Id.*

## II. LEGAL POLICY ANALYSIS

Building on the economic foundation of the two overbuying strategies, a legal policy analysis demonstrates that a four-step rule of reason standard should be applied to overbuying.<sup>40</sup>

### A. LEGAL TREATMENT OF SINGLE-FIRM UNILATERAL MONOPSONY RESTRICTIONS

As discussed earlier, a firm may achieve monopsony power without engaging in any exclusionary conduct. As with monopoly power, the legitimate achievement of monopsony power and the exercise of that power do not raise antitrust concerns under the Sherman Act.<sup>41</sup> Again, as with monopoly power, antitrust instead has focused on cartel activity and exclusionary conduct that has the effect of achieving or maintaining monopsony power.

The *Kartell*<sup>42</sup> case provides an example of the lenient antitrust treatment of the exercise of monopsony power by a single buyer assumed to have legitimate monopsony power. Judge (now Justice) Breyer's opinion treats Blue Cross as a buyer seeking the lowest possible price for medical services. Blue Cross apparently had monopsony power in the purchase of medical services and also may have had market power in the sale of insurance in Massachusetts. By viewing Blue Cross as an agent for the customers it insured, rather than as an intermediary firm that purchased inputs and sold output as a re-seller, the court seemed to view Blue Cross as benefiting the "final" consumers who used the health care and purchased health insurance to pay for it. The court apparently assumed

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<sup>40</sup> For clarity of exposition, the analysis presented here generally assumes that the competitiveness of the conduct is being evaluated after the fact and focuses on the type of evidence that would be useful in making the determination. Of course, exclusion complaints often are brought as attempt to monopolize cases before the strategy has fully played itself out. In those situations, some of the relevant evidence possibly may be unavailable or sketchy. It may be possible only to determine the likelihood of effects, rather than providing definitive proof. However, these are general issues that arise in all attempt cases. Therefore, this section will not specifically examine these evidentiary issues.

<sup>41</sup> Monopsony power sometimes may be considered the legitimate reward for beneficial economic activity. In any event, courts have little interest in carrying out the necessary remedies for legitimately achieved monopsony power. Regulating input prices is avoided by antitrust courts for the same reason that these courts avoid regulating output prices—courts do not have the expertise of regulatory commissions. A structural remedy of disintegrating a large firm in order to create input market competition is a remedy of last resort and would only be used in response to egregiously anticompetitive conduct, if ever. That remedy would not be used to remedy legitimately achieved monopsony power.

<sup>42</sup> *Kartell v. Blue Shield of Mass., Inc.*, 749 F.2d 922 (1st Cir. 1984).

that Blue Cross would pass on its lower input costs to its customers in the form of lower insurance premiums.<sup>43</sup>

Under this interpretation, which will be assumed in the remainder of this section, Blue Cross would be an agent that formed and managed a buyer-side cooperative for health care consumers. In light of Blue Cross's substantial position in the market and its assumed impact on the prices received from the health care providers, this interpretation would seem to imply that Blue Cross and its customers were co-conspirators in a final-buyer, buyer-side cartel.

This interpretation has an interesting implication with respect to the antitrust welfare standard. It implies that Judge Breyer and the court were concerned with consumer welfare, not efficiency or aggregate economic welfare. Although this conflict among antitrust goals arises and is resolved elsewhere in antitrust, the scenario of a final-buyer buyer-side cartel is a telling example.

There has been longstanding antitrust controversy regarding the proper economic welfare standard. Some commentators favor the *aggregate economic welfare* standard, sometimes called the "efficiency" standard. Other commentators favor the *pure consumer welfare* standard. The aggregate economic welfare standard would permit conduct if it increases the aggregate welfare, *without regard to distributional effects*. The pure consumer welfare standard only would permit conduct if it raises the welfare of consumers, irrespective of its impact on producers.<sup>44</sup> For example, consider a merger to monopoly that permits the merged firm to reduce costs significantly but also endows the firm with the ability and incentive to raise its price above the premerger level. That merger would violate the pure consumer welfare standard. However, the merger would pass muster under the aggregate economic welfare standard if costs were reduced sufficiently to raise the firm's profits by more than it harms consumers.<sup>45</sup>

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<sup>43</sup> See Peter J. Hammer & William M. Sage, *Monopsony as an Agency and Regulatory Problem in Health Care*, 71 ANTITRUST L.J. 949 (2004). As discussed in that article, Judge Breyer seems to assume that Blue Cross's conduct would not restrict output and raise price. In light of the regulatory structure imposed on Blue Cross in Massachusetts at the time, that outcome could be possible despite Blue Cross's potential market power in the insurance market. This regulation could have permitted consumer harm from the monopsony conduct. Judge Breyer's opinion and its effects on health care antitrust have been criticized by a number of antitrust commentators that specialize in health care issues. *See id.*

<sup>44</sup> For a review of these issues, see Robert H. Lande, *Wealth Transfers as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged*, 34 HASTINGS L.J. 65, 74-77 (1982).

<sup>45</sup> This is the standard Williamson-diagram tradeoff. Oliver E. Williamson, *Economies as an Antitrust Defense: The Welfare Tradeoffs*, 58 AM. ECON. REV. 18 (1968). The distinction

Courts and the federal enforcement agencies appear to have opted for the pure consumer welfare standard. This is indicated by their focus on the price effects of allegedly anticompetitive conduct. For example, the Merger Guidelines are quite explicit that mergers that raise prices violate the Guidelines irrespective of their impact on the costs of the merging firms.<sup>46</sup> Cost savings only could save a merger in a highly concentrated market if they prevent prices from rising. Similarly, if a seller-side cartel increases the price of a product with perfectly inelastic demand so that there is no output restriction, that cartel nonetheless would violate the antitrust laws.

Finally, exclusionary conduct law also opts for the consumer welfare standard.<sup>47</sup> For example, in an exclusionary conduct case under Section 2, it is not enough for the plaintiff to prove injury to competitors. The plaintiff must also show injury to consumers. In his article, Professor Kirkwood agrees that overbuying allegations should be subject to the consumer welfare standard.<sup>48</sup> In contrast, Professor Zerbe prefers a total welfare standard.<sup>49</sup> Under a total welfare standard, harm to competitors

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between the pure consumer welfare and aggregate economic welfare standards is made more complicated because Robert Bork referred to the aggregate economic welfare standard as a “consumer welfare” standard. ROBERT H. BORK, *THE ANTITRUST PARADOX*, 372–74 (1978). The two standards come closer together in merger analysis if they are interpreted as *long-term* welfare standards and it is assumed that merger-specific cost-savings and other innovations will be rapidly imitated or emulated by other firms, increasing the rate of pass-on to consumers. See Gary L. Roberts & Steven C. Salop, *Efficiencies in Dynamic Merger Analysis: A Summary*, 19 *WORLD COMPETITION* 5 (1996). The aggregate welfare standard also would protect consumer welfare if the tax system were used to redistribute income to the consumers who lose out from anticompetitive conduct. But this type of redistribution is neither carried out today, nor does it seem very practical.

<sup>46</sup> Federal Trade Comm’n and U.S. Dep’t of Justice, Horizontal Merger Guidelines § 4 (1992, revised 1997), reprinted in 4 Trade Reg. Rep. (CCH) ¶ 13,104; see also *United States v. Long Island Jewish Med. Ctr.*, 983 F. Supp. 121, 149 (E.D.N.Y. 1997) (finding that efficiencies will benefit consumers because merged hospitals will “pass on cost savings”); *FTC v. Staples, Inc.*, 970 F. Supp. 1066 (D.D.C. 1997).

<sup>47</sup> See also Steven C. Salop & R. Craig Romaine, *Preserving Monopoly: Economic Analysis, Legal Standards, and Microsoft*, 7 *GEO. MASON L. REV.* 617, 646 (1999).

<sup>48</sup> John B. Kirkwood, *Buyer Power and Exclusionary Conduct: Should Brooke Group Set the Standards for Buyer-Induced Price Discrimination and Predatory Bidding?*, *supra* this issue, 72 *ANTITRUST L.J.* 625 (2005).

<sup>49</sup> Professor Zerbe indicates a preference for the aggregate welfare (efficiency) standard. He says that efficiency losses in one market lead to consumer harm in other markets. Richard O. Zerbe Jr., *Monopsony and the Ross-Simmons Case: A Comment on Salop and Kirkwood*, *infra* this issue, 72 *ANTITRUST L.J.* 717 (2005). While this may be true, it does not imply an advantage for the aggregate welfare standard because those deadweight losses in consumer surplus involve a loss that also is counted in the consumer welfare standard. The real difference between the two standards is whether the monopoly transfer from consumers to the profits of the firm “count” as a cognizable harm. In particular, the transfer generally is not counted as a cognizable harm in the aggregate welfare standard. But, the monopoly transfer cannot be assumed to translate into higher consumer welfare.

would count and would be sufficient for liability. Competitor injury would be a cognizable harm, independent of the harm to consumers. Indeed, harm to competitors would be given the same weight as benefits to consumers. For example, suppose that a dominant firm engages in conduct that raises its profits by \$100, increases consumer welfare by \$100, and reduces the profits of competitors by \$250. That conduct would reduce total welfare (efficiency) by \$50 (i.e.,  $+100 + 100 - 250$ ) while raising consumer welfare by \$100. As a result, under the aggregate welfare standard, the \$250 harm to competitors in effect would trump the \$100 consumer benefit. Thus, the total welfare (efficiency) standard is inconsistent with a view that antitrust is for the protection of consumers, not competitors.<sup>50</sup>

Antitrust treatment of seller-side cartels does not implicate the controversy over the welfare standard because a naked seller-side cartel typically reduces both consumer and aggregate welfare. Even if demand is perfectly inelastic, aggregate welfare does not rise, but simply remains the same. Similarly, a buyer-side cartel of intermediate firms also reduces both consumer and aggregate welfare because the cartel restricts input purchases, which leads to less output downstream and higher prices paid for the product by the final consumers. For example, consider a cartel of tobacco companies that reduces the wholesale price its members pay

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Instead, the monopolist might distribute the monopoly profits to its shareholders or use the extra profits to maintain its monopoly power by erecting entry barriers. The quest to maintain monopoly (or cartel) profits in principle can drive innovation, but that has never been treated as a defense to otherwise anticompetitive conduct. Conduct that raises entry barriers makes innovation less necessary, not more.

<sup>50</sup> Professor Zerbe also provides an example of predatory pricing in complementary goods where the predation has effects on consumers in multiple markets. This is an interesting issue, but I must be brief. First, Professor Zerbe's analysis of this specific example is incomplete. For example, if all consumers bought bread and butter in fixed proportions, then the total price of the bread-and-butter product would fall and consumers on balance would be better off during the predatory period. There could be consumer harm, but only for the lactose-intolerant consumers who buy only bread and no butter. (And, presumably these benefits and harms would all be reversed during the recoupment period.) Of course, if the bread market were perfectly competitive with constant costs, the price of bread would not change and there would be no impact on the lactose-intolerant bread purchasers. Second, as a general matter, it is certainly recognized in antitrust that conduct in one market can have effects in other markets as well. This is true for vertically linked markets as well as standard complementary product markets, and multiple markets often are affected by mergers. In exclusionary conduct cases, the antitrust focus has always been on the impact on consumers in the output market, not competitors in the input market. In mergers, trumping consumer harms in one market with consumer benefits in another market generally has not been permitted since *Philadelphia National Bank*, *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321 (1963). See also Horizontal Merger Guidelines, *supra* note 46, § 4. If consumer benefits and harms were to be balanced, that process clearly complicates the analysis and requires resolution of knotty issues involving interpersonal comparisons. But, the right answer for antitrust law is not to throw up its hands and replace consumer welfare with aggregate welfare, which also requires adding

to tobacco farmers. The reduced supply of tobacco will increase the retail price of tobacco products sold to consumers by these firms, even if the firms do not collude in the retail market. Both the input providers and consumers of tobacco products would be harmed.

However, the controversy over the proper antitrust standard is nicely put into focus by a buyer-side cartel of final consumers. Monopsony conduct undertaken by a cartel of final consumers is inefficient because it reduces output below the competitive level. It reduces aggregate economic welfare. However, a buyer-side cartel of final consumers raises consumer welfare (i.e., consumer surplus) because the gains accruing from the lower price outweigh the losses from the associated output reduction.

In permitting Blue Cross to achieve and exercise monopsony power by aggregating the underlying consumer demands for medical care—i.e., permitting Blue Cross to act as if it were the agent for a buyer-side cartel of final consumers—the *Kartell* court implicitly opted for the pure consumer welfare standard. Blue Cross's assumed monopsony conduct on behalf of its subscribers would lead to higher consumer welfare but lower efficiency and aggregate economic welfare. Thus, this result represents a clear (if only implicit) judicial preference for the pure consumer welfare standard rather than the aggregate economic welfare (efficiency) standard.<sup>51</sup> The legal analysis in this article will be based on the consumer welfare standard.

#### B. CONSUMER WELFARE AND THE RULE OF REASON STANDARD

Economic analysis of overbuying implies that overbuying allegations state a valid antitrust claim under conventional Sherman Act standards because overbuying can lead to consumer harm. Thus, overbuying should not be deemed per se legal. At the same time, anticompetitive overbuying

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up effects in multiple markets, and (most importantly) permits increased monopoly or cartel profits to trump consumer losses.

<sup>51</sup> Warren Grimes makes the argument that the antitrust laws should and have protected input suppliers without reference to consumer harm. Warren S. Grimes, *Buyer Power and Retail Gatekeeper Power: Protecting Competition and the Atomistic Seller*, *supra* this issue, 72 ANTITRUST L.J. 563 (2005). However, to the extent that the cases involve monopsony conduct by intermediary firms, a buyer cartel generally would injure consumers as well as input suppliers, and so consumer injury might be inferred by the court. In the case of a buyer-cartel comprised of final consumers, or overbuying, that inference cannot be made. For example, compare *Kartell to Bellevue Drug v. Advance PCS*, CV 03-4731, Opinion (E.D. Pa. Mar. 2, 2004), in which the plaintiff survived a motion to dismiss. In that case, the plaintiffs alleged a horizontal conspiracy of competing intermediary health insurers. In contrast, *Kartell* involved a single insurer that arguably was forced by regulation to pass along input cost savings to its subscribers.

may be difficult to distinguish from legitimate, procompetitive conduct, which means that a rule of per se illegality also would not be appropriate.

Economic analysis further suggests a four-step rule of reason standard for overbuying allegations in which the following facts must be established: (1) artificially inflated input purchasing by a defendant with buyer power; (2) injury to competitors; (3) achievement of market power by the defendant; and (4) consumer harm. It is important to emphasize that all four steps are necessary for an accurate competitive evaluation.

The four-step rule of reason analysis would vary somewhat, depending on the type of overbuying under review. The first step of the analysis is the same for both types of overbuying: whether the defendant firm has significantly increased purchasing activity in the input market and, if so, whether the increased purchases were procompetitive.<sup>52</sup> As part of this inquiry, the fact-finder would determine whether the defendant firm bid up the input price. It is important to emphasize that evidence of artificial increases in input price or purchases, even to the point that output price is less than marginal cost, is not sufficient by itself to allow an inference of consumer harm.

The second step, which differs for the two types of overbuying, examines the effect of the overbuying on competing input purchasers. For predatory overbuying, the second step involves establishing whether exit or irreversible capacity reductions by input market competitors occurred. For RRC overbuying, the focus is whether the costs of output market rivals that are also input market competitors have increased, an impact that does not require exit.

The third step examines the conduct's impact on the overbuying firm. This step also differs for the two types of overbuying because of the differences in the type of market power achieved. For predatory overbuying, the third step involves establishing whether the firm achieves profitable monopsony power in the input market. For RRC overbuying, the third step involves establishing whether the firm achieves profitable market power in the output market. Although the third step includes recoupment analysis, recoupment by itself is not sufficient for inferring that alleged overbuying harms consumers because recoupment in predatory overbuying may not lead to higher output prices.

The fourth step involves the impact on consumers. This key step varies somewhat for the two types of overbuying. This difference arises because

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<sup>52</sup> Pre-existing monopsony power is not a strictly necessary condition for successful overbuying, particularly RRC overbuying. However, the typical overbuying firm would have pre-existing monopsony power.



successful predatory overbuying involves a predatory phase in which consumers typically benefit, followed by a distinct recoupment period in which consumers may be harmed by more than the previous benefit. In contrast, in RRC overbuying the two phases essentially take place simultaneously, making the analysis more streamlined. The evaluation of the effect on consumer welfare also would take into account any procompetitive justifications for the conduct that might have been identified in the first step.

Given that it is now well-accepted that the goal of antitrust is consumer welfare, not competitor protection,<sup>53</sup> it should not be sufficient merely to show that competitors are harmed by the overbuying conduct because consumer injury cannot be inferred solely from a showing that competitors are injured from this type of exclusionary conduct. Therefore, it should be necessary to show consumer harm in overbuying cases.<sup>54</sup>

The case of naked overbuying represents an obvious exception to this view in an RRC overbuying case.<sup>55</sup> If the defendant firm purchases an input used by its competitors, which the firm does not utilize in its own production process, and if this conduct raises the input price and harms competitors, it seems reasonable to assume the firm acted with anticompetitive intent to raise competitors' costs to gain power over the price of output (absent some legitimate economic justification for the defendant's conduct). Thus, consumer harm might be inferred instead of requiring evidence. This approach corresponds to the quick-look standard used in Section 1 of the Sherman Act for seller-side joint pricing allegations.<sup>56</sup> Warehousing is less susceptible to this quick-look standard because it is more difficult to know whether the apparent warehousing has a legitimate rationale.

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<sup>53</sup> See, e.g., *Reiter v. Sonotone Corp.*, 442 U.S. 330 (1979).

<sup>54</sup> Overbuying conduct might lead to lawsuits by the input suppliers. Under the consumer welfare standard, they would have to show consumer harm as well as antitrust injury.

<sup>55</sup> As discussed earlier, naked overbuying would not be a profitable predatory overbuying strategy because the firm would have no interest in achieving monopsony power over an input that it does not use.

<sup>56</sup> See, e.g., *NCAA v. Bd. of Regents*, 468 U.S. 85, 109–10 (1984). A similar proposal was set out in *Krattenmaker & Salop*, *supra* note 30, for the purchase of naked exclusionary rights. For similar approaches, see Jonathan B. Baker, *Promoting Innovation Competition Through the Aspen/Kodak Rule*, 7 *GEO. MASON L. REV.* 495, 500–03 (1999); A. Douglas Melamed, *Exclusionary Vertical Agreements*, Speech Before the ABA Antitrust Section (Apr. 2, 1998), available at <http://www.usdoj.gov/atr/public/speeches/1623.htm>.

For the contrary view, see Timothy J. Muris, *The FTC and the Law of Monopolization*, 67 *ANTITRUST L.J.* 693, 699 (2000); Dennis W. Carlton, *A General Analysis of Exclusionary Conduct and Refusal to Deal—Why Aspen and Kodak Are Misguided*, 68 *ANTITRUST L.J.* 659 (2001).

Building upon the above analysis, a more detailed examination of the four-step rule of reason approach suggests the type of facts that must be established with respect to the two types of overbuying.<sup>57</sup>

1. *Step 1: Buyer Power and Artificially Inflated Input Purchasing*

For both predatory and RRC overbuying, the analysis focuses on whether the defendant firm has artificially increased its purchasing activity in the input market by a significant amount and whether input prices have increased as a result.<sup>58</sup> Because increased purchasing may be driven by various procompetitive rationales, procompetitive explanations for the challenged conduct are relevant because they provide a “non-artificial” (i.e., procompetitive or competitively neutral) reason for the increase in purchasing. These rationales also are relevant to the determination of consumer harm in the last step. Of course, these claims also could be pretexts for anticompetitive overbuying strategies.<sup>59</sup>

The increased purchasing activity will lead to higher input prices in the market. However, an increase in input prices above the monopsony level is not sufficient evidence to conclude that overbuying has occurred. Input prices could have risen because of other changes in demand and supply.<sup>60</sup> These factors imply that it may be difficult to determine in practice whether artificial increases in purchasing activity have taken place. Examining only chronological changes in price and quantity could lead to errors if the analysis does not control for other causes, including new entry and reduced monopsony power. This is a key source of “false positives.” This difficulty is another reason why the analysis should not stop with the first step. It also provides a possible rationale for the use of additional tests for making this step-1 determination, for example, profit-sacrifice and below-cost pricing tests.<sup>61</sup> These tests are discussed below in Section II.C.

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<sup>57</sup> The issue of the optimal allocation of the burdens of proof and persuasion is beyond the scope of this article. For consistency, the article generally assumes that the burden rests on the plaintiff.

<sup>58</sup> As mentioned earlier, it is possible that the defendant would lack the power to profitably reduce the input price until after the predatory overbuying strategy has succeeded. But, in practice, the firm usually would have some pre-existing monopsony power.

<sup>59</sup> These procompetitive rationales also raise an issue of the proper benchmark for evaluating increases in purchases, an issue that is discussed in more detail in Part II.C. below.

<sup>60</sup> For example, entry into a monopsonized input market would increase input demand and lead to higher input prices, even if the monopsonist does not increase its input purchasing activity. Moreover, if the firm finds that its monopsony power has been dissipated by the entry, then it may increase its input purchases despite the higher input price. Similarly, an increase in demand or a reduction in market power in the output market can increase the demand for inputs.

<sup>61</sup> That discussion also evaluates the potential role of these tests as short-cut substitutes for the full rule of reason.

## 2. *Steps 2–4 of the Rule of Reason Standard*

If input purchases and prices have increased significantly and are not explained fully by procompetitive justifications, then the remaining three steps of the rule of reason become relevant.

### a. *Predatory Overbuying*

In the second step of a predatory overbuying case, the analysis focuses on whether the predatory overbuying leads input market competitors on the buyer side to exit from the market or permanently reduce their capacity, a necessary condition for achieving monopsony power. If those competitors merely reduce their purchases during the predatory period but stand ready to increase their input purchases if and when the defendant begins to exercise monopsony power, then the defendant would not achieve any durable monopsony power from its conduct. In this case, the predatory overbuying would not be profitable, and it would not harm consumers.

In the third step, the analysis focuses on whether the defendant firm gains monopsony power and is able to recoup the cost of the predatory strategy, an outcome that could be prevented in several ways. The victims of the strategy could re-enter the competition for inputs during the recoupment phase and prevent the exercise of monopsony power. New entry also could provide sufficient input market buyer-side competition. The exercise of monopsony power also would not be profitable if the supply of inputs is highly elastic, which would prevent the defendant from achieving significant input price reductions by restricting output. This step also would establish whether the strategy likely was profitable, taking into account the higher costs that the overbuying inflicts on the firm.

In the fourth step, the analysis focuses on whether consumers are harmed. Consumer harm is not inevitable because the profitability of exercising monopsony power can come solely from reducing input costs (such as when the monopsonist is a perfect competitor in an output market with highly elastic supply). Thus, recoupment may be a poor proxy for consumer injury. In addition, because consumers typically benefit during the predatory period, it would be necessary to show that harm during the recoupment period dominates the previous gains. For this reason, the consumer welfare harm test is important.

In the naked overbuying scenario, there is no output increase during the predatory period because the overbuying firm does not use the excess inputs that are purchased. As discussed above, consumer harm might be inferred for naked overbuying if rivals are harmed. Consumer harm

also is easier to show in the scenario of a bidding market where the defendant firm bids up the prices of inputs ultimately purchased by rivals without winning any bids itself. In such a scenario, there also is no output increase during the predatory period.

In a recent article, Professor John Kirkwood analyzes predatory overbuying, under the rubric of “predatory bidding.”<sup>62</sup> (Professor Kirkwood considers only predatory overbuying, not RRC overbuying.) Our approaches are consistent in some important ways. For example, we agree that the impact on input suppliers should not be the focus of the liability analysis. We also agree that the legal analysis of overbuying should be based on the rule of reason under the consumer welfare standard. Professor Kirkwood advocates a four-step rule of reason standard similar to the one set out here.

However, our approaches differ in two significant ways. First, we differ with respect to the utility of a below-cost pricing test for predatory overbuying, an issue that is discussed below. Second, we differ on the rule of reason standard, in that Professor Kirkwood would lighten the burden on the consumer harm standard to require the plaintiff merely to show only “minimal” impact, not “significant” consumer harm.<sup>63</sup>

I have two main concerns with his “minimal impact” standard for predatory overbuying. First, a “minimal” consumer harm standard could easily turn into an “incipiency” or “tendency” standard (in which consumer injury would be inferred merely from harm to competitors or suppliers, or from intent evidence), a standard that would lead to significant false positives and overdeterrence of procompetitive input competition.<sup>64</sup> Second, a “minimal impact” standard might be implemented by fact finders in ways that erroneously ignore the benefits of lower prices achieved by consumers during the (allegedly) predatory phase.

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<sup>62</sup> Kirkwood, *supra* note 48.

<sup>63</sup> *Id.* at 55.

<sup>64</sup> At some points in the article, Professor Kirkwood comes somewhat closer to a “tendency” standard. For example, he states that “[w]hen an upstream monopsonist has no significant power in the downstream product market, its acquisition of monopsony power through predatory bidding may have no significant effects on downstream consumers. That, however, should not absolve the defendant. . . . The magnitude of the effect is secondary.” *Id.* at 664. Professor Kirkwood’s analysis also raises the knotty question about the benchmark for the price increase. The right benchmark is not the price and output levels during the predatory phase, but rather a non-overbuying benchmark.

Professor Kirkwood appears to suggest the relevance of intent evidence to liability analysis where the effects of the defendant’s conduct on consumers are difficult to predict, though this intent evidence may be in addition to evidence on likely consumer harm. *Id.* at 665. However, where intent evidence is introduced, the jury likely would use that evidence in resolving all the issues, including effect.

Indeed, Professor Zerbe adopts this type of standard. Professor Zerbe argues that consumer harm can be presumed even without direct evidence, and the burden should be shifted to the defendant in situations where *any* of the following conditions are found: the monopsonist has little market power in the output market; the supply of the input is (relatively) inelastic; or, some of the input is not used.<sup>65</sup> In these circumstances, Professor Zerbe would not require evidence that the output price increased during the recoupment period above a no-overbuying benchmark. He would not require evidence that the consumer gains during the predatory period are more than offset by consumer losses during the recoupment period. His approach would represent a dramatic difference from the usual rule of reason approach.<sup>66</sup> In fact, Professor Zerbe's market power condition would place the burden of persuasion on the defendant to justify its conduct in the input market when the defendant lacks market power in the output market, even though consumer welfare harm is highly unlikely to occur in that situation, even if the predatory strategy did succeed.

Lower downstream prices during the predatory phase generally result because predatory overbuying tends to lead to higher input purchases, which generally leads to additional output that benefits consumers. To sell its additional output, the defendant generally would have to offer consumers either a lower price or a superior product, both of which would benefit consumers. There can be exceptions, but these exceptions do not imply that consumers are necessarily harmed on balance.<sup>67</sup>

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<sup>65</sup> Zerbe, *supra* note 49, at 720.

<sup>66</sup> To take an extreme case, suppose that a small wheat farmer is accused of predatory overbuying because it outbid another farmer and increased its purchases of fertilizer during a year when the fertilizer was in short supply at the local dealer, and then the other farmer exited the market as a result of lacking money to finance planting next year's crop. The plaintiff farmer in this hypothetical case apparently would escape summary judgment because the defendant lacks market power in the wheat market. Suppose that there were only a fixed amount of fertilizer available in the local area, an amount that was less than was needed by all the farmers. That fact would be an additional reason to eliminate the need to show competitive harm if it implies that the supply of fertilizer was inelastic. That fact also would imply that the farmer had buyer power, the ability to push up input prices by increasing its demand. And, if it turned out that the defendant farmer did not use every drop of the fertilizer that it purchased but wasted some of the scarce supply, or if the defendant held some fertilizer over in inventory out of a fear there would be another shortage next year, that fact would be a third reason why competitive harm could just be presumed. Under Professor Zerbe's approach, any one of these three conditions would be enough to permit the jury to infer competitive harm without direct evidence and place the burden on the defendant.

<sup>67</sup> For example, for inputs in fixed supply (i.e., perfectly inelastic supply), output would not rise during the predatory phase. But there also would be no output reduction and no consumer harm during the recoupment period. If the defendant faces perfectly elastic output demand, the price of output would not fall during the predatory period, but it

These consumer benefits imply the need to balance harms in the recoupment period against benefits during the predatory period. One cannot simply assume that the balance tips against consumers.<sup>68</sup> Harm (and harm in excess of benefits) cannot simply be assumed or inferred from the conduct or injury to competitors or suppliers, except perhaps in the case of naked overbuying. The conditions identified by Professor Zerbe—and other conditions discussed in this article—are relevant to determining the likely impact on consumer welfare, but they do not eliminate the need to prove with evidence that consumers are harmed on balance.

### b. RRC Overbuying

The last three rule of reason steps of the analysis of RRC overbuying differ somewhat from predatory overbuying. In the second step, the analysis must establish whether RRC overbuying will cause rivals' marginal costs to materially increase. Only if the rivals' marginal costs increase will these competitors have the incentive to reduce their output and increase the prices they charge.<sup>69</sup> Unlike predatory overbuying, it is not necessary for rivals to exit (or permanently reduce their capacity) for successful RRC overbuying.<sup>70</sup> Because downstream prices may not rise in a successful predatory overbuying strategy, and because consumers may gain during the predatory period, the competitive risks to consumers from RRC overbuying are relatively higher than for predatory overbuying.

In the third step, the analysis must establish whether the defendant firm gains market power in the output market. This step involves analysis

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also would not rise during the recoupment period, so there would be no consumer harm. Naked overbuying does not lead to lower prices or increased output during the predatory period and there can be consumer harm. However, as discussed earlier, *see supra* Part I.E., naked overbuying does not make sense as a predatory overbuying strategy. Warehousing also can eliminate the price effect during the predatory phase. However, because it is difficult to be sure that alleged warehousing lacks any procompetitive rationale, *see supra* Part I.E., the consumer welfare step of the rule of reason should still be included for warehousing allegations.

<sup>68</sup> Professor Zerbe prefers an economic efficiency standard over the consumer welfare standard that I used. Zerbe *supra* note 49, at 719. However, antitrust seems clearly focused on consumer welfare. In an efficiency standard, harm to competitors can be used to trump consumer benefits, a stance that antitrust studiously avoids. Professor Zerbe also sometimes seems to equate a consumer welfare standard with a "price" standard. They are not equivalent. The consumer welfare standard focuses on consumer surplus, not just price.

<sup>69</sup> If fixed costs are increased, investment in capacity and product quality may be reduced, reducing output in the longer run.

<sup>70</sup> In predatory overbuying, the predator's input rivals do not even have to be its output rivals.

of profitability, taking into account the higher costs that the overbuying inflicts on the overbuying firm. In contrast to predatory overbuying, RRC overbuying allows recoupment to occur contemporaneously with the overbuying investment; as soon as rivals' costs are raised, they have the incentive to raise their prices. This difference also increases the risks to competition from RRC overbuying relative to predatory overbuying.

In the fourth step, it is necessary to establish whether there is consumer harm. This step takes into account any procompetitive effects of the alleged overbuying. Unlike predatory overbuying, there is no necessary lag between the RRC overbuying and consumer harm. Moreover, consumer harm and profitability of the defendant firm are highly correlated because both result from the higher prices in the output market. In contrast, consumer harm is less likely from profitable predatory overbuying. Again, this difference increases the relative risk to competition arising from RRC overbuying.

Thus, all these factors imply that RRC overbuying raises more significant competitive concerns than does predatory overbuying. RRC overbuying creates a smaller likelihood of "false positives" and a higher likelihood of "false negatives." Therefore, the antitrust laws should be more restrictive towards RRC overbuying. Predatory overbuying should be subject to more permissive legal rules.

### C. LEGAL POLICY ANALYSIS AND SHORT-CUT RULES: THE PROFIT-SACRIFICE AND PREDATORY PRICING TESTS

The rule of reason is the gold standard of antitrust rules. By focusing on the impact on consumer welfare, the rule of reason provides the most accurate competitive evaluation of alleged anticompetitive conduct. However, the rule of reason also places the greatest burden on the parties and the courts. To ease their analytic and decision-making burden, courts have developed a number of truncated rules, including the *per se* rule and quick-look standard in Section 1 of the Sherman Act. These short-cuts also include the use of Section 2 proxy tests, such as the profit-sacrifice, below-cost pricing, and likely recoupment tests.

A number of decision-theoretic policy rationales have been suggested for short-cuts. The main rationale is judicial economy. Truncated procedures can ease the evidentiary burden on the parties and the courts, which in turn can reduce uncertainty and facilitate planning by firms. This judicial economy rationale recognizes that the short-cuts could lead to erroneous determinations in a fraction of the cases. But for certain

types of conduct, those errors may be a small price to pay for the streamlined process.<sup>71</sup>

A second rationale for short-cut rules is to consciously place a thumb on one side of the scales of justice. In the case of the per se rule against price fixing, for example, the antitrust bias is that the likely consumer harm from erroneously permitting a successful price-fixing conspiracy is far greater than the likely consumer harm from erroneously prohibiting joint price setting that has no anticompetitive effects. In decision-theoretic terms, the harm from a “false negative” (i.e., an erroneous acquittal) exceeds the harm from a “false positive” (i.e., an erroneous condemnation). In terms of deterrence, the expected cost of over-deterrence is seen as smaller than the expected cost of under-deterrence in these cases. In this sense, short-cut rules can be designed to provide optimal deterrence when the probability and consumer welfare costs of these two types of errors are not symmetric.

The proper decision-theoretic analysis of antitrust rules is complex and should be based on estimated consumer welfare effects. It also is possible that systematic errors can be more easily corrected by better jury instructions and other guidance by higher courts. Moreover, short-cut tests are not necessary the optimal way to balance the costs of false positives and false negatives. The full rule of reason standard could be used instead, but with the burden of persuasion adjusted to reflect differential expected error costs.<sup>72</sup> Finally, one cannot blindly draw conclusions about the relative likelihood and harm from false positives and false negatives based on reported cases, particularly appellate cases.<sup>73</sup> For example, in light of the record in the case, the Supreme Court’s

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<sup>71</sup> For example, this is the basic approach taken in *FTC v. Superior Court Trial Lawyers Ass’n*, 493 U.S. 411 (1990). For a general analysis of antitrust short-cut rules in the context of decision theory, see C. Frederick Beckner, III & Steven C. Salop, *Decision Theory and Antitrust Rules*, 67 ANTITRUST L.J. 41 (1999). For the application of this approach to monopolization law, see Salop & Romaine, *supra* note 47, at 626–42 (1999); Ronald A. Cass & Keith N. Hylton, *Preserving Competition: Economic Analysis, Legal Standards and Microsoft*, 8 GEO. MASON L. REV. 1 (1999).

<sup>72</sup> For example, if the consumer welfare cost and probability of false positives were larger than for false negatives, the preponderance of the evidence test (i.e., 51% likelihood) could be replaced by a more disproportionate test like clear and convincing evidence, or something in-between. See Salop & Romaine, *supra* note 47; see also Andrew I. Gavil, *Dominant Firm Distribution: Striking a Better Balance*, 72 ANTITRUST L.J. 3 (2004).

<sup>73</sup> First, the set of cases that proceed to trial and reach the appellate stage is not a random sample of the conduct. George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1 (1984). Second, judicial decisions and the accompanying opinions also are significantly affected by the parties’ litigation strategies and the skill of their attorneys.



result in *Aspen Skiing* was compelled by the profit-sacrifice test.<sup>74</sup> Any errors were caused by the defendant's lawyers, who dropped relevant appeal issues.<sup>75</sup>

Notwithstanding their limitations, short-cut tests are used. For example, predatory pricing, which shares certain analytic similarities to predatory overbuying, utilizes short-cut tests instead of the full rule of reason because of the Court's greater concern about false positives than false negatives.<sup>76</sup> Market power is used as common screen for this purpose, and monopsony power is an analogous screen here.<sup>77</sup> Both the profit-sacrifice test used in refusal to deal cases and the below-cost pricing and recoupment tests used in predatory pricing cases are short-cut rules potentially applicable to overbuying.

### 1. *The Profit-Sacrifice Test*

According to the profit-sacrifice test, if a firm engages in conduct that would not be economically rational (i.e., profitable) absent a reduction in competition, then it can be inferred that the firm intended to cause an anticompetitive effect. The Supreme Court made this point in *Aspen Skiing*.<sup>78</sup> Thus, profit sacrifice is possible evidence of anticompetitive intent. The profit-sacrifice test also could be declared the *sole* intent test.<sup>79</sup> Indeed, the profit-sacrifice test could be declared the sole liability standard instead of a full rule of reason analysis. For example, in *Trinko*<sup>80</sup> the government's first amicus brief seemed to take this more extreme position as a way to reduce false positives (and, by implication, increase false negatives).<sup>81</sup>

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<sup>74</sup> See *Verizon Communications Inc. v. Law Firm of Curtis V. Trinko*, 124 S. Ct. 872 (2004).

<sup>75</sup> *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585 (1985).

<sup>76</sup> See *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993); *Matsushita Elec. Indus. Co., Ltd. v. Zenith Radio Corp.*, 475 U.S. 574 (1986).

<sup>77</sup> In this regard, it should be emphasized that pre-existing market power is an imperfect screen. The firm may initially lack market power, but achieve it as a result of exclusionary conduct. In fact, exclusionary conduct can be profitable even if the firm never achieves "classical" market power. See Krattenmaker & Salop, *supra* note 30; Salop, *First Principles*, *supra* note 10.

<sup>78</sup> *Aspen Skiing Co.*, 472 U.S. at 585.

<sup>79</sup> That is, other evidence of anticompetitive intent, such as documents and testimony, would not be permissible.

<sup>80</sup> *Trinko*, 124 S. Ct. at 881.

<sup>81</sup> See Brief for the United States and the Federal Trade Commission as Amici Curiae Supporting Petitioner at 15, *Verizon Communications Inc. v. Trinko*, 124 S. Ct. 872 (2004); see also R. Hewitt Pate, Assistant Attorney General, Antitrust Division, U.S. Department of Justice, *The Common Law Approach and Improving Standards for Analyzing Single Firm Conduct* 10, Address Before Fordham Corp. L. Inst. (Oct. 23, 2003), available at <http://www.usdoj.gov/atr/public/speeches/202724.htm>.

Additional input purchases beyond the monopsony level involve a sacrifice in short-term profits that is economically irrational for a firm with monopsony power, absent an expectation of higher future profits from some source.<sup>82</sup> The defendant firm might claim that it has lost its monopsony power and was purchasing competitively as a result. The defendant firm might also be able to show that its profits have increased as a result of procompetitive efficiency benefits that led it to increase its purchases. However, absent those benefits, a court might conclude that the expectation of higher future profits likely would come from a subsequent increase in monopsony power in the case of predatory overbuying allegations. The future profits might come from a simultaneous (or subsequent) increase in market power in the output market, as in the case of RRC overbuying. Thus, the profit-sacrifice test in principle could be used as one source of probative evidence in the first step of the four-step rule of reason.

However, going further and using the profit-sacrifice test as the sole liability standard is clearly a poor substitute for the full rule of reason. And given its limitations, it is not clear why there would be need for that short-cut test when a direct analysis of consumer welfare is possible. Reliance on the profit-sacrifice test as a liability standard in overbuying cases inevitably would lead to significant judicial errors, either false negatives or false positives.

These twin errors are straightforward to explain. On the one hand, successful exclusionary conduct that raises rivals' costs for the purpose of gaining market power in the output market may not involve a short-run sacrifice of profits because recoupment is simultaneous with the conduct.<sup>83</sup> Use of the profit-sacrifice test for RRC overbuying could lead to false negatives by failing to identify significant competitive injury. On the other hand, the profit-sacrifice test could lead to false positives, as in the case of a firm that responds competitively to the entry of input market competitors by expanding its input purchases. The profit-sacrifice test might erroneously use pre-entry conditions as the benchmark for evaluating profit sacrifice. Exclusive reliance on the profit-sacrifice test also could deter firms from engaging in vigorous competition for inputs and instead restrict input purchases out of fear of being found in violation

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<sup>82</sup> That is, the short-run profit-maximizing strategy for a firm with monopsony power is to restrict input purchases to the point where the marginal factor cost equals marginal revenue.

<sup>83</sup> See Krattenmaker & Salop, *supra* note 30, at 224. For other views of the profit-sacrifice test for nonprice conduct, see Mark R. Patterson, *The Sacrifice of Profits in Non-Price Predation*, ANTITRUST, Fall 2003, at 37; Einer Elhauge, *Defining Better Monopolization Standards*, 56 STANFORD L. REV. 253 (2003).

of the antitrust laws. If so, output would be lower, output prices would be higher, and consumers would be harmed by the rule.

Moreover, the profit-sacrifice test must begin with a proper benchmark, which may involve a complicated economic determination. For example, if a firm is using overbuying to maintain market power in the input or output market, then the proper benchmark is not necessarily the current price but rather the price that would occur absent the overbuying.<sup>84</sup> Or, if the monopsony power of the firm is being eroded in the market, absent any overbuying conduct, then the benchmark may not be the initial monopsony (pre-overbuying) level, if there is some other more realistic prediction that accounts for the erosion of its power.

This knotty measurement issue has an analogue in the debate over predatory pricing law. Predatory pricing law employs two short-cut tests, a price-cost comparison that evaluates whether there is below-cost pricing, and a recoupment test, in addition to some measure of market power. The price-cost test is not a real profit-sacrifice test, although it is sometimes expressed as if it is. The two tests are not equivalent because the alleged predator generally would *not* set price equal to its cost, in the absence of any ability to drive its rivals out of business. Under a strict profit-sacrifice test, price decreases below the monopoly level (or below the short-run equilibrium price) would be illegal because they involve profit-sacrifice, relative to alternative prices.<sup>85</sup>

## 2. *Below-Cost Pricing Test*

The below-cost pricing test could be applied to overbuying. The comparison between price and cost is useful evidence for the first step of the rule of reason. A court in principle might go further and replace the four-step rule of reason analysis with a short-cut standard that looked

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<sup>84</sup> See Salop, *First Principles*, *supra* note 10.

<sup>85</sup> To avoid the implication that all price decreases below the monopoly level are found to involve profit-sacrifice, Ordover and Willig used the profit level at the perfectly competitive outcome (i.e., where price equals marginal cost) as the profit benchmark for their modified profit-sacrifice test in the simplest case. They refer to this modified benchmark with the proviso that it is the outcome “under competitive conditions.” However, if the defendant would not have priced at marginal cost in the “but-for” world in which the entrant remains a viable competitor, then this benchmark does not measure the *actual* profit sacrifice. For example, suppose that the incumbent and an equally efficient entrant both sell differentiated products. In such a market, the equilibrium prices, if the entrant remained viable, would exceed the firms’ marginal costs, given this differentiated product competition. The profit-sacrifice test as modified by Ordover-Willig does not use this market equilibrium price level as the benchmark, but rather uses marginal cost or another incremental cost measure. Janusz A. Ordover & Robert D. Willig, *An Economic Definition of Predation: Pricing and Product Innovation*, 91 *YALE L.J.* 8, 9–10 (1981). These same issues would apply to the use of a price-cost test to measure profit-sacrifice in overbuying.

only to the below-cost pricing test, perhaps supplemented with a test for the likelihood of recoupment.<sup>86</sup>

As previously discussed, the relationship between output price and marginal cost is relevant in monopsony. Monopsony can lead to an outcome in which the firm's output price strictly exceeds its marginal cost, as conventionally measured, even if the monopsonist is a perfect competitor in the output market and the output price is fixed.<sup>87</sup> Thus, "modest" but significant overbuying still would leave the firm in a position where its output price exceeds its conventionally measured marginal costs.<sup>88</sup> Only if the firm went beyond the competitive purchase level would its output price fall below its conventionally measured marginal cost.

The difficulty of distinguishing an anticompetitive overbuying strategy from a competitive purchase expansion can be similar to the difficulties in predatory pricing matters. Indeed, predatory pricing might instead be called predatory "overselling."<sup>89</sup> If the alleged predator's price is above its marginal cost, it may be difficult for a court to know whether the firm is attempting to predate or simply competing on the merits in the face of increased competition.<sup>90</sup> The same issue arises in the context of predatory overbuying. If the alleged predator's overbuying strategy results in an output price that remains above the firm's conventionally measured marginal cost, it may be difficult for a court to know whether the firm is attempting to predate or simply competing in the input market with rivals who also are purchasing the inputs.<sup>91</sup>

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<sup>86</sup> See, e.g., *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

<sup>87</sup> As mentioned earlier, the term "as conventionally measured" distinguishes between "marginal factor cost" and "marginal cost," taking input prices as constant. The phrase "as conventionally measured" refers to the latter concept.

<sup>88</sup> This outcome corresponds to a situation where the firm is purchasing more inputs than it would if it were acting as a purely short-run profit-maximizing monopsonist. But, at this level, the firm still would be purchasing less input than if it ignored its monopsony power altogether and purchased as if it were a perfect competitor with no impact on the input price.

<sup>89</sup> A monopolist sets a supracompetitive price, that is, a price in excess of marginal cost. To drive rivals out of business, that firm might "modestly" reduce its price below the monopoly level but above its marginal cost. Such a price cut would leave the output price above the perfectly competitive level and the firm's output below the competitive level. Only if the firm cuts its price to a level below its marginal cost would the market price fall below the perfectly competitive level and output rise above the perfectly competitive level.

<sup>90</sup> Frank Easterbrook, *Predatory Strategies and Counterstrategies*, 48 U. CHI. L. REV. 263, 266 (1981).

<sup>91</sup> Some commentators (though not this one) take the view that antitrust should be concerned with total welfare (efficiency only) instead of consumer welfare. Zerbe, *supra* note 49. This view tends to support a requirement that plaintiffs satisfy the below-cost pricing test. Overbuying that increases input purchases, but not to the point that price is below cost, actually increases market-wide efficiency during the predatory phase. This is

In *Brooke Group*<sup>92</sup> the Supreme Court held that allegedly predatory prices that remain above cost are not unlawful. This view is based on a belief that “false positives” are a much greater policy concern than “false negatives”; therefore, permitting above-cost predatory pricing cases to proceed could deter beneficial price competition.<sup>93</sup> Moreover, although the recoupment test can be a rough proxy for a consumer welfare test,<sup>94</sup> the Court was unwilling to rely exclusively on recoupment analysis—or an explicit consumer welfare test—to prevent potential judicial errors.<sup>95</sup>

The *Brooke Group* below-cost pricing standard also can be applied to predatory overbuying. Alleged overbuying in which output market prices remain above cost would be lawful. Alleged overbuying would be condemned only if output market price falls below conventionally measured marginal cost.<sup>96</sup> This would ensure that antitrust law would not condemn firms that have stopped exercising monopsony power because of increased competition in the input market. In light of the shortcomings of the profit-sacrifice test, the below-cost pricing test can be used to

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because “modest” overbuying by a firm with monopsony power brings price closer to marginal cost.

<sup>92</sup> *Brooke Group*, 509 U.S. 209.

<sup>93</sup> The Supreme Court was particularly concerned with “false positives” given their view that predatory pricing is “rarely tried, and even more rarely successful.” *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 589 (1986).

<sup>94</sup> Predatory pricing is not a zero-sum game. The impact of predatory pricing on the predator’s profits is substantially (but imperfectly) negatively correlated with the impact on consumer welfare. In the case of predatory overbuying, it is clear that a test of “likely recoupment” (i.e., likely profitability) is a poor proxy for consumer injury. The exercise of monopsony power can be profitable even when there is no increase in the price of output over the non-predatory benchmark. For example, as discussed earlier, this outcome can occur when the overbuying firm lacks market power in the output market during the recoupment period and its output reductions are offset by output increases by other firms with elastic supply. Moreover, as discussed below, successful recoupment may involve an output price above the level that occurs during the predatory phase of the conduct, but below the non-predatory price. It is the comparison to the latter price that is relevant for evaluating consumer welfare.

<sup>95</sup> The economic foundation of the *Brooke Group* approach has been subject to certain valid criticisms by post-Chicago economists with respect to the scope of potential gains from predatory pricing and, thus, the likelihood of recoupment. For a survey of that literature, see, e.g., Patrick Bolton et al., *Predatory Pricing: Strategic Theory and Legal Policy*, 88 GEO. L.J. 2239, 2241 (2000); Jonathan B. Baker, *Predatory Pricing After Brooke Group: An Economic Perspective*, 62 ANTITRUST L.J. 585, 590 (1994). The courts appear recently to have taken a portion of their criticism to heart. See *United States v. AMR Corp.*, 335 F.3d 1109, 1114 (10th Cir. 2003).

<sup>96</sup> In predatory pricing, there is disagreement and some confusion over the proper cost measure to use. In overbuying, the proper measure is marginal cost and, in particular, the marginal cost of increasing output by expanding the use of the input subject to the overbuying. Because of monopsony power and overbuying, marginal cost may differ among the inputs. This is because the monopsonist equalizes marginal factor costs, which do not equal (conventionally measured) marginal costs in the presence of monopsony.

gauge “clear” overbuying. In fact, a below-cost pricing test was mandated for predatory overbuying by the Fifth Circuit in the *Beef Industry* case.<sup>97</sup>

To be sure, requiring the plaintiff to satisfy the below-cost pricing test also could lead to “false negatives.”<sup>98</sup> An alternative approach to reducing false positives would be to apply the full rule of reason solely with a rigorously applied consumer welfare harm standard.

### 3. Policy Recommendations

The primary legal standard should be the full rule of reason under the consumer welfare standard. To prevent false positives and deterrence of legitimate input competition, it is important that the consumer welfare harm prong be retained. The consumer welfare standard makes far more economic and policy sense than would sole reliance on any one or two short-cut tests.<sup>99</sup> The consumer welfare rule standard would require evidence of harm to competition (i.e., consumers), not just harm to competitors. The one possible exception would be naked overbuying, where a truncated quick-look decision process could be used.

However, the short-cut tests can provide probative evidence to be incorporated into the rule of reason standard. For example, the profit-sacrifice and below-cost pricing tests can have utility in the first step of the rule of reason, along with other evidence of increased purchasing activity by a firm with monopsony power. The likely recoupment test involves evaluating the profitability of an alleged overbuying strategy, which is part of the third step of the rule of reason. Evidence of recoupment also would be useful in helping to evaluate the impact on consumer welfare.

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<sup>97</sup> *In re Beef Industry Antitrust Litig.*, 907 F.2d 510, 515 (5th Cir. 1990) (“The cattlemen presented no evidence that IBP ever paid a predatory price (in this case, a price higher than that which would allow the packer to make a profit) for fed cattle. Thus, the cattlemen’s allegations of predatory activity by IBP in the cattle procurement market were not supported.”). In *Reid Bros. Logging*, the Ninth Circuit did not apply a below-cost pricing test to a predatory overbuying claim. However, this case was decided before *Brooke Group* and also involved a buyer-side market division conspiracy. *Reid Bros. Logging Co. v. Ketchikan Pulp Co.*, 699 F.2d 1292, 1297 (9th Cir. 1983).

<sup>98</sup> With predatory pricing, for example, price cuts that remain above marginal cost can drive out both equally efficient entrants who have not yet sunk all their capital costs and less efficient entrants whose entry would nonetheless increase consumer welfare. A monopolist also could gain a reputation for predation that could deter future equally efficient entrants under certain circumstances. See Aaron Edlin, *Stopping Above-Cost Predatory Pricing*, 111 YALE L.J. 941 (2002). But see Einer Elhauge, *Why Above-Cost Price Cuts to Drive Out Entrants Are Not Predatory—And the Implications for Defining Costs and Market Power*, 112 YALE L.J. 681 (2003).

<sup>99</sup> One could raise the fear that potential defendants in predatory and RRC overbuying cases would forgo more intense competition rather than defend themselves with the

In predatory overbuying cases, the law should go further and require the plaintiff to satisfy the below-cost pricing test as part of the first step of the rule of reason standard. In predatory overbuying, consumers generally benefit from increased input purchases during the predatory phase because the increased input usage tends to translate into increased output and lower output prices. In light of these benefits and the potential that the defendant firm is responding competitively to entry, a decline in monopsony power or another legitimate rationale for increased purchasing, the below-cost pricing test is useful as a first screen to prevent excessive false positives. If the plaintiff's evidence passes the below-cost pricing test, the analysis would proceed.

In contrast, satisfying the below-cost pricing test should not be required for an RRC overbuying case to proceed. RRC overbuying raises more serious competitive concerns than either predatory pricing or predatory overbuying, so a more restrictive standard is appropriate. If the below-cost pricing test were required, it might cause excessive false negatives. The need for the plaintiff to prove consumer harm should be adequate to prevent excessive false positives here. This standard still would allow the defendant to justify its increased purchases on the basis of procompetitive considerations. Moreover, as discussed below, the relationship between price and cost is relevant for RRC overbuying and can be used as probative evidence, even though satisfying it is not a necessary requirement for liability.

Professor Kirkwood argues that the analogy between predatory overbuying and predatory pricing is weak. As a result, he would not require the below-cost pricing test for predatory overbuying.<sup>100</sup> According to Professor Kirkwood, predatory overbuying cases raise fewer competitive risks of consumer harm from over-deterrence than do predatory pricing cases.<sup>101</sup> I disagree. In the case in which the overbuying would benefit consumers in the predatory period and harm them in the recoupment period, if it is successful, the case raises the same type of concerns. In addition, I do not think that the few reported cases indicate that predatory bidding raises greater competitive concerns than predatory pricing.<sup>102</sup>

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consumer welfare standard. But, this concern is reduced in light of the high bar facing plaintiffs in the consumer welfare test.

<sup>100</sup> Kirkwood, *supra* note 48, at 667.

<sup>101</sup> *Id.* at 666–67.

<sup>102</sup> Professor Kirkwood discusses the reported outcomes of two overbuying cases in which plaintiffs prevailed, *American Tobacco Co. v. United States*, 328 U.S. 781 (1946), and *Reid Brothers Logging Co. v. Ketchikan Pulp Co.*, 699 F.2d 1292, 1297 (9th Cir. 1983)). There is clearly a very small number of reported cases, and reported cases are not necessarily

The distinction between the competitive risks of overbuying and predatory pricing applies more forcefully to the analysis of RRC overbuying. For several reasons, RRC overbuying is more likely to harm consumers than is predatory pricing or predatory overbuying. First, unlike predatory pricing or predatory overbuying, successful RRC overbuying does not require a risky investment or associated profit sacrifice during an initial predatory period that may only be recouped at some point in the future. Instead, recoupment occurs simultaneously with the overbuying conduct. Second, unlike predatory pricing or predatory overbuying, successful RRC overbuying does not involve a short-term consumer benefit that may or may not be overwhelmed by a longer-term consumer harm during the recoupment period. In RRC overbuying, the consumer harm occurs immediately. Third, unlike predatory pricing or predatory overbuying, successful RRC overbuying does not require the exit of rivals, or even the permanent reduction in competitors' production capacity. If the marginal costs of established competitors are raised, those rivals will have the incentive to raise their prices and reduce their output, even if they remain viable. Fourth, unlike predatory pricing, neither type of overbuying is necessarily more costly to the defendant than its victims in the short run.

On the last point, it is commonly noted that a dominant firm engaged in predatory pricing loses more money than an equally efficient victim during the predatory phase because the predator has a larger market share. In overbuying, however, this higher relative loss may not occur because the predator firm may be partially vertically integrated or may have a production process that utilizes less of the input. This factor also makes RRC overbuying more likely to succeed than predatory pricing.<sup>103</sup>

For these reasons, the required use of the below-cost pricing test for predatory pricing or predatory overbuying does not compel a conclusion that this test also should be required for RRC overbuying. The differences imply that false positives are less of a risk for RRC overbuying, so there is less need for a below-cost pricing test there. That RRC overbuying

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representative of the universe of the conduct. Priest & Klein, *supra* note 73. In addition, these two cases do not provide convincing evidence for a view that predatory overbuying is likely to succeed and harm consumers. *American Tobacco* was more of an RRC overbuying case, as observed by Professor Kirkwood. Kirkwood, *supra* note 48, at 659 n.103. Professor Kirkwood cites *Matsushita* for the proposition that concerted predation is considered generally less likely to succeed because a conspiracy (especially a tacit conspiracy) may fail. Although this may be true under some circumstances, it does not apply to *Reid Brothers Logging*. In that case, the court found that the conspiracy was a "well orchestrated and successful effort." *Reid Brothers Logging*, 699 F.2d at 1297, 1298 n.7. *American Tobacco* also involved a successful conspiracy.

<sup>103</sup> Although this last point also applies to predatory overbuying, it is not sufficient to eliminate the need for the below-cost pricing test.



raises more significant consumer harm concerns also suggests that a below-cost pricing test for RRC overbuying is more likely to lead to false negatives. Thus, a court should not require the below-cost pricing test as a formal requirement for RRC overbuying, but plaintiffs alleging predatory overbuying should be required to satisfy the below-cost pricing test during the first step of the rule of reason standard.

This approach does not mean that the price-cost relationship is irrelevant for RRC overbuying. To the contrary, it would represent probative evidence. On one side, if price is less than marginal cost, that fact generally could rebut a defendant's claim that it was not overbuying. For example, it would rebut a claim that the defendant was simply responding to a reduction in its monopsony power. On the other side, if the firm's input purchases increase significantly above the monopsony level but the output price remains above marginal cost, then overbuying still might be occurring (absent an alternative procompetitive explanation for the defendant's conduct). In both cases, the price-cost relationship should not be the sole test for RRC overbuying; the consumer welfare standard should remain the key focus of the analysis.

### III. APPLYING THE ANALYTIC FRAMEWORK

In this section the analytic framework is illustrated and applied to two overbuying cases.

#### A. *CARGILL, INC. V. MONFORT OF COLORADO, INC.*<sup>104</sup>

The issue of overbuying arose in *Cargill*, a merger case decided by the Supreme Court in 1986. Monfort sued to block the merger of two large competitors, Excel (owned by Cargill) and Spencer Beef. The firms competed in the input market for the purchase of fed cattle and in the output market for the sale of boxed beef. Monfort alleged that the merger would lead to a "price-cost squeeze" that would "'severely narrow' Montfort's profit margins" and threaten Monfort's "ability to compete in the boxed beef market."<sup>105</sup> As described in more detail by the district court:

Following the planned sale, Monfort contends that Excel and IBP would attempt to enlarge their respective market shares as rapidly as possible at the expense of each other and, more significantly, at the expense of the smaller competitors such as Monfort. Plaintiff argues that to acquire increased market shares IBP and Excel would engage in a price-cost "squeeze" bidding up the price of the necessary raw product input

<sup>104</sup> 479 U.S. 104 (1986).

<sup>105</sup> *Id.* at 107.

supply (fed cattle) while at the same time lowering the cost of the finished output product (boxed beef).<sup>106</sup>

The price-cost “squeeze” language could suggest that Monfort was claiming that Excel would pursue a conscious policy to bid up the price of the input to raise rivals’ costs or drive them out of the market. The language also could suggest a claim that the higher input prices might simply be a natural consequence of increased competition between the merged firm and IBP. Thus, Monfort’s complaint might really have been about increased competition resulting from the merger. This latter interpretation caused the district court, the appellate court, and the Supreme Court to question Monfort’s standing to challenge the merger.<sup>107</sup>

However, it seems clear that Monfort did not simply allege increased competition, but instead directly claimed that predation would occur. As described by the Court,

Eventually, according to Monfort, smaller competitors lacking significant reserves and unable to match Excel’s prices would be driven from the market; at this point Excel would raise the price of its boxed beef to supracompetitive levels, and would more than recoup the profits it lost during the initial phase.<sup>108</sup>

The Supreme Court analyzed the case solely as a claim of possible predatory pricing in the output market, not as overbuying.<sup>109</sup> The Court reversed the lower courts because Monfort did not allege below-cost pricing.

Reconstructing Monfort’s claim as an overbuying allegation, Monfort’s focus on the output market suggests RRC overbuying, not predatory overbuying. However, as part of its argument, Monfort claimed that the merger would cause its exit from the output market, and not just cause it to bear higher costs. Monfort also argued that it was an equally efficient

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<sup>106</sup> *Monfort of Colo., Inc. v. Cargill, Inc.*, 591 F. Supp. 683, 691 (D. Colo. 1983).

<sup>107</sup> In its amicus brief, the Department of Justice invited the Court to “adopt in effect a *per se* rule ‘denying competitors standing to challenge acquisitions on the basis of predatory pricing theories,’” an invitation that the Court declined. Because there was “ample evidence” that predatory pricing does occur, the Court concluded that it would be “novel indeed” to deny standing simply because “such injuries rarely occur.” *Cargill*, 479 U.S. at 121.

<sup>108</sup> *Id.* at 114.

<sup>109</sup> This focus may not be surprising in light of the lower court opinions. The district court defined a relevant input market, but then undertook a structural analysis rather than examining the likelihood that an overbuying strategy would succeed. *See Monfort*, 591 F. Supp. at 710. In affirming the district court, the Tenth Circuit treated the conduct as “a form of predatory pricing.” *Monfort of Colo., Inc. v. Cargill, Inc.*, 761 F.2d 570, 575 (10th Cir. 1985), *rev’d*, 479 U.S. 104 (1986).

competitor. These two claims in effect concede the importance of showing below-cost pricing (a concession noted by the Court in its opinion), even in the context of RRC overbuying.<sup>110</sup>

Despite this outcome, one cannot conclude that the Court would mandate a below-cost pricing test for RRC overbuying claims brought by plaintiffs that do not allege that the overbuying would drive them from the output market. *Cargill* has only limited applicability to an overbuying case for a second reason: it involved allegations that a merger would lead to anticompetitive conduct in the future, not allegations that the anticompetitive conduct already had been implemented. Thus, *Cargill* does not demand that a below-cost pricing test is required for RRC overbuying.

### B. ROSS-SIMMONS<sup>111</sup>

The economic and legal analysis of overbuying also can be applied to a recent antitrust case brought against Weyerhaeuser by two sawmill competitors in the Northwest.<sup>112</sup> This case demonstrates the need for rigorous rule of reason analysis, including the need to show consumer harm. It also shows how the below-cost pricing test would help to avoid false positives in predatory overbuying matters.

This case involves alleged overbuying by Weyerhaeuser of alder sawlogs that are processed into hardwood lumber. The plaintiffs alleged that Weyerhaeuser caused input prices to increase to a level that would drive competitors out of the market, thereby allowing Weyerhaeuser to monopsonize the input (alder sawlogs) market and monopolize the output (alder lumber) market. Thus, the plaintiffs alleged both predatory and RRC overbuying. One plaintiff prevailed in the allegations of monopolization (i.e., monopsonization) of the input market, recovering trebled damages of \$78 million.<sup>113</sup> With respect to monopolization of the output market, Weyerhaeuser prevailed against both plaintiffs.

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<sup>110</sup> *Cargill*, 479 U.S. at 115 n.10.

<sup>111</sup> *Weyerhaeuser v. Ross-Simmons Hardwood Lumber Co.*, Case No. 03-35669 (9th Cir. filed Nov. 26, 2003) (*Ross-Simmons*), on appeal from *Confederated Tribes of Siletz Indians of Or. v. Weyerhaeuser Co.*, Civil No. 00-1693-PA. All references to the briefs of appellant Weyerhaeuser and appellee Ross-Simmons in the appellate briefing in *Ross-Simmons* are referred to as "Weyerhaeuser Appellate Brief" and "Ross-Simmons Appellate Brief," respectively.

<sup>112</sup> I have been consulting with Weyerhaeuser on this matter. As mentioned previously, the analysis and the opinions expressed in this article are my own and may not reflect the views of Weyerhaeuser. Professor Kirkwood has consulted with the plaintiffs. Professor Zerbe served as an expert witness for the plaintiffs.

<sup>113</sup> For reasons not apparent from the verdict, the jury found against the co-plaintiff, Confederated Tribes of Siletz Indians of Oregon. The district court dismissed a third

The plaintiffs asserted that Weyerhaeuser engaged in predatory overbuying by “maintain[ing] artificially high sawlog costs designed to hurt competition and control competitive access to a necessary and limited natural resource.”<sup>114</sup> Further, the plaintiffs alleged that “[u]nless checked by a court action, additional competitors of Weyerhaeuser will be forced out of the alder sawmill business, and Weyerhaeuser will be in a position to force sawlog prices down significantly.”<sup>115</sup> The plaintiffs also alleged that Weyerhaeuser “continually increas[ed] capacity” and put “financial pressure on its competitors by continuing to increase lumber production.”<sup>116</sup> Although the length of the alleged predatory period is not entirely clear, it appears from its damages analysis that Ross-Simmons alleged a predatory period from 1997–2001. In the follow-on cases, the alleged predatory period seems to continue until the second or third quarter of 2002.<sup>117</sup> This is, of course, a long period to be sacrificing profits.

With respect to their RRC overbuying theory, the plaintiffs did not specifically assert that Weyerhaeuser imposed higher costs on its competitors in an effort to cause a price increase in the downstream lumber market. To the contrary, their theory was that Weyerhaeuser *increased* downstream output.<sup>118</sup> In his expert report for the plaintiffs, Professor Zerbe opined that Weyerhaeuser implemented a strategy to drive sawlog prices up and lumber prices down to eliminate competition in anticipation of a shortage of sawlogs.<sup>119</sup> Of course, a claim that lumber prices fell is inconsistent with consumer harm from RRC overbuying. In a

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plaintiff's claims. The initial litigation sparked a number of follow-on cases brought by competitors and a class of lumber purchasers. One of these competitor actions settled. *Westwood v. Weyerhaeuser*, Civil No. 03-551-PA (D. Or. Mar. 9, 2004) (Judgment). Another resulted in a jury verdict against Weyerhaeuser for more than \$15 million after trebling. *Washington Alder v. Weyerhaeuser*, Civil No. 03-753-PA (May 20, 2004) (Verdict). The jury found liability for the time period covered by issue preclusion based on the *Ross-Simmons* case, but not for the time period thereafter. *Id.* *Washington Alder* withdrew its claim of monopolization with respect to the output market. *Washington Alder*, Trial Tr. Vol. 4A, at 157:3-7 (Apr. 14, 2004). Still pending are *Smith Street Mill, Inc.*, Civil No. 04-1049-PA (D. Or. filed July 30, 2004) (competitors), and *Morelock Enterprises, Inc. v. Weyerhaeuser*, Civil No. 04-583-PA (D. Or. filed Apr. 28, 2004) (lumber consumers).

<sup>114</sup> *Ross-Simmons* Appellate Brief at 23.

<sup>115</sup> *Ross-Simmons* Action, Fourth Amended Complaint ¶ 55 (filed Feb. 27, 2003).

<sup>116</sup> *Id.* ¶¶ 25(b) and 26(c).

<sup>117</sup> *Ross-Simmons* Appellate Brief at 21; *Washington Alder* Third Amended Complaint ¶ 13; *Westwood* Fourth Amended Complaint ¶ 17.

<sup>118</sup> The Complaint alleged that Weyerhaeuser put “financial pressure on its competitors by continuing to increase lumber production . . . particularly during the period of 1997–2000.” *Ross-Simmons*, Complaint ¶ 26(c).

<sup>119</sup> *Ross-Simmons*, Plaintiff's Corrected Expert Witness Statement of Richard O. Zerbe Jr., ¶¶ 23, 24 (filed Mar. 10, 2003). Professor Zerbe also opined that Weyerhaeuser had monopoly power in a separate alder output market. *Id.* ¶¶ 25, 26. In his article, Professor Zerbe says that 80% of the supply was price inelastic. Zerbe, *supra* note 49, at 722. But that

predatory overbuying scenario, the falling prices during the predatory period imply a consumer benefit.

Professor Zerbe argues in his article that fewer alder seedlings would be planted and that the alder log supply eventually would fall—“thirty or more years into the future when the seedlings would mature into merchantable alder timber.”<sup>120</sup> This thirty-year period before lumber prices would rise significantly is even longer than the period in *Matsushita*.<sup>121</sup> In light of this very long time lag before consumer injury, and the substantial predatory period in which consumers apparently gained from lower lumber prices, it is certainly unclear that the alleged overbuying strategy would lead on balance to a reduction in the net present value of consumer welfare, even if the output of alder lumber did eventually fall. Moreover, a reduction in alder log output might not ever translate into significantly higher lumber prices (or lower total lumber output) because alder competes in a broader lumber market and additional seedlings of other varieties might be planted to offset any reduction in alder stocks.<sup>122</sup>

Application of the four-step rule of reason analysis demonstrates that the jury likely reached an incorrect verdict. With respect to the first step, the plaintiffs presented evidence that Weyerhaeuser significantly increased its purchases of logs, beginning in 1997.<sup>123</sup> The plaintiffs reasoned that because the prices of alder sawlogs and alder lumber moved in unison until 1997 and “[f]rom 1997 to 2001 . . . log prices climbed steadily” while lumber prices declined, then Weyerhaeuser must have increased its purchases.<sup>124</sup> The plaintiffs also said that Weyerhaeuser had paid more than it needed to for the alder sawlogs. The plaintiffs essentially inferred that the change had to be the result of predatory overbuying.<sup>125</sup>

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condition still would lead to some increase in output and some lumber price reduction if alder lumber were a separate market.

<sup>120</sup> Zerbe, *supra* note 49, at 724. Professor Zerbe argues that during the interim the supply of mature alder logs is highly inelastic.

<sup>121</sup> *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986).

<sup>122</sup> That also could apply to price reductions during the predatory period. But, as discussed above, it was alleged by the plaintiffs that lumber prices fell during the 1997–2001 period.

<sup>123</sup> The plaintiffs at times also argued that Weyerhaeuser overbought sawlogs back in the early 1990s, becoming a monopsonist around 1995 and beginning to raise the cost of sawlogs then. Ross-Simmons Appellate Brief at 20.

<sup>124</sup> *Id.* at 21.

<sup>125</sup> The plaintiffs also presented internal Weyerhaeuser documents that supported the assertion that Weyerhaeuser had paid more than it could have for the sawlogs during this timeframe. *Id.* Weyerhaeuser disputed the meaning of these internal documents. Weyerhaeuser Appellate Brief at 10.

This same pattern could have been caused by increased competition (in either the input or output market) or decreased input supply. There apparently was no direct evidence that Weyerhaeuser increased its purchases of sawlogs over the alleged period.<sup>126</sup> Weyerhaeuser presented evidence that the upward pressure on sawlog prices resulted from a decrease in the alder sawlog supply and an increase in competition for these sawlogs.<sup>127</sup> In fact, in his article Professor Zerbe agrees, and cites record evidence supporting that the supply of logs” may have been “declining during the period of the alleged predation.”<sup>128</sup> Weyerhaeuser also argued that to the extent it was willing to pay higher prices for logs, such conduct was legitimate competition because it was becoming a more efficient firm after making extensive capital improvements in its mills, allowing it to reduce costs and increase log yield.<sup>129</sup> This ambiguity underscores the concern about false positives.

The plaintiffs also alleged a warehousing strategy of “stockpiling and wasting sawlogs to keep them from the market.”<sup>130</sup> However, the warehousing allegations related only to two specific instances that apparently occurred years before any alleged input price increases or competitor exit.<sup>131</sup> The defendant argued that the purchases represented a rational inventory policy.<sup>132</sup> Moreover, because Weyerhaeuser was selling lumber in a broad output market in which it lacked market power, it is not clear why it would have an incentive to engage in warehousing, rather than producing additional output if it had additional input available.

With respect to the second step, the plaintiffs presented evidence that one of the plaintiffs, Ross-Simmons, exited from the market in 2001 as a result of Weyerhaeuser’s conduct. The other two co-plaintiffs had exited the alder lumber business in 1998 and 1999. Nevertheless, as

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<sup>126</sup> Ross-Simmons Appellate Brief at 21.

<sup>127</sup> Weyerhaeuser Appellate Brief at 8, n.8.

<sup>128</sup> Zerbe, *supra* note 49, at 722.

<sup>129</sup> Weyerhaeuser Appellate Brief at 10.

<sup>130</sup> Ross-Simmons Appellate Brief at 23; *see also id.* at 55.

<sup>131</sup> The warehousing allegedly occurred in 1989 and 1993. According to the Complaint, one of the plaintiffs entered the market in 1996 and the other did not exit the market until 2001. *See Ross-Simmons*, Complaint ¶ 49.

<sup>132</sup> Weyerhaeuser asserted that it bought additional logs “to carry them through the winter.” Weyerhaeuser Appellate Brief at 30. That could be a perfectly rational inventory strategy if, for example, the potential cost of the risk of running out of logs outweighs the potential cost of having to let inventory go to waste. Therefore, if some logs were not used *ex post*, that fact would not necessarily mean that there was predatory overbuying *ex ante*. In addition, with respect to the two incidents of alleged spoiling of logs in 1989 and 1993, Weyerhaeuser executives testified that these were not sawlogs. Instead, the alder sawmill stored alder *pulp logs* for the adjacent pulp mill, which had overestimated its needs. *Id.*

stated above, the jury found in favor of Weyerhaeuser with respect to one plaintiff, and the district court dismissed the claims of the other.

With respect to the third step, plaintiffs' overbuying theory was not supported by evidence of likely recoupment, either in the form of lower log prices or higher lumber prices. In the relevant output market, which the jury determined to be the hardwood lumber market, the defendant's market share was about 3 percent.<sup>133</sup> This would seem to eliminate any notion that the defendant could or did raise prices downstream.<sup>134</sup> With respect to the predatory overbuying claim, there was no evidence that the defendant could or did recoup through lower log prices.<sup>135</sup>

With respect to the key fourth step, the plaintiffs did not establish consumer harm. Ross-Simmons argued in its brief that "attempts to monopsonize by artificially high prices inevitably lead to consumer harm."<sup>136</sup> However, as discussed above, consumer harm cannot be presumed, but rather must be established through evidence. A necessary condition for consumer harm under both overbuying theories is evidence of higher output prices caused by the overbuying strategy. However, the plaintiffs provided no evidence of higher lumber prices. In fact, the plaintiffs did not even allege that the overbuying strategy would increase the price of lumber. Instead, they argued that the overbuying led to a lower price of lumber as Weyerhaeuser increased its timber purchases and produced more lumber. There was no allegation or evidence in the *Ross-Simmons* case of subsequent lumber price increases that more than

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<sup>133</sup> *Id.* at 10.

<sup>134</sup> In contrast, Professor Zerbe suggests in his article that evidence of a broad output market should eliminate the need for direct evidence of consumer harm. In his view, lack of market power in that broad product market should be sufficient to shift the burden of proof to the defendant. Zerbe, *supra* note 49, at 724. For commentary on this point, see *supra* Part II.B.2.a.

<sup>135</sup> The main evidence put forward by plaintiffs was the testimony of a prior employee of the defendant that Weyerhaeuser intended to recoup once competitors exited from the market. However, this employee was basing his testimony on his experiences significantly before the alleged overbuying even started. Weyerhaeuser Appellate Brief at 32. Professor Zerbe offers evidence from the subsequent *Washington Alder* trial to support the argument that Weyerhaeuser expected to recoup by lowering log prices. *Westwood* never went to trial and the *Washington Alder* jury found that there was no unlawful monopolization for the post-2001 time period, which was not subject to collateral estoppel by the *Ross-Simmons* verdict. In any event, I understand that the evidence also shows that Weyerhaeuser expected the supply to increase in the future. *Washington Alder*, Ex. 8305 at 21. I also understand that at the *Washington Alder* trial there was testimony that Weyerhaeuser was unsuccessful in its efforts to keep the log prices down during the alleged recoupment period. *Washington Alder*, Trial Tr. Vol. 6B at 165:4-167:2 (May 18, 2004).

<sup>136</sup> Ross-Simmons Appellate Brief at 49 (citing OZ SHY, INDUSTRIAL ORGANIZATION: THEORY AND APPLICATIONS 68-69 (1995)).

offset these consumer gains, or even that the price of lumber subsequently increased.<sup>137</sup>

It appears, then, that Weyerhaeuser was found liable because the court did not require evidence of consumer harm. The court's instruction instead was like a loose profit-sacrifice test, instructing the jury that it could find a violation if it merely found that the "Defendant purchased more logs than it needed, or paid a higher price for logs than necessary, in order to prevent the Plaintiffs from obtaining the logs they needed at a fair price."<sup>138</sup> For the reasons explained above, such an amorphous "fair price" standard is not an adequate benchmark for courts or juries to accurately determine whether a defendant predatorily overbought or overpaid. "More than needed" and "higher price than necessary" are vague standards, except in the case of naked overbuying and proven warehousing. Thus, this standard raises a high risk of false positives because it cannot distinguish between price increases resulting from vigorous competition versus predation. For example, one can easily see how a firm that simply was bidding more for inputs in order to increase input purchases to expand production could be found liable under this standard.

The problems with this "fair price" standard also demonstrate the benefit of requiring the below-cost pricing test for predatory overbuying. In this regard, the plaintiffs did not allege or provide evidence that overbuying led to Weyerhaeuser's costs exceeding its price. Instead, the plaintiffs merely alleged that Weyerhaeuser paid an "artificially high" price for inputs that rivals could not afford to match.<sup>139</sup> Applying the rule of reason (including the consumer harm analysis) and requiring the below-cost pricing test would have prevented a likely false positive and reduced legal process costs.

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<sup>137</sup> In his article, Professor Zerbe claims that sawlog prices decreased and lumber prices increased in 2002. In making these claims, it is important to note that Professor Zerbe is not relying on evidence in the *Ross-Simmons* case, but rather is relying on submissions from the *Westwood* and *Washington Alder* cases, both of which postdated the trial in *Ross-Simmons*. Based on my limited access to the record in these subsequent cases, I understand that log prices actually increased in 2002. *Washington Alder* Ex. 9943, 9944. I also understand that the claims regarding the lumber market were not tried in either of these subsequent cases. Indeed, *Westwood* never went to trial. Further, the *Washington Alder* jury found in favor of Weyerhaeuser for the post-2001 period. In any event, if there is any ambiguity about level of prices for logs and lumber during the recoupment period, relative to the non-overbuying benchmark, such ambiguity once again underscores the need for evidence of consumer harm. One cannot simply rely on a presumption of harm in these predatory overbuying cases.

<sup>138</sup> *Ross-Simmons*, Jury Instructions at 10 (Apr. 17, 2003).

<sup>139</sup> *Ross-Simmons*, Complaint ¶ 40.



#### IV. CONCLUSION

There are two types of overbuying conduct: predatory overbuying and raising rivals' costs (RRC) overbuying. Predatory overbuying is intended to cause input market competitors to exit from the market or permanently shrink their capacity and thereby allow the firm subsequently to exercise monopsony power in the input market. RRC overbuying is intended to raise the input costs of output market competitors and thereby give the firm the market power to raise or maintain the price it charges in the output market. These two strategies differ both in their target market and in their likelihood of consumer injury.

Application of the four-step rule of reason standard, using a consumer welfare analysis, can reduce the potential for errors in identifying instances of predatory and RRC overbuying. Although the profit-sacrifice test is a poor short-cut for analysis of either type of overbuying, the below-cost pricing test can be useful, and should be required of the plaintiff, for predatory overbuying cases. However, because successful RRC overbuying raises more significant risks to consumer welfare than predatory overbuying, requiring the plaintiff to satisfy the below-cost pricing test in RRC overbuying cases would cause excessive false negatives. Thus, the below-cost pricing test should not be required for a plaintiff's case to proceed when the allegation is RRC overbuying.

