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What Is Competition? A Comparison of U.S. and European Perspectives

William J. Kolasky*

*WilmerHale

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BY WILLIAM J. KOLASKY*

I. Introduction

During the year and a half that I served as Deputy Assistant Attorney General for International Enforcement in the Antitrust Division of the U.S. Department of Justice, the Division undertook two major initiatives designed to promote greater international convergence and cooperation in the enforcement of competition law—the formation of a new International Competition Network (ICN) and the strengthening of the bilateral relationship between the United States and the European Union (EU). The Division made more progress in both areas than any thought possible when it began. The ICN is not only up and running, but is already serving as an important force for international cooperation and convergence and the relationship between the United States and Europe, despite occasional disagreements, is stronger than ever. The European Commission and the Antitrust Division worked closely together in launching ICN and making it a success. The bilateral U.S./EU joint merger working group has stepped up its activities and now meets regularly to discuss important issues of common concern. Based on this group's work, a

* Co-chair of the Antitrust and Competition Practice Group at Wilmer Cutler & Pickering.

new set of best practices for coordinating merger reviews was released in October 2002.¹

Until recently, efforts in the international area have been largely devoted to institution- and relationship-building and to improving the processes for merger review. In going forward, attention needs to turn more to the substance of the antitrust laws and to strengthening the analytical framework used to enforce those laws. And that is the focus of this article.

I will begin by discussing the purposes of competition policy. In the United States, antitrust practitioners like to say that the purpose of the antitrust laws is to protect competition, not competitors. This principle has now become such a central part of American antitrust jurisprudence that it is taken for granted. However, it is surprising to find that this principle does not resonate quite the same way in Europe. When I suggested in London in May 2002 that it be used as a guiding principle for sound competition policy,² a European competition official responded that it seemed an empty slogan, devoid of content. And in the debate over *GE/Honeywell*, Commission officials treated this principle as more of a paradox, arguing that without competitors, there can be no competition.³ These reactions underscore the need for a better explanation of this principle in order to persuade others to apply it in designing and enforcing their competition laws. That cannot be done without first defining what is meant by “competition.”

¹ U.S.-EU MERGER WORKING GROUP, BEST PRACTICES ON COOPERATION IN MERGER INVESTIGATIONS, *available at* <http://www.usdoj.gov/atr/public/international/docs/200405.htm>.

² William J. Kolasky, North Atlantic Competition Policy: Converging Toward What?, Address at the British Institute of International and Comparative Law Second Annual International and Comparative Law Conference (May 17, 2002) (transcript available on U.S. Department of Justice Antitrust Division Web site, www.usdoj.gov/atr/).

³ Götz Drauz, *Unbundling GE/Honeywell: The Assessment of Conglomerate Mergers Under EC Competition Law*, 2001 FORDHAM CORP. L. INST. 183, 197–98 (B. Hawk ed., 2002).

I will follow by discussing how the principle is applied in practice in the United States, focusing on three areas, cartels, mergers, and abuse of dominance. On cartels, strong enforcement is absolutely critical. On mergers, efficiencies should be a central part of the competitive effects analysis. And on abuse of dominance, administrable standards are needed that permit even dominant firms to compete aggressively, lest we restrain competition in the name of protecting it.

II. Protect competition, not competitors

When a lay person thinks of competition, he or she probably has one of two images in mind. The first is a sporting event, in which two evenly matched opponents, play a spirited, but closely contested, match like the 2002 World Cup final between Brazil and Germany. The second is a market that resembles a scrum in a rugby match with numerous firms scrambling for every scrap of business—the more numerous, the more competitive.

Economists see competition differently. An economist sees competition not in terms of rivalry per se, but in terms of market performance. An economist would say that a market is perfectly competitive when firms price their output at marginal cost and costs are minimized by internal efficiency. This does not necessarily require a large number of rivals. Where entry and exit are costless, markets can be perfectly competitive even with only one firm serving the entire market. Similarly, some models of oligopoly show that in some markets prices may be driven to marginal cost, even where there are entry barriers, with as few as two competitors. In both types of markets, allocative and productive efficiency may be perfectly aligned even at relatively high levels of concentration, so that no rearrangement of productive assets could enhance total economic welfare. In these markets, antitrust intervention to preserve or create a larger number of rivals would harm consumer welfare and worsen economic performance.

Joseph Schumpeter was the first to teach that in other markets, especially those driven by innovation, there may be a tension between

allocative efficiency on the one hand and productive or dynamic efficiency on the other.⁴ For example, where firms need to invest in order to innovate, prices will need to be above short-term marginal cost to provide an incentive to make the needed investments. As Schumpeter observed, these markets are often marked by “gales of creative destruction,” in which one firm may serve the entire market or at least a large portion of it for a period of time, only to be displaced by another firm with a leapfrogging technological innovation that delivers dramatically improved performance or dramatically lower cost. Think of Visicalc being displaced by Lotus, which in turn was displaced by Excel. In these markets an efficient monopolist, constrained by overall market demand and the threat of entry, will often charge quality-adjusted prices that, while above marginal cost, are still below the prices that would be charged by a group of less efficient competitors. To an economist, the competitive process is working in these markets, even if it results in only one firm serving the entire market for some period of time. In such markets, government intervention to preserve rivals or create new ones will again worsen overall economic performance.⁵

Even in markets in which price, rather than innovation, is the principal driver of competition, there is no necessary relationship between concentration and competition, except at very high levels of concentration. In some cases, as has been seen in many recently

⁴ See J.A. SCHUMPETER, *CAPITALISM, SOCIALISM AND DEMOCRACY* (1942).

⁵ A number of empirical studies have confirmed Schumpeter’s basic insight. They show that the social costs associated with the static resource misallocation caused by market power are generally quite small while the gains from increases in productive and dynamic efficiency can be very large. See A.C. Harberger, *Monopoly and Resource Allocation*, 44 AM. ECON. REV. 2 (1954); F.M. SCHERER & D. ROSS, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* (1990). These studies have important implications for competition policy. They show, among other things, a “hump-shaped” relationship between concentration and innovation, with innovation occurring at the fastest pace in industries falling in the mid-range of concentration. See P. Aghion, N. Bloom, R. Griffith & P. Howitt, *Competition and Innovation: An Inverted U Relationship*, THE INSTITUTE FOR FISCAL STUDIES (Feb. 2002).

deregulated industries, an increase in competition may lead to increased concentration as aggressive competition reallocates profits from inefficient firms to more efficient ones, thereby driving out inefficient firms and increasing market concentration. For this reason, industries in which cartel activity is rampant tend to be less concentrated than industries in which competition is fierce.

Similarly, there is no necessary relationship between price-cost margins and the intensity of competition. Some of the most fiercely competitive markets, in which large sunk investments must be made to remain competitive, exhibit relatively high price-cost margins. This is particularly true in innovation-driven markets where high margins are needed to support recurring R&D expenditures and to provide the incentive to make highly risky investments in innovation. Not surprisingly, therefore, markups tend to be highest in R&D-intensive industries.

One of the most interesting recent books on economics is entitled *The Free-Market Innovation Machine*, written by Professor William J. Baumol.⁶ In it, Baumol brings his usual economic rigor to help provide a better understanding of the competitive dynamics of markets driven by innovation. Baumol shows that in many key parts of our economy, innovation, not price, is “the primary instrument of competition.” In these markets, Baumol argues that competition resembles the “Red Queen Game” in *Alice in Wonderland*, in which it is necessary to run as rapidly as possible in order just to stand still. He also shows, with an impressive collection of data, that free markets, by allowing this process to operate unimpeded by governmental or private restraints, have delivered remarkable economic growth.

Baumol maintains that the competitive model that is most helpful in understanding competition in markets driven by innovation is the perfectly contestable market, which he helped develop, where entry and exit are instantaneous and costless. Baumol acknowledges that few markets are perfectly contestable, just as few markets are perfectly competitive. The contestability models nevertheless can help

⁶ WILLIAM J. BAUMOL, *THE FREE-MARKET INNOVATION MACHINE: ANALYZING THE GROWTH MIRACLE OF CAPITALISM* (2002).

us better understand how these markets perform. In such markets, sunk costs, notably the sunk costs required to innovate, are substantial, mandatory, and constantly repeated. As a result, prices will have to be above marginal cost and price discrimination becomes the norm rather than the exception because otherwise the sunk costs necessary for innovation could not be recouped. In such markets, while prices are above marginal cost, the firms are nevertheless price takers, and do not therefore meet the legal definition of a dominant firm. This produces what Baumol calls a “churning equilibrium,” which is another name for Schumpeter’s “gales of creative destruction.”

In such markets, it is the threat of entry that constrains the incumbent’s pricing. The threat of entry will not prevent the innovating firm from recovering its sunk costs because no firm will enter if no feasible prices will enable the entrant to cover its fixed or sunk common costs. But entry will occur and drive prices down if those prices are above the levels needed to cover these costs. Thus, potential entry will drive prices to the levels that just permit competitive returns overall, but it will not depress them down to marginal cost.

Similarly, discriminatory pricing will occur because of the need to recover continuing and repeated sunk costs. This is because, under these common conditions involving common costs, firms constrained from earning monopoly rents by competition or the threat of entry will have to adopt price discrimination as the optimal strategy to allocate these common costs among buyers. In these markets, firms that employ discriminatory prices may charge some customers prices that are above marginal cost, but are nevertheless powerless price takers, because they are forced by the market to adopt those prices. For this reason, price discrimination is common in many highly competitive markets, such as airlines, car rental, hotels and restaurants, in which the firms are earning normal or even below normal returns. Price discrimination in these circumstances is welfare enhancing and is not evidence of market power.

To formulate a sound competition policy, there needs to be a definition of competition that takes these lessons into account. The one I would propose, and I believe is consistent with the U.S. case

law,⁷ is that *competition is the process by which market forces operate freely to assure that society's scarce resources are employed as efficiently as possible to maximize total economic welfare.*⁸

This formulation solves the paradox of how to protect competition without protecting competitors. Competition is fiercest when competitors have no protection from their government; when, to paraphrase Tennyson's, *In Memoriam*, competition is "red of tooth and claw." It is in those circumstances that firms will strive the hardest, motivated both by the hope of success and the fear of failure. Nor should it be feared that this may result in one firm serving the entire market. If a market is most efficiently served by a single firm, using the antitrust laws to prevent that outcome would not only burden society with the additional costs of having two or more firms serve that market, but would require "an effort worthy of King Canute."⁹ As Judge Bailey Aldrich put it, "society has an interest in competition even though that competition be an elimination bout."¹⁰

⁷ See, e.g., *Rebel Oil Co. v. Atlantic Richfield Co.*, 51 F.3d 1421, 1433 (9th Cir. 1995) ("Competition consists of rivalry among competitors. Of course, conduct that eliminates rivals reduces competition. But reduction of competition does not invoke the Sherman Act until it harms consumer welfare. Accordingly, an act is deemed anticompetitive under the Sherman Act only when it harms both allocative efficiency and raises the prices of goods above competitive levels or diminishes their quality.").

⁸ This definition is similar to that proposed by Areeda and Hovenkamp. See 1 PHILIP E. AREEDA & HERBERT HOVENKAMP, *ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION* 4 (2d ed. 2000) ("Today it seems clear that the general goal of the antitrust laws is to promote 'competition' as the economist understands that term. Thus we say that the principal objective of antitrust policy is to maximize consumer welfare by encouraging firms to behave competitively, while yet permitting them to take advantage of every available economy that comes from internal or jointly created production efficiencies, or from innovation producing new processes or new or improved products.").

⁹ *Omega Satellite Prods. Co. v. City of Indianapolis*, 694 F.2d 119, 126 (7th Cir. 1982) (Posner, J.).

¹⁰ *Union Leader Corp. v. Newspapers of New England, Inc.*, 284 F.2d 582, 590 (1st Cir. 1960).

It should be made clear, however, as Aldrich did, that antitrust still has an important role to play, even in markets in which the competitive outcome may be a monopoly. The purpose of the antitrust laws is to assure that the war is fought and the outcome determined on the basis of efficiency. The antitrust laws should intervene only when one combatant employs methods that would deny victory to the most efficient firm or create barricades to entry by equally or more efficient new entrants.

The case that best illustrates these principles is *Monfort of Colorado, Inc. v. Cargill, Inc.*¹¹ That case arose from an action by a meat packing company seeking to block a merger of two larger rivals. The plaintiff, Monfort, argued that the merger would make the combined firm more efficient and would also give the merged firm the ability to engage in predatory pricing, as a result of which Monfort would be driven from the market. The Supreme Court held that Monfort lacked standing because it had not alleged “antitrust injury”—that is, injury of the kind the antitrust laws are designed to prevent. The Court held that efficiencies generated from a merger could never give rise to antitrust injury, even if they resulted in rivals being driven from the market, because that is an inevitable part of the competitive process. As to predatory pricing, the Court held that Monfort had not sufficiently alleged antitrust injury because it had not shown that the merged firm, if it succeeded in driving its rival from the market through below-cost prices, would be able to recoup those losses by later raising prices above competitive levels. Without such a showing, the Court held, below-cost pricing can only benefit consumers.

III. Implementing the objective of protecting competition, not competitors

Having tried to explain what is meant by striving to protect competition, not competitors, the discussion now turns to how this philosophy should be implemented in three key areas: cartels, mergers, and abuse of dominance.

¹¹ *Monfort of Colorado, Inc. v. Cargill, Inc.*, 479 U.S. 104 (1986).

A. *Cartels*

The number one priority of any competition law regime should be vigorous anticartel enforcement. Cartels are the very antithesis of competition. They allow small and inefficient competitors to join together to enjoy the easy life at the expense of their customers. Whereas monopolies can sometimes produce greater efficiency, cartels, by definition, have no efficiency-enhancing potential whatsoever.

There is solid empirical evidence that hard-core cartels inflict serious efficiency losses on the economy. Estimates by national enforcement agencies of the cartel overcharges for 14 large multinational cartel cases in the period 1996 to 2000 range from 5% to 65%, with the median being around 15% to 20%.¹² One study found that before the U.K. adopted anticartel legislation, price fixing affected three-quarters of the British industry and reduced average labor productivity by nearly one percentage point.¹³ This may sound small but is actually very large given that labor productivity growth in developed countries rarely exceeds 3%–4%.

Cartels are treated as crimes in the United States and have been punishable as felonies, with jail time for individuals, since 1975. There is a very active enforcement program, with nearly one-third of the Antitrust Division lawyers working full time in this area. The European Commission, under Mario Monti, has now developed an equally vigorous program of anticartel enforcement. Although cartels have been unlawful in most major European jurisdictions for decades, enforcement was lax at best in most jurisdictions until very recently and cartel behavior was deeply ingrained in the culture of many European industries. It was no accident that many of the major multinational cartels that were prosecuted in the 1990s were organized and led by European companies.

¹² See OECD, REPORT ON THE NATURE AND IMPACT OF HARD-CORE CARTELS AND SANCTIONS AGAINST CARTELS UNDER NATIONAL COMPETITION LAWS, DAF/COMP (2002)/7.

¹³ See S. Broadberry & N. Crafts, *British Economic Policy and Industrial Performance in Early Post-War Period*, 38 BRITISH HISTORY 56 (1996).

Over the last 3 years, this picture has changed dramatically. Both the European Commission and the member states are stepping up anticartel enforcement, increasing the size of their staffs, increasing the penalties for cartel activity and adopting effective leniency programs. In 2001 alone, the Commission completed investigations into ten cartels involving a total of 61 companies and imposed fines of more than 1.8 billion euros.

While there is no way to document it, it may be that lax anticartel enforcement was one of the many reasons economic growth in Europe has been slower in the past than in the United States.¹⁴ If so, Europe may reap a “growth premium” from the recently stepped-up anticartel enforcement. It is hoped that the business community will support the efforts of Commissioner Monti and the national competition authorities in this area. One of the most important things businesses can do (other than not form cartels) is to implement effective internal antitrust compliance programs. An effective compliance program is critical, not only in preventing cartel activity by employees, but also in early detection so that a company can take full advantage of leniency programs and avoid potentially disastrous fines and save its employees from prison.¹⁵

B. Mergers

The rationale for most mergers is procompetitive and most mergers have no adverse effects on competition. Some mergers do create or increase market power, and thereby reduce competition and total economic welfare. The task of competition authorities is to screen out the few bad mergers from the many good ones. It is critical that this task

¹⁴ See *The Need for Shock Treatment—the EU Barcelona Summit*, *ECONOMIST*, Mar. 9, 2002, 2002 WL 7245446 (reporting that the gap in GDP per capita between Europe and the U.S. widened from 42% in 1991 to 54% in 2001).

¹⁵ For advice on how to design an effective compliance program, see William J. Kolasky, *Antitrust Compliance Programs: The Government Perspective*, Address at the Corporate Compliance 2002 Conference, Practising Law Institute (July 12, 2002) (transcript available on U.S. Department of Justice Antitrust Division Web site, www.usdoj.gov/atr/).

be performed in a way that does not interfere unduly with the free market for corporate control, because that market plays as important a role as any product market in pressuring managers to perform efficiently.

There has been a great deal of effort devoted in the United States over the last quarter century to improving the processes for reviewing proposed mergers. The agencies clear 97% of all mergers in the first 30 days and now challenge nearly two-thirds of all mergers in which there is a full-blown second request investigation. It is encouraging that Europe is now devoting an equal or greater amount of attention to strengthening its own review processes.¹⁶

I have only three observations to offer, based on the U.S. experience in the merger area. The first is that efficiencies should be a central part of any competitive effects analysis. There is simply no way to evaluate whether a merger will give the merged firm the ability and incentive to raise prices either unilaterally or in coordination with other firms without examining the efficiencies the merger may produce, whether they be in the form of production efficiencies, transactional efficiencies, allocative efficiencies, or dynamic efficiencies. In evaluating efficiencies, care must be taken to impose no heavier burden on the parties to prove those efficiencies than is imposed on complainants to prove that the merger will harm competition.

A second observation is to emphasize the importance of involving professional economists in merger reviews, both at the staff level during the investigation and at the senior decision-making levels. There are now over 50 Ph.D. industrial organization economists and econometricians working at the Antitrust Division in a separate and independent unit headed by a leading academic economist. The Division simply could not do its job without them.

A third observation relates to predictability. One of the principal reasons for having merger guidelines is to increase transparency and to make the outcomes of merger investigations more predictable, so as to

¹⁶ In this respect it is worth noting that the European Commission, as part of the competition policy reforms, has recently announced the creation of the post of Chief Economist in the Directorate General for Competition.

facilitate efficient transactions. To achieve that objective, it is absolutely necessary that the guidelines be applied consistently. This makes it important, among other things, that jurisdictions follow their own precedents and base their decisions on sound economics supported by strong empirical evidence, not on novel and untested theories.

C. Dominance

Abuse of dominance, or monopolization as it is called in the United States, is now the area of greatest divergence between competition policies of the United States and Europe. The ensuing discussion will focus on four key topics: first, the need for administrable standards; second, the thresholds for finding dominance; third, the framework for separating exclusionary and predatory conduct from competition on the merits; and fourth, price cutting by dominant firms. This will be followed by an examination of the respective policies of Europe and the United States toward price cutting by dominant firms, which is probably the area of greatest divergence.

1. NEED FOR ADMINISTRABLE STANDARDS Competition law has always treated concerted action more harshly than single-firm conduct. The reason is simple. Concerted activity is inherently “fraught with anticompetitive risk” because “it deprives the marketplace of the independent centers of decision-making that competition assumes and demands.”¹⁷ But competition also assumes and demands that individual firms be allowed to compete freely. Efforts to regulate the conduct of individual firms, whether through the antitrust laws or otherwise, run the risk of destroying competition in the name of saving it.

For this reason, in both the United States and Europe, the competition laws regulate single-firm conduct only when the firm possesses a substantial degree of market power—what is called monopoly in the United States and dominance in Europe. In the United States, it is considered important that the antitrust laws allow even dominant firms to compete aggressively. Positions of dominance

¹⁷ *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 769 (1984).

are generally the natural result of market dynamics due to innovation, superior management, technological characteristics, or product differentiation. Punishing dominant firms for their success, and handicapping them to protect their rivals, may have some appeal and may even produce short-term gains, but all too often the only longer-term winners are inefficient rivals protected from the rigors of competition. Therefore, U.S. antitrust law recognizes, as Judge Learned Hand put it in one of his most famous aphorisms, that “[t]he successful competitor, having been urged to compete, must not be turned upon when he wins.”¹⁸

It is not clear to what extent European competition policy shares this philosophy. Under EC law an undertaking with a dominant position is often said to have “a special responsibility not to allow its conduct to impair genuine undistorted competition in the common market.”¹⁹ To the extent this reflects a true difference in attitude, it may derive from the different histories in Europe and the United States. In Europe, national markets were formerly protected by internal trade barriers, resulting in more local monopolies, and many more government-owned monopolies. As a result, there may be more undertakings with dominant positions that are not the natural result of market dynamics than exist in the United States. If so, greater vigilance by competition authorities may well be warranted to assure that the competitive process can operate freely to restore or create competitive conditions.

Whether or not Europe shares the belief that dominant firms should be allowed to compete as aggressively as smaller firms, it is hopefully agreed that, whichever philosophy prevails, there must be administrable standards to assure that the laws do not unduly interfere with the competition they are trying to protect. It is well known that legal institutions are not omniscient and that some error is inevitable. Further, fact-finding in competition cases is costly and those costs can deter efficient conduct. Finally, there is a tradeoff between cost and the risk of error—a system that strives to eliminate all error would

¹⁸ United States v. Aluminum Co. of America, 148 F.2d 416, 430 (2d Cir. 1945).

¹⁹ Case No. 322/81, *Nederlandsche Baden-Industrie Michelin NV v. Commission*, 1983 E.C.R. 3461.

almost certainly be too costly to administer. In designing decision rules, it is important therefore to take into account the relative costs of type I (false positive) and type II (false negative) errors. Because markets tend to be self correcting, enforcement in the United States tends to put more emphasis on reducing false positives in order not to chill competition.

In designing the analytical frameworks and decision rules to apply competition laws, and especially in incorporating the best economic learning into the decision-making, it is also important to remember that while technical economic discussion helps inform antitrust laws, those laws cannot precisely replicate the economists' views. Unlike economics, law is an administrative system. Rules that embody every economic complexity and qualification may well prove counter-productive by, for example, discouraging legitimate price competition.

Applying these principles, in the United States, a two-part test has been developed for monopolization. To be guilty of monopolization, a firm must both (1) have monopoly power in a well-defined market, and (2) have acquired or maintained that monopoly power through means of exclusionary or predatory conduct rather than "competition on the merits."²⁰ The abuse of dominance law in Europe applies a similar two-part test.

2. THRESHOLDS FOR FINDING DOMINANCE The definitions of dominance in Europe or monopoly in the United States are very similar. In the United States, monopoly is defined as the power to exclude competitors;²¹ in EC competition law, dominance is defined as "a position of economic strength" that gives the undertaking "the power to behave to an appreciable extent independently of its competitors, customers and ultimately of consumers."²² Both of these tests rely principally on a firm's market share to determine whether it is dominant. Both jurisdictions, however, recognize the need to look

²⁰ See *United States v. Grinnell Corp.*, 384 U.S. 563, 570–71, 576–80 (1966).

²¹ See *id.* at 576.

²² Case No. 85/76, *Hoffmann-La Roche & Co. AG v. Commission*, 1979 E.C.R. 461.

beyond market shares to examine other factors that may constrain a firm's ability to raise price, although in Europe a high market share may still be sufficient in itself to find dominance. One of the most important questions is how durable the firm's current market position is likely to be. As is well known, entry and even the threat of entry is a major constraint on behavior, especially in innovation-driven markets.

In identifying and examining these and other nonmarket-share factors, a better definition of monopoly power and dominance is needed. It has long been known that market shares are at best only a rough proxy for market power, the value of which is increasingly in doubt. The legal definition of dominance and monopoly power—that is the ability to exclude competitors or to act independently of competitors and customers—is also of limited use. All firms, even monopolists, are price takers in the sense that market forces determine the price that will maximize profits. In markets in which there are significant fixed costs, firms will almost invariably have some degree of market power, in the sense of being able to charge prices above marginal cost. Without some ability to price above marginal cost, there would be no investment or innovation. The difficult task is identifying when price levels are indicative of monopoly power or dominance. It is important that competition authorities everywhere begin focusing on the question of how to define monopoly power or dominance in ways other than by market share.

3. IDENTIFYING EXCLUSIONARY AND PREDATORY CONDUCT This leads to the next difficult question: How does one separate the sheep from the goats?²³ In other words, how is competition on the merits separated from exclusionary and predatory conduct?

One way to think of these twin concepts is in terms of another sports metaphor. Predation is like punching below the belt and exclusionary conduct is like putting opponents in a stranglehold. The fundamental objective of both rules in boxing is to assure that the fight is decided on the merits—may the best man win. Translated into economic terms, competition rules are designed to assure that market

²³ See *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227, 232 (1st Cir. 1983).

outcomes are determined by the relative efficiency of the rivals. *This allows defining exclusionary and predatory conduct as conduct that is likely to exclude equally (or more) efficient rivals from the market.*²⁴ But in order to assure that the bout is determined by the market and not by the referee, it is also important not to intervene too often or too soon. Otherwise, in boxing all matches would be decided on points, rather than by knockouts; and in economics, firms would have less incentive to compete hard because the prize for winning and the cost of failure would be smaller. It is for this reason that in the United States there is no intervention unless the conduct is likely to cause serious harm to consumers, not just to rivals.

(a) *Exclusionary conduct* In the United States, the courts have struggled over the years to come up with a satisfactory general formulation for exclusionary conduct. For many years, the standard formulation simply declared that the Sherman Act prohibited “the willful acquisition or maintenance of [monopoly] power as distinguished from growth or development as a consequence of a superior product, business acumen, or historical accident.”²⁵ Another equally unhelpful formulation was that the Act prohibited acts that “unnecessarily exclude actual or potential competition,” on some basis other than through “competition based on pure merit.”²⁶ The Supreme Court finally clarified the law somewhat in *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*,²⁷ where it held that in determining whether conduct was exclusionary the courts should examine whether the firm had been “attempting to exclude rivals on some basis other than efficiency.”²⁸ The Court went on to find that this test was met in *Aspen Skiing* because the evidence supported an inference that Ski Co. “was willing to sacrifice short-run benefits and consumer good will in exchange for a perceived long-run impact on its smaller

²⁴ See RICHARD POSNER, *ANTITRUST LAW* 195 (2d ed. 2001).

²⁵ *U.S. v. Grinnell Corp.*, 384 U.S. 563, 570–71 (1966).

²⁶ *U.S. v. United Shoe Corp.*, 110 F. Supp. 295 (D.Mass. 1953) (Wyzanski, D.J.), *aff'd per curiam*, 347 U.S. 521 (1954).

²⁷ 472 U.S. 585 (1985).

²⁸ *Id.* at 605.

rival.”²⁹ The evidence supporting this inference included that Ski Co. refused to sell tickets to Aspen Highlands even though Highlands was willing to pay the full retail price and that by eliminating the four-mountain pass, Ski Co. made its own product, as well as Highlands’ product, less attractive to consumers.

Based on *Aspen Skiing*, the lower courts have developed a bright-line test for exclusionary conduct under which conduct may be found exclusionary only if it both harms consumers and would make no business sense but for its potential to exclude rivals.³⁰ This will typically require a showing that the defendant was willing to sacrifice short-term profits in order to further its anticompetitive objectives. The lower courts have further held that the exclusion of a single rival is not sufficient to trigger liability under section 2. A plaintiff must show, rather, that the exclusion of rivals will have an anticompetitive effect in the form of higher prices and reduced output, thereby harming consumer welfare.

In applying this test some courts have adopted an analytical framework similar to that used to evaluate alleged restraints of trade under the rule of reason.³¹ This framework relies on shifting burdens of proof to structure the inquiry so that judges and juries cannot second-guess business conduct unless it is likely to harm competition and consumers. Under this framework, the complaining party has the initial burden of showing that the conduct is likely to “harm the competitive *process* and thereby harm consumers.”³² If the

²⁹ *Id.* at 608, 610–11.

³⁰ *See, e.g.,* *Advanced Health-Care Serv. v. Radford County Hosp.*, 910 F.2d 139, 148 (4th Cir. 1990) (“if a plaintiff shows that a defendant has harmed consumers and competition by making a short-term sacrifice in order to further its exclusive, anti-competitive objectives, it has shown predation by that defendant”); *General Indus. Corp. v. Hartz Mountain Corp.*, 810 F.2d 795, 804 (8th Cir. 1987) (“conduct without a legitimate business purpose that makes sense only because it eliminates competition”).

³¹ *See* *United States v. Microsoft Corp.*, 253 F.3d 34, 59 (D.C. Cir. 2001).

³² *Id.* at 58.

complainant meets this initial burden, the alleged monopolist may then be required to show a “procompetitive justification” for its conduct—that is, “a nonpretextual claim that its conduct is indeed a form of competition on the merits because it involves, for example, a greater efficiency or enhanced consumer appeal.”³³ If the alleged monopolist meets this burden, its conduct will be found lawful unless the complainant can prove that the same consumer benefits could be achieved in a less exclusionary manner.

The best recent example of this type of conduct that may be found exclusionary under this approach is the Antitrust Division’s case against Microsoft, decided in 2001.³⁴ The conduct found to be exclusionary in that case included: license restrictions on original equipment manufacturers that thwarted distribution of competing browsers; integrating Internet Explorer into Windows in a manner that deliberately made it more difficult for consumers to use another browser; agreements with Internet access providers, Internet service vendors, and Apple that closed off enough significant channels of distribution to keep usage of Netscape Navigator below the critical level necessary for it to become a rival software development platform; deceiving developers into believing that Microsoft Java would operate cross-platform; and pressuring Intel not to support cross-platform Java. In each case, the court found that the conduct served to maintain Microsoft’s market power in operating systems by preventing Netscape from gaining sufficient sales to become a competing platform and that Microsoft failed to show any legitimate business justifications for its actions.

(b) *Predatory conduct* No area has more bedeviled U.S. antitrust courts for the last quarter century than developing a sound test for predation, and no area has more divided lawyers and economists. What makes this area so difficult is that, as Kenneth Elzinga has stated, “if you are hunting for a predator and mistakenly shoot a competitor, you injure consumers.”³⁵

³³ *Id.* at 59.

³⁴ *Id.* at 59–78.

³⁵ Kenneth G. Elzinga & David E. Mills, *Predatory Pricing and Strategic Theory*, 89 *GEO. L.J.* 2475, 2479 (2001).

The U.S. courts now use a two-part test for predation that generally works quite well.³⁶ The first part requires that the resulting prices be below “an appropriate measure of cost.” The second requires that the monopolist be able to recoup its losses from the period of predation once its rivals have been excluded from the market.

(c) *The appropriate measure of cost* The reason U.S. courts will not condemn prices that are above cost as predatory is twofold. First, the exclusionary effect of prices above a relevant measure of cost simply reflects the lower cost structure of the alleged predator, and so represents competition on the merits. Second, price cutting that is above cost is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price cutting.³⁷

The test that is generally used in the United States for determining whether prices are below cost is that originally developed by Areeda and Turner in 1975.³⁸ Under the Areeda-Turner test, prices can be found to be predatory only if they are below marginal cost or, if that cannot be determined, below average variable cost. Many economists have objected to the Areeda-Turner test as not economically pure.³⁹ Whatever merits the alternative tests they propose may have as a matter of economics, no one has yet been able to suggest a test that is as administrable as the Areeda-Turner test or that does any better job in striking a balance between cost of administration and type I and type II error, thereby minimizing the risk of chilling aggressive, nonpredatory price cutting. For those reasons, U.S. courts generally continue to use the Areeda-Turner test.

³⁶ See *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 210 (1993).

³⁷ See *id.* at 223.

³⁸ Philip Areeda & Donald F. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697 (1975).

³⁹ See, e.g., Oliver E. Williamson, *Predatory Pricing: A Strategic and Welfare Analysis*, 87 YALE L.J. 284 (1977); Janusz A. Ordover & Robert D. Willig, *An Economic Definition of Predation: Pricing and Product Innovation*, 91 YALE L.J. 8 (1981).

The courts do not use this cost-based test to establish predatory pricing. Rather, below-cost prices create a presumption of predation. Many forms of below-cost pricing are motivated by market-expanding efficiencies. These include promotional pricing, pricing to accelerate learning-by-doing, and investment in building a large network where low prices are a way of paying the customer for the incremental value she adds to the network.⁴⁰ The courts will, therefore, allow a defendant to rebut the presumption that below-cost prices are predatory by showing that its pricing served a procompetitive, efficiency-enhancing objective.

(d) *Recoupment* The reason for the second requirement, recoupment, relates to the definition of competition—U.S. antitrust law does not condemn competitive behavior unless it is likely to harm consumer welfare. Without recoupment, predatory pricing produces lower aggregate prices in the market, and consumer welfare is enhanced.⁴¹ A recoupment requirement also serves as a useful screening device. It is often “much easier to determine from the structure of the market that recoupment is improbable than it is to find the cost a particular producer experiences.”⁴²

(e) *Role of intent* Before leaving the general subject of exclusionary and predatory conduct, a word about the role of intent is in order. In the United States, intent is considered an unreliable guide for deciding the lawfulness of single-firm conduct, especially in the heads of a jury. As Judge Frank Easterbrook has written, “Firms intend to do all the business they can, to crush their rivals if they can”; “[t]o penalize this intent is to penalize competition itself.”⁴³

Under U.S. law, if intent is relevant at all, it is to “help us understand the likely effect of the monopolist’s conduct.”⁴⁴ Even here,

⁴⁰ See Elzinga & Mills, *supra* note 35, 2485; see also William J. Kolasky, *Network Effects: A Contrarian View*, 7 GEO. MASON L. REV. 577, 605 (1999).

⁴¹ See *Brooke Group Ltd.*, 509 U.S. at 210.

⁴² *A.A. Poultry Farms, Inc. v. Rose Acre Farms, Inc.*, 881 F.2d 1396, 1401 (7th Cir. 1989) (Easterbrook, J.).

⁴³ *Id.* at 1401.

⁴⁴ *Microsoft Corp.*, 253 F.3d at 59.

caution is called for because intent evidence, especially in the hands of juries, is generally more likely to mislead than to illuminate.

4. PRICE CUTTING BY DOMINANT FIRMS One of the areas of single-firm conduct in which European abuse of dominance law seems farthest apart from the U.S. law on monopolization is the area of price cutting by dominant firms.

EC competition law appears much more hostile than U.S. law toward price cutting by leading firms. The former seems to take a broader view of predatory pricing than exists in the United States, and it also condemns at least two types of nonpredatory price cuts—selective above-cost price cuts in response to new entry, and fidelity or loyalty discounts.

(a) *Predatory pricing* The leading European Court of Justice (ECJ) decisions on predatory pricing are *Tetra Pak*⁴⁵ and *Akzo*.⁴⁶ In *Tetra Pak*, the Court expressly rejected a recoupment test and instead adopted a cost-based test that also looks at the firm's intent in cutting prices. Under the Court's test, when a dominant undertaking prices below average variable cost, those prices are presumed abusive; when it prices above average variable cost, but below average total cost, its prices are abusive if they are intended to eliminate a competitor.

This test for predation is substantially broader than in the United States. For the reasons outlined above, U.S. antitrust law considers a recoupment test to be essential because price cuts that do not create any danger of recoupment unambiguously benefit consumers, even if they are below cost. In addition, there is reluctance in the United States to base the treatment of price cuts that leave prices above average variable cost on the dominant firm's subjective intent. Two of the main reasons for cutting price are to discourage entry and to take sales away from rivals; if such price cuts are disallowed, competition would necessarily be less intense.

⁴⁵ Case C-333/948, *Tetra Pak Int'l v. Commission* (*Tetra Pak II*), 1996 E.C.R. I-5951.

⁴⁶ Case No. C-62/86, *Akzo Chemie BV v. Commission*, 1991 E.C.R. I-3359.

Whatever the relative merits of the European and American approaches, the European Commission at least seems to be moving away from *Tetra Pak's* intent-based test toward a test based, as in the United States, on whether prices are below incremental cost. The Commission's *Deutsche Post* decision of March 20, 2001, for example, established incremental cost as the appropriate measure of cost that an incumbent beneficiary of a statutory monopoly must cover in providing postal services open to competition.⁴⁷

(b) *Above-cost selective price cuts in response to entry* Those cases that hold that price cuts can be deemed an abuse of dominance even if they do not meet the requirements for predatory pricing raise additional issues. The leading ECJ case adopting this approach is *Compagnie Maritime*, where the Court held that it was an abuse for a dominant firm to adopt a "fighting ships" strategy of responding to entry by cutting prices even though the resulting prices were above cost where (1) the price cuts were reactive and selective; (2) the reduced prices met and beat the entrant; (3) the price cuts reduced the defendant's profits compared to what they would have been at the previously prevailing prices; and (4) the avowed purpose was to eliminate the entrant.⁴⁸

A recent article in the *Yale Law Journal* by Professor Einer Elhauge outlines four concerns with this approach.⁴⁹

First, restricting selective above-cost price cuts will often penalize efficient pricing behavior. In many markets, incumbent firms can maximize profits and output only by charging more to customers that value the product more highly, thus making them bear a greater proportion of common costs. In such markets, selective discounts to customers on the margin will be output and welfare enhancing.

⁴⁷ Case No. COMP/35.141, *United Parcel Service/Deutsche Post AG*, Commission Decision, 2001 O.J. (L 125/27).

⁴⁸ *Compagnie Maritime Belge Transports v. Commission*, Nos. C-395-96O & C396/96P, Opinion of Advocate General, ¶¶ No. 111-39 (Oct. 29, 1998).

⁴⁹ Einer Elhauge, *Why Above-Cost Price Cuts to Drive Out Entrants Do Not Signal Predation or Even Market Power—and the Implications for Defining Costs*, 112 *Yale L.J.* 681 (2002).

Second, restricting above-cost price cuts is undesirable because it will not encourage long-term entry. Firms that are equally efficient will enter and remain in the market irrespective of the prospect of above-cost price cuts. Less efficient firms will be driven out when the restrictions expire. Restricting above-cost price cuts is likely to increase price and harm consumer welfare in the lion's share of cases.

Third, restricting above-cost price cuts will lessen the pressure on rivals and potential entrants to become more efficient, which will mean higher costs and lower quality for society as a whole.

Fourth, these adverse effects are worsened by implementation difficulties that are not avoidable but rather are an inherent consequence of trying to regulate firm pricing, output and responsiveness to entry.

(c) *Fidelity rebates* Another area in which European courts frequently find above-cost price cuts abusive relates to fidelity or loyalty discounts. The European courts treat such discounts as an abuse of dominance on the theory that they raise switching costs and barriers to entry, unless they are cost justified in which case they can be viewed as "normal" competition.⁵⁰ Under U.S. law, similar arrangements have only rarely been challenged and have generally been found to be lawful unless the resulting prices are predatory.⁵¹

These disparate approaches point up a fundamental difference between European and U.S. law with respect to pricing by dominant firms. In the U.S., price cuts are viewed as inherently efficiency enhancing; as now-Justice Breyer explained in *Barry Wright*, "price cuts that leave prices above incremental costs are probably moving prices in the right direction—toward the competitive ideal."⁵² In Europe, by contrast, the courts see price cuts as efficiency enhancing

⁵⁰ OECD, Roundtable on Loyalty or Fidelity Discounts and Rebates (May 23, 2002).

⁵¹ See, e.g., *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8th Cir. 2000); *Virgin Atlantic Airways Ltd. v. British Airways PLC*, 257 F.3d 256 (2d Cir. 2001).

⁵² *Barry Wright Corp.*, 724 F.2d at 232.

only if they reflect lower costs, a much narrower definition of efficiency.

In the United States, it is acknowledged that there may be some narrow circumstances in which fidelity rebates may be anticompetitive, at least when they involve bundling products as to which a firm has a monopoly with other products for which it faces competition. By foreclosing the market share rivals need to reach minimum efficient scale, bundled discounts may, in some narrow circumstances, serve to exclude equally efficient rivals from the market. It is important, however, to weigh these potential anticompetitive effects against the many potential procompetitive justifications for such rebates. For example, when a manufacturer has significant fixed costs, average costs of production will exceed marginal cost, at least up to full capacity utilization. In these circumstances, fidelity rebates may be an efficient way to lower price to sell more output to customers on the margin without having to lower price on all units of output, which a firm would be unlikely to do because it would severely erode its profitability. In such circumstances, fidelity rebates will be efficiency enhancing and will benefit consumers even if rivals exit.

(d) *Summary* In summary, it is important that both Europe and the United States take a hard look at this entire area of pricing by dominant firms. In the United States, there are currently two cases pending in the courts raising these issues. One is the *American Airlines* case, in which the Antitrust Division accuses American of engaging in predation by adding money-losing flights on routes served by new, low cost carriers.⁵³ The other is *LePage's*, recently decided by the Third Circuit en banc.⁵⁴ That case involves bundled discounts by the monopoly seller of Scotch-brand tape in order to exclude smaller private-label manufacturers from the market. The pendency of these two cases has given rise to a large and growing number of articles in the legal and economic journals grappling with

⁵³ *United States v. AMR Corp.*, 140 F. Supp.2d 1141 (D.Kan. 2001), *appeal pending*.

⁵⁴ *LePage's, Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003).

these difficult questions.⁵⁵ There is likely a similar level of interest in these issues in Europe, and both jurisdictions would benefit from sharing perspectives with one another.

IV. Conclusion

There is need to initiate a serious and substantive transatlantic dialog on these important issues, which are critical to the future performance of our economies. Other competition authorities around the world look to the United States and Europe for leadership in the development of competition policy. A divergence of policies can only breed chaos and confusion, unless there are clearly articulated reasons for the differences. Increased dialog on these issues is essential to providing a coherent understanding of how the concept of competition should inform sound antitrust policy.

⁵⁵ See, e.g., Elhauge, *supra* note 49; Aaron S. Edlin, *Stopping Above-Cost Predatory Pricing*, 111 YALE L.J. 941 (2002); Willard K. Tom, David A. Balto & Neil W. Averitt, *Anticompetitive Aspects of Market-Share Discounts and Other Incentives to Exclusive Dealing*, 67 ANTITRUST L.J. 615 (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).