20 Years of Raising Rivals' Costs: History, Assessment, and Future

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*** Opinions are those of author, not necessarily those of the Commission or individual Commissioners**
This presentation arises from joint work with Richard Higgins of LECG

20 Years of RRC

- History
- Assessment
- Future

History

- What was going on at the time that the RRC research was undertaken?
  - Predatory pricing research and policy debate
  - FTC cases such as *General Foods*, *DuPont, Ethyl, Kellogg, Exxon*
  - 1981 FTC Conference
    (Salop: *Strategy, Predation, and Antitrust Analysis*)
  - *Exxon* case (shared monopoly oil case)

History

- Predatory pricing research and policy debate
  – Areeda/Turner, Joskow/Klevorick, *etc*.

- That debate has been substantially over for some time now
  – *Until recently*, when theoretical research has developed theories of above-cost predatory pricing
    - DOJ American Airlines case

History

- FTC cases such as *General Foods*, *Ethyl, DuPont, Kellogg,* and *Exxon*
  - *DuPont* and *General Foods* had significant elements of "non-price predation" that were soundly rejected by the courts
  - Despite the resolution of those cases, theoretical economists never "looked back" – vertical and non-price predation theories filled the journals

History

- 1981 FTC Conference
  (Salop: *Strategy, Predation, and Antitrust Analysis*)
  - This conference included noted economists and lawyers (*e.g.*, Salop, Mike Porter, Ordover & Willig, Rich Gilbert, Mike Scherer, Vernon Smith and Charles Plott, Jim Liebeler, Frank Easterbrook, Larry Sullivan)
  - The focus was what has come to be called "non-price" predation
  - The conference did not produce a unifying conceptual framework
  - The conference stimulated a lot of later theoretical research
  - But very little empirical research (other than swapping "stories" about what the facts really were in past cases)

History

- ***Exxon* case** (shared monopoly oil case)
  - I was assigned to see if I could develop a theory for *Exxon*
  - Central allegation was an alleged "vertical squeeze" of the independents via tacit or explicit collusion by the largest "majors"
    - The vertical squeeze was alleged to be effected from the majors "overbuying" crude oil and then pushing the price down downstream to squeeze the independents
  - **The denouement of this assignment (and following what happened in the other monopolization cases – including my participation in *Ethyl*) was important to my conclusions about the policy implications of RRC-type theories**

Assessment

- The RRC article provided a simple and implementable implementable framework for dominant firm “non- “non-price predation”*

- The theory showed that non-price predation had substantial benefits over price predation
  - In profitability
  - In ***credibility***

*** As the papers pointed out there were antecedents in Nelson and Williamson, and others have pointed to Levi & Director**

Assessment

- As the economy has evolved barriers, are more "breachable" because of technological change and reductions of impediments to trade

- In addition, entry barriers more often involve intangibles such as IP, regulatory impediments, *etc*., rather than bricks-and-mortar/economies of scale

- "New Economy" barriers are more "breachable" than bricks and mortar/economies of scale

- However, these sort of barriers are more "manipulateable" – *i.e.*, more amenable to RRC strategies than bricks-and-mortar barriers

Assessment

- Thus I would argue that RRC was both of theoretical and policy relevance
  - Of policy relevance because we should be “on the lookout” for potential anticompetitive “foreclosure” conduct by dominant firms
- BUT:

  What contribution does RRC make to policy presumptions and to fact-based analyses?
  - *Exxon* redux

What Does RRC Theory Establish?

- One problem in my view is that two of the most important RRC papers appear to be rarely read or cited*

* Salop and Scheffman (1987) "Cost-Raising Strategies", *Journal of Industrial Economics;* Salop, Scheffman & Schwartz (1984), "A Bidding Analysis of Special Interest Regulation: Raising Rivals' Costs in a Rent Seeking Society", in B. Yandle and R. Rogowsky (eds.) *The Political Economy of Regulation: Private Interests in the Regulatory Process,* FTC

What Does RRC Theory Establish?

- RRC (1987) establishes that:
  - RRC can be a profitable strategy for a dominant firm with market power
  - But even without any potential efficiencies profitable RRC:
    - May not raise price
    - May not reduce total welfare
    - May not harm the fringe
- That is, establishing a dominant firm with market power engaging in RRC is not "enough" – even without efficiencies

What Does RRC Theory Establish?

- Although the 1987 paper does conclude that the important results are ambiguous, the paper does lay out conditions susceptible to **empirical "test"**
- However, what the paper does <u>not</u> do is analyze how to distinguish procompetitive *vs*. anticompetitive RRC or take into account efficiencies
- In concentrated markets the competitive dynamics and competitive strategies are often focused on changing relative *positioning* which can involve things that might look like RRC **(Research in Progress)**

Why are the Results Theoretically Ambiguous?

- **Even without efficiencies**

  A dominant firm with market power leads to "***Second Best***" issues
  i.e., with pre-existing market power – a change in the market has ambiguous theoretical effects

- This has some important implications for where the RRC literature "went" – i.e., vertical mergers

Credibility/Logical Consistency

- One important issue that many of the “original” RRC papers did not adequately address is:
are there effective counterstrategies by adversely affected parties that would thwart RRC?

- This is answered probably most clearly in Salop, Scheffman, and Schwartz (1984):
  - As a general matter the gains to the “predator” can exceed the losses to the directly affected “victims”
    - i.e., Counterstrategies may not “work”
  - This paper developed empirically “testable” propositions

Evidence

- Competitor complaints must be weighed with great care – particularly when they have been coached by antitrust lawyers and economists
- Stubborn facts *vs.* theories re: competitive effects and "efficiencies" – not focusing on foreclosure
- Customer and credible independent expert opinions

Some Examples

- ***JTC Petroleum Company v. Koch Materials Company***
  - This is similar to the Klein/Granitz Standard Oil analysis
    - Downstream cartel "using" upstream suppliers to blockade entry
  - **Sustained by Posner and Easterbrook on Appeal***

* "So what JTC has tried to show is that the applicators enlisted the producers in their conspiracy, assigning them the role of policing the applicators' cartel by refusing to sell to applicators who defied the cartel--such as JTC **…The producer was the cat's paw; the applicators were the cat….** Given the evidence of cartelization at both the applicator and producer level, the suspicious price behavior of the producers (indicative of their being "paid off" by the cartel to boycott JTC and other upstarts), and the pretextual character of the reasons the producers gave for the refusal to deal, a rational jury could conclude that JTC was indeed the victim of a producers' boycott organized by the applicator defendants."

Some Examples

- ***Bartholdi Cable v. Time Warner, Inc., et al.***
  - Business Torts of various kinds, not much in the way of credible efficiencies
  - Evidence that foreclosure had price effects
  - Key argument was what was appropriate competitive response by a cable monopolist?
- ***Conwood Company, L.P. et al. v. USTC, et al.***
  - Business Torts plus arguably procompetitive activities (category management with Wal-Mart, *etc*.),
  - Clear evidence of lack of "gross" exclusion

The "Vertical" Literature

- For many years now the focus of the literature has shifted from RRC to vertical – mostly vertical mergers
- The models find a potential for anticompetitive vertical mergers
- But the literature has been misleading in my opinion:
  - Theory does not justify a change in policy presumptions about vertical mergers
  - These theories provide little help in diagnosing or analyzing anticompetitive vertical mergers
    - **It's the stubborn facts**

What is the Basis of the Anticompetitive Vertical Mergers Theories?

- As I have already discussed – even RRC theory of a dominant firm with market power and with no efficiencies has *theoretically* ambiguous effects

- How do you get a anticompetitive vertical merger oligopoly theory (strongest version – Ordover/Saloner/Salop)?
  - No efficiencies
  - Assume that one stage is *perfectly* competitive (**so you don't get 2nd Best issues**)
    - No inefficient substitution or double-marginalization issues

Vertical Merger Enforcement

- We have had vertical merger investigations and challenges (***Synopsys/Avant!*** and ***Cytyc/Digene***)
- In fact, a vertical merger in a concentrated market that does not have vertical integration is probably rare
  - And probably will be a source of *at least* potential *business* (if not antitrust) concern by customers
- **Is there a viable theory of foreclosure (dominant firm theory) supported by knowledgeable <u>customers</u> and/or credible independent parties?**

Synopsys/Avant!

- Significant *potential* for efficiencies supported by customer opinions
  - The most likely basis of foreclosure would arise if efficiencies were actually realized
- Strong competitor concerns about foreclosure
- Not much customer support for theories or for merger challenge

Comm. Anthony: " …I have voted to close this investigation because, at this time, there are too many "mights" and "maybes" to satisfy the reason-to-believe standard. To conclude otherwise would require excessive speculation by the Commission especially given that EDA industry participants themselves cannot agree on the likely impact of the acquisition, or even on the direction in which EDA technology may be heading." – *i.e.*, the "*stubborn facts*" are not there

Cytyc/Digene

- Apparently not much in the way of credible efficiencies supported by customers/knowledgeable independent parties

- Arguably market power at each level, but threats to upstream level
  - Neither fixed or variable proportions

- Upstream could arguably impede "critical" access of upstream competitor(s) to downstream product – FDA Approval issues

- Customer and knowledgeable independent party concerns

Conclusion

- RRC is a valid theoretical framework
- There are vertical merger cases
- Focus on dominant firms
- It's the stubborn facts
  - Efficiencies
  - Competitive Effects rather than complaining rivals
    - Evidence from knowledgeable customers and <u>independent</u> "experts"
- Need more work on legally administrable fact-based analyses that can distinguish competitive strategies from anticompetitive RRC
(Work in Progress)