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FEDERAL TRADE COMMISSION

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Meeting Before the Commission

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FEDERAL TRADE COMMISSION

I N D E X

WITNESS:

EXAMINATION

None.

E X H I B I T S

FOR IDENTIFICATION

Commission's:

None.

FEDERAL TRADE COMMISSION

In the Matter of:)
)
) Docket No.: P951201
HEARINGS ON GLOBAL AND)
INNOVATION-BASED COMPETITION)

Wednesday,
November 8, 1995

Federal Trade Commission
Sixth and Pennsylvania Avenues
Room 432
Washington, D.C. 20580

The above-entitled matter came on for hearing,
pursuant to notice, at 9:30 a.m.

SPEAKERS:

JANET D. STEIGER
Commissioner, Federal Trade Commission

ROSCOE B. STAREK III
Commissioner, Federal Trade Commission

SUSAN S. DE SANTI
Director, Policy Planning

DEBRA VALENTINE
Deputy Director, Policy Planning

MICHAEL E. ANTALICS
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SPEAKERS (Continued):

TIMOTHY A. DEYAK
Assistant Director Antitrust
Bureau of Economics

WILLIAM BAER
Director, Bureau of Competition

TIM DANIEL
Director Antitrust
Bureau of Economics

CHICKERY J. KASOUF
Professor, Worcester Polytechnic
Sloan Foundation Powder Metal Study

BOYD BERENDS
CEO, Cryogenic Product Recovery
Representing the U.S. Chamber of Commerce

CAREY HECKMAN
Professor, Stanford Law School

CALVIN H. KNOWLTON
President, American Pharmaceutical Association

ROBERT SKITOL
Drinker, Biddle & Reath

GREGORY SHAFFER
Professor, University of Michigan

NICOLAS PYLE
Independent Bakers Association

1 interject in answering our questions or ask us some if you
2 want, not that you necessarily will get an answer but you
3 will certainly get a hearing.

4 We are delighted that Mr. Berends is going to lead
5 off for us.

6 He is President and CEO of Cryogenic Product
7 Recovery Inc. This is a company that recycles rubber tires
8 through a freezing process.

9 Prior to joining CPR, Mr. Berends was the founder
10 and CEO of Progressive Technology in Lighting, Inc., a
11 company which grew to \$15 million in revenue over 10 years.

12 For his work with PTL, Mr. Berends was honored as
13 Michigan's Small Business Person of the Year. He has also
14 received the Ernst & Young Inc. Magazine-Merrill Lynch Award
15 for Entrepreneur of the Year, as well as the U.S. Chamber of
16 Commerce-Connecticut Mutual Blue Chip Enterprise Award.

17 With that very distinguished resume preceding you,
18 will you lead off for us, Mr. Berends.

19 MR. BERENDS: Sometimes that reminds me of a
20 eulogy.

21 COMMISSIONER STEIGER: You always want to take
22 those before you need them if you can get them.

23 MR. BERENDS: Exactly. In reviewing the panelists
24 and the people that have testified before this committee and
25 those that are to come, I feel a little bit in awe, because

1 I seem to find myself as the only small business person that
2 comes before you; and I don't have the credentials,
3 probably, that some of your more distinguished panelists and
4 other people have.

5 COMMISSIONER STEIGER: Let's clear the air by
6 saying: We don't have yours.

7 I never created \$15 million dollars in anything.

8 MR. BERENDS: Thank you.

9 Going back just a little bit, before I go into the
10 prepared speech, if I may give you just a little bit of
11 background that goes further back.

12 At year 18, my family purchased a wholesale
13 produce business. I dropped out of college to run that,
14 later purchased that. And then seven years and five
15 children later, I went back for my college degree.

16 Over the years, I've been an entrepreneur and I've
17 worked for large companies. I've worked for Burls
18 Corporation, which today we know as UNISYS and North
19 American Philips Lighting Company, which is also a large
20 company.

21 And in between, I have had the privilege of
22 working with some entrepreneurial-type opportunities in
23 starting companies.

24 And having said that, if you will allow me to read
25 the prepared statement and, if I may, from time to time,

1 make a few interjections, with your permission.

2 COMMISSIONER STEIGER: Delighted to hear anything
3 you have to tell us, Mr. Berends.

4 MR. BERENDS: And then I would be very honored to
5 take any questions that you might have.

6 Having said all of that, Mr. Chairman -- it's not
7 "Mr. Chairman." It's "Madam Chairman" today, and I
8 apologize for that.

9 Madam Chairman and members of the Federal Trade
10 Commission, my name is Boyd Berends, and I am pleased to be
11 here today to testify on behalf of the U.S. Chamber of
12 Commerce. The Chamber federation represents 215,000
13 businesses, 96 percent of which have fewer than 100
14 employees, 68 percent of which have fewer than 10, 3,000
15 state and local chambers of commerce, 1,200 trade and
16 professional associations, and 72 American Chambers of
17 Commerce abroad.

18 Speaking for the Chamber, we appreciate the
19 opportunity to appear before this Commission to comment on
20 antitrust issues affecting the small business in a global
21 economy.

22 As you mentioned earlier today, I am President and
23 CEO of Cryogenic Product Recovery, Inc., a start-up company
24 located in Holland, Michigan. Contrary to what you think of
25 sometimes with cryogenic, we do not freeze bodies. Okay?

1 CPR processes rubber from discarded tires using a
2 cryogenic or a freezing process. Through this process, the
3 basic tire components are separated. Because each of the
4 component parts individually has a market, the entire tire
5 is recycled into new and useable products. CPR is currently
6 engaged in discussions with three foreign countries
7 regarding various types of supply and joint venture
8 possibilities.

9 Prior to my involvement with Cryogenic, I founded
10 a company that focused on the manufacture of energy
11 efficient lighting. Over a 10-year period, the company's
12 revenues grew to \$15 million, with 100 employees. The
13 company marketed its product in three countries, with joint
14 business ventures established in China, Hong Kong, Taiwan,
15 and in Western Europe.

16 Just to digress a little bit, those joint ventures
17 were more of a supply side nature rather than sales and
18 marketing. Sales and marketing were done in Canada and
19 Mexico.

20 Since divesting myself of Pro Light, or PTL
21 Lighting, I had the opportunity to purchase a minority
22 interest in a former East German lighting manufacturing
23 concern. And maybe we can talk about that a little more
24 later.

25 It is because of my involvement in these various

1 small business ventures that the U.S. Chamber of Commerce
2 asked me to provide comments on antitrust law in a global
3 economy. The comments below reflect my experience and
4 viewpoint from the perspective of a small business owner.
5 And we have to say that they may not necessarily reflect the
6 views of the U.S. Chamber of Commerce or its membership.

7 First off is one that is very dear to all small
8 businesses, and that's the small business access to capital.

9 From the perspective of the small business owner,
10 one of the primary concerns in today's economy is the
11 availability of and access to capital. The small business
12 community faces continual difficulty securing necessary
13 capital to fund operations or to expand the business. This
14 problem is not new and, in fact, is a very recurring
15 dilemma.

16 During the 1970's and early 1980's, small
17 businesses were faced with the prospect of surviving during
18 a period of very expensive and, in many cases, non-existent,
19 borrowed money. Because of the high cost of capital during
20 this period, there were many small businesses that did not
21 survive. I know of many of those personally. But equally
22 important, there were many more that never moved beyond the
23 conceptual stage.

24 Despite historical difficulties that small
25 businesses owners face in securing adequate financing, there

1 are many small business success stories to be told. Many
2 small businesses that were started during the period of high
3 interest rates have, today, grown to become successful
4 larger businesses.

5 My former company was one of those.

6 Companies in high-tech industries have experienced
7 tremendous growth during the past two decades. Of course,
8 we all know about Microsoft.

9 Companies which are closer to where I reside, my
10 home State of Michigan, many of the founders of which I have
11 known for some years, companies such as Amway, Steelcase,
12 Herman Miller, and Haworth, are all demonstrated examples of
13 large businesses that started small.

14 This past summer, the White House Conference on
15 Small Business reaffirmed what many already believe, that
16 the small business community is the driving force of this
17 country's economy.

18 Despite this conclusion, delegates to the
19 conference also agreed that the small business owners still
20 face substantial obstacles in gaining access to capital. If
21 you review the report that came out of the White House
22 conference on small business, you will find that access to
23 capital was one of the highest vote-getting items on the
24 agenda.

25 We can only wonder, if small businesses are such a

1 potent force in a national economy why these barriers still
2 exist to the capital markets.

3 And here I'm going to digress just for a minute
4 and put a plug in for a government agency that has been
5 very, very beneficial and helpful to many small businesses;
6 and that's our SBA, or Small Business Administration.

7 If it wasn't for that governmental agency working
8 in conjunction with financial institutions, there would be a
9 whole lot less success stories to be talked about and
10 printed about.

11 Access to the capital markets is critical if small
12 business owners are to be able to compete effectively in
13 today's global economy. The ability of small businesses to
14 compete globally is dependent, in a large measure, upon
15 their fiscal health.

16 Small business enterprises depend upon capital to
17 fund operations, engage in research and development, bring
18 new products to the market, or to quickly change directions
19 in response to market conditions.

20 Like all business enterprises, small business
21 owners depend upon a close working relationship with the
22 lending institutions that serve their communities.

23 Over the years, my various business concerns have
24 developed relationships within our little town with four
25 different financial institutions. To further enhance this

1 relationship, I regularly have luncheons with
2 representatives from these institutions, mostly on a monthly
3 or bi-monthly basis.

4 And it's through these meetings, the financial
5 institutions gain an understanding of all facets of my
6 business operations; they are kept abreast of the
7 developments as they occur, both good and bad. And, in
8 return, I gain their respect and an appreciation of my
9 business needs.

10 And I'm reasonably certain that, on more than one
11 occasion, my relationship with these -- I say "financial
12 institutions," but I believe it's more of a personal
13 relationship with the financial institutions -- have enabled
14 me to secure financing for my business that, absent such a
15 relationship, probably would not have occurred.

16 There is concern among the small business
17 community that some of the merger activity involving
18 financial institutions -- and we read about these, it seems
19 like, almost daily or weekly -- may result, in some
20 instances, in working relationships not being able to be as
21 close as what I currently experience.

22 And I think it's important that, throughout this
23 consolidation, that all aspects of government keep in mind
24 that what we are experiencing in the consolidation and
25 merger, that in the process we, as small businesses, do not

1 lose the deliverance of financial services. And that the
2 needs of small businesses really remain a priority.

3 I mentioned earlier what came out of the White
4 House Conference for Small Business, the part that small
5 business is playing in today's economy. And it's been
6 adequately researched, and the numbers that were presented
7 are accurate. We can't afford not to support small
8 business. And, obviously, in any business, the most
9 important, critical thing you need is money.

10 So while merger activity among financial
11 institutions in the aggregate is positive -- and I mean that
12 sincerely; all of us in business today are looking how we
13 can improve bottom line costs of operations and getting rid
14 of excess assets, if you will, definitely aid in that
15 direction. So what I say here, it is a positive move.

16 It does result in larger pools of capital
17 available for investment. However, the merged institutions
18 should be encouraged to maintain existing relationships with
19 the business owners in the communities that they or their
20 predecessor institutions serve.

21 The next one is really dear to my heart, and
22 that's the necessity for small business to be flexible and
23 innovative.

24 Having been in that situation many times and
25 forced to be innovative and flexible, it's one I identify

1 with very, very much.

2 One of the most powerful and effective resources
3 of the small business enterprise is its ability to adapt to
4 changing conditions. For the smaller businesses, it is
5 usually a matter of survival.

6 When competition in a particular market becomes
7 heightened, small businesses must react quickly, or they may
8 lose market share, or even more importantly, they could lose
9 their business.

10 An advantage of being small is the ability to move
11 and to make decisions quickly. In many instances, this
12 gives the small business an advantage over large
13 competitors.

14 The ability to adapt quickly to changing market
15 conditions allows the small business to remain competitive,
16 and ahead of adversaries. In fact, most small businesses
17 survive, even in new competitive situations, simply because
18 of innovation and flexibility.

19 And while small employers are necessarily
20 innovative, there continues to be many good innovations
21 that, while implemented by small businesses -- and here we
22 could also say by new businesses -- they were conceived at
23 larger companies.

24 And I grin a little bit, but that's how really I
25 started that last company.

1 These innovations may not, for various reasons,
2 have been endorsed by the larger company. However, the
3 individual working on the project may, following a decision
4 against implementation by the larger company, depart that
5 company for a smaller employer or take the idea with him or
6 her and start their own company.

7 The smaller company may find implementation of the
8 idea a much easier decision, turning the larger
9 organization's concept into a successful business venture.
10 Small employers also may be more willing to take the
11 necessary risks associated with bringing a new or unproven
12 product to market.

13 Why is that so? We'll deviate just a little bit
14 here.

15 Usually the small business owner has everything at
16 risk anyway. And so to bring a new product to market, he's
17 not risking a whole lot more. Whereas, a big company, by
18 the time their lawyers get looking at all of the
19 ramifications, many times they'll walk away and abandon an
20 idea that a small company turns into a very successful
21 product.

22 A prime example of innovation involving large and
23 smaller employees involves a former business enterprise of
24 mine. And that was prior to starting Progressive Technology
25 in Lighting, Inc., a business focusing on energy efficient

1 lighting, I was employed by North American Philips Lighting
2 Company. And while at North American Philips, the idea for
3 implementation of an energy efficient lighting product was
4 conceived; and I was involved in some of the product
5 implementations that were begun.

6 The company decided not to pursue the opportunity,
7 but they allowed me the latitude to depart and pursue the
8 idea on my own. And, later, North American Philips also
9 became a very good customer of the products that my company
10 produced.

11 I could deviate here and say that, today, my
12 former company is also supplying these products to Sylvania,
13 Osram, General Electric, as well as Philips.

14 However, the idea may very well never have been
15 pursued had I not been employed at North American Philips
16 initially.

17 The same flexibility and innovation that is
18 necessary to compete effectively in the domestic marketplace
19 has similar importance in a global economy.

20 Businesses both large and small must work within
21 the framework of increasing global competition; they must
22 learn how to take advantage of opportunities created by
23 markets that open in foreign countries; or by new products
24 or designs introduced domestically by foreign or domestic
25 competitors.

1 However, small and large employers do not
2 necessarily face the same problems when competing globally.

3 Your larger companies have access to capital, the
4 ability of large employers to form noteworthy joint ventures
5 and alliances that exceeds that of small businesses.

6 And not only are the alliances on a much larger
7 scale, but so is the capital that is available to consummate
8 those deals.

9 And, yet, small businesses need access to
10 counterparts in foreign countries for these joint ventures
11 which, while on a much smaller scale, nevertheless provide
12 products to meet the demands and the needs of today's
13 marketplace. In some instances, these joint ventures and
14 alliances are necessary simply for the survival of the
15 business.

16 And I could explain a little bit about an
17 interesting venture that I've been involved with that
18 involved an East German company, companies in mainland
19 China, Hong Kong, as well as in the United States.

20 COMMISSIONER STEIGER: Please do. We'd be very
21 interested.

22 MR. BERENDS: Would you like me to digress here a
23 little bit?

24 COMMISSIONER STEIGER: Yes. Please.

25 MR. BERENDS: There's a company in East Germany

1 that at one time supplied 80 percent of all the lighting
2 products that were supplied to the Eastern Bloc countries,
3 including Russia.

4 When the East and West German countries were
5 unified, obviously things changed; and where payments before
6 had been made in scrip, now they had to be paid in hard
7 currency. And, of course, the former East German company --
8 it was not possible to get the hard currency from its former
9 customers.

10 And so that was downsized considerably. And just
11 about a year ago, we purchased a large minority interest in
12 what was left of the company, simply because they had
13 developed one of the most innovative, compact, energy
14 efficient lamps that, in my history, I had seen.

15 However, they did not have the money to purchase
16 equipment to mass produce this product and neither did the
17 alliance that we had over here in the United States.

18 So we had to be very innovative. Now, from being
19 a very large company at one time, they had 50,000 employees;
20 they were down to less than 100 employees; their cash flow,
21 of course, had shrunk dramatically; and we were small
22 companies on this side of the water.

23 And yet the product was innovative; it had a lot
24 of promise. So we had to come up with a way to circumvent
25 the problem of not having access to a lot of capital.

1 So literally what we did was took the development
2 that the East Germans had developed while they were still an
3 East German company, and we took the expensive
4 labor-producing part of it over to a country which was --
5 well, they had labor available; they wanted to put a lot of
6 people to work; and the cost of that labor was very, very
7 low compared to Germany and the United States.

8 So we took the most labor-intensive part of that
9 process and we brought it over to Asia and had that part of
10 it developed in Asia. That part was then returned to
11 Europe, to East Germany, as well as to the United States
12 where the assembly was accomplished and the marketing was
13 accomplished.

14 All this was done with limited capital but just by
15 being innovative and flexible. It was a real experience
16 because there were a lot of cultures involved and it worked.
17 It really worked.

18 Ultimately one of the U.S. partners that I had
19 pulled out because they were going to go public and they
20 were afraid that this was going to mess up their reporting
21 sheets and so forth. So it's much smaller than it could
22 have been, but it still is working, which probably ties into
23 some of the other things we will be talking about.

24 But it was a real experience.

25 Getting back to our written portion here: Small

1 businesses really have natural advantages when it comes to
2 joint ventures and alliances with foreign parties.

3 Why do I say that? Well, it's much easier for
4 small employers to engage in accelerated decisionmaking.
5 And in most cases, quick decisions are required to move in
6 and out of such alliances.

7 Small businesses are also very adaptable to
8 particular needs or cultural requisites of their partners.

9 The big drawback always is -- it seems to be any
10 way -- that the resources, the capital resources that are
11 necessary are in limited supply; as well as -- there are
12 many small businesses that do not have access to
13 partnerships that could be available to be beneficial in
14 forming alliances and joint ventures. And because of this,
15 they're not always able to take full advantage of such
16 opportunities.

17 And if and when a partner is found, quite often
18 the paperwork required when entering into or operating
19 within an alliance or joint venture is significant, and it
20 could act to impede such activity.

21 To achieve greater participation and success in
22 small business alliances and joint ventures, it's possible
23 the Federal Trade Commission could contemplate issuance of
24 simplified guidelines and simplified regulations designed to
25 ease the regulatory burdens that employers may currently

1 face.

2 Possibly the FTC could develop "safe harbors" --
3 small "mini safe harbors," if you will -- that, if met by
4 business, would obviate the need for meeting filing
5 requirements or other regulatory compliance burdens.

6 However, any safe harbor should be designed to be
7 utilized to expand opportunities; and they should not be so
8 cumbersome that they cause delays that will only nullify any
9 gains that could be realized and result in losing any
10 "windows of opportunities" that may have existed.

11 If I may digress here just a bit. Back in our
12 small town, we have established what we call "free trade
13 zones." And it took seven years to establish this free
14 trade zone. And during that time, opportunities came and
15 went.

16 If there was a way to do a small, mini safe harbor
17 -- or even if it was on a temporary basis so that these
18 windows of opportunities would not be missed, I think it
19 would be very, very beneficial to small businesses.

20 The third one is very interesting, the third
21 point: Are antitrust regulations limiting factors to
22 strategic alliances and/or joint ventures? And we probably
23 should say: ...for small businesses?

24 It's the belief of many small employers that
25 current antitrust laws impede their ability to form

1 strategic alliances and/or joint ventures in foreign
2 countries.

3 Having been involved in a number of these, I would
4 say that this impediment is indirect by nature.

5 What do I mean?

6 Well, for instance, one of the greatest concerns
7 that small business owners face is the inability to keep
8 abreast of the regulatory environment in which they must
9 operate.

10 It's difficult enough for us to stay abreast just
11 in a local situation; but when we start looking at going
12 international and going into different countries, those
13 regulations are things that are very foreign to us.

14 We don't know how to get ahold of current
15 regulations easily and simply to find out if they are an
16 impediment to making some of these joint ventures.

17 So that uncertainty that comes from just not
18 knowing fully the ramifications of certain regulations,
19 while they're not that serious, they keep many small
20 business owners from really exploiting what they could be
21 doing in foreign ventures.

22 I personally do not believe that antitrust
23 regulations are necessarily overly burdensome or even too
24 expansive in scope. Or expensive even.

25 The small business person, however, will simply

1 forego an opportunity if he or she perceives potential
2 regulatory problems or conflicts.

3 Now, for example, traditional sources of
4 information for small business owners desiring to do
5 business abroad, such as our industry trade associations --
6 and these trade associations do have global contacts. They
7 could be great channels for the establishment of business
8 alliances or joint ventures.

9 And, yet, these trade associations that I am
10 involved with anyway, in an effort to avoid any potential
11 conflict with federal trade regulations and other regulatory
12 agencies -- they have opted to stay out of that area or that
13 arena, if you will.

14 The small employer, faced with the knowledge that
15 these organizations avoid such initiatives, may simply
16 decide to forego any attempts to seek and form joint
17 alliances.

18 It's possible the FTC could take the lead in prom
19 -- I can't even say the word -- simplified guidelines that
20 could be utilized by American businesses when forming
21 strategic alliances and joint ventures with overseas
22 competitors.

23 And by taking the lead enunciated in such
24 guidelines, the FTC could demonstrate its commitment to
25 enhancing the ability of small businesses to engage in such

1 businesses dealing without fear of unknown or complex rules.

2 And I'm going to pass on the slotting fees,
3 although they are very important to small businesses; that's
4 your afternoon session. And so I'm going to pass on that
5 and just go to summarizing.

6 In conclusion, while the small business community
7 has concerns with complexities that are inherent in
8 conducting business in a global economy, we nonetheless
9 appreciate the efforts to encourage small business
10 participation.

11 And we all share in the goal of enhancing the
12 ability of American businesses to compete effectively and,
13 with a minimal amount of restraint, with competitors at home
14 and abroad.

15 Speaking for the U.S. Chamber now, we remain very
16 willing to work with the Federal Trade Commission to achieve
17 this goal.

18 And speaking from my input as a small business
19 member of the U.S. Chamber, we also, as small businesses,
20 would work very closely with the FTC if we get the
21 opportunity.

22 Thank you, madam.

23 COMMISSIONER STEIGER: Mr. Berends, thank you for
24 a very cogent statement with your experiences being brought
25 to this Commission. And our particular thanks to the

1 Chamber. We expected nothing less of them; but they,
2 obviously, sent one of their best and brightest. And we're
3 grateful for that.

4 MR. BERENDS: I hope they heard that.

5 COMMISSIONER STEIGER: How about if we send them a
6 transcript, Mr. Berends.

7 I'm interested to see whether you ever -- you have
8 mentioned alliances that you have formed in the small
9 business arena. Have you ever taken advantage of the Joint
10 Production Research and Development Act that allows for the
11 registration of an alliance or joint venture that is then
12 reviewed by DOJ, or Justice?

13 MR. BERENDS: I'm going to have to tell you that I
14 have not, simply because I did not know about it.

15 And I think therein lies the problem with so many
16 small businesses: There are so many resources that may be
17 available to us that, very frankly, we don't know how to
18 access.

19 I might say, in this respect, that the Small
20 Business Administration is now putting many of their
21 offerings on the Internet, on the Web, and making them
22 available through electronic transfer.

23 It may be something that could be very beneficial
24 to small businesses if the Federal Trade Commission were to
25 consider doing something similar.

1 COMMISSIONER STEIGER: We are on the net now.

2 MR. BERENDS: Fantastic. Now I'm going to look
3 for you.

4 COMMISSIONER STEIGER: Thanks in no small measure
5 to the efforts of Commissioner Varney, who identified this
6 very rapidly after her arrival, as a significant means of
7 participating with those interested in what we do.

8 But that raises a question for us as to whether,
9 indeed, there is information more targeted that we might be
10 able to provide.

11 And I'll ask Susan to make sure that we have that
12 down on our list.

13 MS. DeSANTI: Yeah, actually I was fascinated to
14 hear that you think the Internet and the Web are very
15 valuable, potential ways of communicating.

16 I was wondering if you could give any other
17 suggestions about what the best ways you think are to
18 communicate with small businesses?

19 COMMISSIONER STEIGER: Let me add to that. I was
20 interested in your comment that your normal channels of
21 assistance, namely industry trade associations, do in order
22 to avoid potential conflict with the antitrust laws simply
23 not get into the joint venture alliances.

24 Is this, in your opinion, because they reasonably
25 fear assisting cooperation between competing entities could

1 run afoul of the antitrust agencies?

2 Or is it simply that they don't provide any
3 information at all which each independent entity in the
4 association could use?

5 MR. BERENDS: Probably the former. In trade
6 organizations, as in most businesses, especially as you get
7 larger, legalities play a very important role in what you
8 choose and what you choose not to do.

9 And if there's potential problems or conflicts,
10 it's sometimes a whole lot easier just to do nothing. And
11 this is where I really feel that the trade association that
12 I'm involved with personally have chosen to probably stay
13 away from a potential problem.

14 To your question: What is the best way to
15 communicate? Being involved in the U.S. Chamber of
16 Commerce, state and local chambers of commerce, I would say
17 those three entities probably reach almost every small
18 business in the United States.

19 And that might be an area that you might wish to
20 take a long, hard look at as far as communicating and being
21 more beneficial in disseminating information to small
22 businesses.

23 COMMISSIONER STEIGER: Can you tell us, from your
24 experience, you mention a safe harbor or a guideline for
25 small businesses interested in joint venturing.

1 MR. BERENDS: Right.

2 COMMISSIONER STEIGER: Can you tell us what
3 elements you think cause the most uncertainty? In other
4 words, if there were some sort of statement, what elements
5 of uncertainty should it address?

6 MR. BERENDS: Can you be just a little more
7 helpful on that one? I'm not quite going in the same
8 direction, I don't think.

9 COMMISSIONER STEIGER: If you were looking for
10 guidelines for joint ventures or alliances as a small
11 business entrepreneur, what kind of guidance would you be
12 seeking?

13 MR. BERENDS: The guidance that would tell me what
14 I should be aware of not doing.

15 Inadvertently, in some of these alliance and joint
16 ventures that I've been involved in, not knowing what the
17 regulations really are, I've made some blunders; we've had
18 to back up and correct those.

19 I don't know if there's a simplified way of
20 putting out a very simple pamphlet that would say: Don't do
21 this. You know, it's very easy and, of course, the
22 regulations are quite thick on what you can do and how you
23 should do things.

24 But it would probably be very helpful if we had a
25 very simplified list to look at that says: Don't do this.

1 COMMISSIONER STEIGER: Extremely useful.

2 Debra, does that raise a question for you?

3 MS. VALENTINE: Only one related question to that,
4 because I think this is really the area where we can help.

5 The act that Commissioner Steiger referred to
6 before, this National Cooperative Research and Production
7 Act, provides if you do file and your filing is accepted by
8 the FTC and Justice that should a competitor sue you, you
9 would not be subject to what antitrust law calls treble
10 damages, three times.

11 Now, are you worried also about people who are not
12 included in your alliance or joint venture suing you? Is
13 this ever a concern? Or you're more concerned about
14 knowing, no, we should not discuss price; yes, we may engage
15 in joint research?

16 MR. BERENDS: Probably. I don't read too much
17 about that, especially in the lighting industry. I had a
18 close enough relationship with the large companies that hold
19 most of the patents that I was aware of what was available
20 and what wasn't.

21 When we did have a difference of opinion, we could
22 usually sort it out. So I don't know that I'm qualified to
23 respond to that question.

24 COMMISSIONER STEIGER: Extremely helpful.

25 Susan?

1 Michael, anything else?

2 MR. ANTALICS: Yeah. I just have one question on
3 an earlier point that you made with respect to access to
4 capital.

5 Do you foresee problems down the road in dealing
6 with the larger institutions because of a philosophical or
7 strategic decision that they might make in not wanting to
8 take that kind of risk?

9 Or do you think it's more a question of, they'd
10 like to serve the smaller business man; but perhaps they're
11 just not as adaptable because of the size?

12 MR. BERENDS: Probably yes to all of your
13 questions.

14 In fairness to the larger institutions, they are
15 faced with some pretty tough regulatory regulations as to
16 what the criteria is for whom they can lend to and loan
17 money to. And, by and large, the small business just
18 doesn't have the assets that will support the funds that
19 they need.

20 And if you remove the local element, if you will,
21 of the financial institutions, a lot of times funds that
22 would be available because that close personal relationship
23 has been removed, it could be a problem. In some cases, it
24 has been a problem.

25 But I don't think it's insurmountable. I think

1 that if the larger institutions, the financial institutions,
2 realize just what an important place small business has in
3 the economy of this country and if they develop the proper
4 resources to working with small business, not only will they
5 benefit but so will this whole country and our economy in
6 the process.

7 Does that answer it a little bit?

8 MR. ANTALICS: Yeah, I think it does.

9 COMMISSIONER STEIGER: Tim, anything?

10 MR. DEYAK: Just one brief question if we could
11 get back to the uncertainty issue.

12 I think what you said is that there is a lot of
13 uncertainty about what the rules and regulations might be
14 and so actions might not have been taken.

15 Are there situations where you may have been
16 uncertain about what to do, took an action, and then found
17 that it was against certain regulations and then where you
18 thought that the application of the regulation was incorrect
19 or it shouldn't apply or that it should be changed?

20 MR. BERENDS: We've run into that. And -- I hate
21 to admit this in front of this Commission, but in most cases
22 we just ignore it and hope we don't get caught.

23 And then, basically what you do is you try and go
24 back and rectify the problem without making too many people
25 aware of it.

1 Small business flexibility and innovation.

2 COMMISSIONER STEIGER: I'm having somebody run
3 right out and see whether my status here allows me to grant
4 conditional immunity.

5 I think the answer is probably no.

6 We thank you most sincerely.

7 MR. BERENDS: Thank you much very much for
8 allowing me to come, and it's been a good experience for me,
9 too.

10 COMMISSIONER STEIGER: Well, I think we have
11 learned. That's the important part as far as we're
12 concerned.

13 We have been remiss in not introducing the folks
14 throwing questions at you, Mr. Berends and our panel. Let
15 me do so now.

16 A Senior Antitrust Economist, Tim Deyak.

17 A Senior -- they're both, in spite of their youth
18 -- Litigator in Antitrust, Attorney Mike Antalics.

19 Susan DeSanti is the Director of the Policy
20 Planning office. Her Deputy is Debra Valentine. And they
21 are the folks responsible for organizing this hearing and
22 coercing you all into coming here and eventually, of course,
23 writing "the" report, which we hope they stay well to do.

24 But thank you, Mr. Berends.

25 MR. BERENDS: Thank you.

1 COMMISSIONER STEIGER: And if you can stay with
2 us, we're delighted to have you.

3 Our next speaker is Calvin Knowlton. He's
4 President of the American Pharmaceutical Association.

5 Dr. Knowlton has been a community pharmacist for
6 more than 20 years. His office-style pharmacy is located in
7 Lumberton, New Jersey. He has a team of 7 pharmacists, one
8 dietician, and more than 20 support personnel throughout the
9 community.

10 Dr. Knowlton is also an Associate Professor of
11 Pharmacy at the Philadelphia College of Pharmacy and
12 Science, where he has taught courses in entrepreneurship,
13 pharmacy administration, and health care ethics.

14 And, Doctor, we are extremely pleased that you
15 give us your valuable time this morning.

16 MR. KNOWLTON: Thank you for the opportunity to
17 appear before the Commissioners.

18 Good morning. Again my name is Calvin Knowlton,
19 representing the American Pharmaceutical Association, which
20 is the National Professional Society of Pharmacists. Our
21 membership is about 47- to 48,000 pharmacists out of a total
22 pool in the country of about 160,000 pharmacists.

23 And our pharmacists work in all types of
24 pharmacies: community, independent, free-standing
25 community, chain community, hospital, HMO's, mail order.

1 About one-third of our members are made up of pharmacy
2 owners and employees of small businesses, all of whom are
3 struggling to meet the challenges of competition and
4 innovation, which are the subjects of the hearing today.

5 As you have mentioned, I am an Associate Professor
6 of Pharmacy and chair the Department of Pharmacy at
7 Philadelphia College of Pharmacy & Science. And I am also
8 on the board of trustees for APhA and am representing APhA
9 as President this year.

10 But the reason that I really wanted to come here
11 this morning was because of my standing as a community
12 pharmacist owner for the past 22, 23 years.

13 And the fact that, as of the 18th of this month, I
14 will no longer have most of that pharmacy because I am
15 transferring the prescription files for over 8,000 patients
16 to a chain right around the corner from me after losing
17 about \$15,000 a month for the past several months, actually
18 dating back to March.

19 And this was a very painful decision for me
20 personally and, obviously, for the staff, to whom I have
21 given notice.

22 We will continue to provide some services in our
23 pharmacy to nursing home patients and hospice patients and
24 selected chronic disease management programs that we have.
25 But it's difficult, after being a full-service, regular

1 prescription pharmacy for a number of years that we can no
2 longer afford to do so.

3 At the college, as I mentioned, I'm a professor
4 there. And for the past 15 years, I have taught courses in
5 entrepreneurship. And this semester I did not offer the
6 course. I usually had 30 students per semester, 35. I
7 can't teach it in good faith. And over the past 10 years,
8 I've also trained residents in pharmacy, which is a
9 year-long program, post graduate. And my residency was in
10 patient-oriented community pharmacy practice and taught them
11 all how to start patient-oriented pharmacy practices.

12 And each of the residents that I trained now
13 operates a full-standing pharmacy business in the greater
14 Philadelphia area that's focused on helping people make the
15 best use of their medications.

16 And this year I stopped the residency program also
17 at the school. All of my residents are in a financial
18 crisis right now. They have joined the entire community
19 pharmacy segment of the pharmacy profession in a precipitous
20 fiscal decline that's occurred in the year 1995.

21 These issues, these foundational, core survival
22 issues for local pharmacists, precisely capture the tension
23 I think -- or I hope -- that the hearing is about today.

24 While myself, and other patient-focused
25 pharmacists, stand poised to provide innovative,

1 valued-added services that enrich the marketplace in some
2 30,000 free-standing pharmacies in the country, the current
3 lopsided and distorted market place in pharmacy does not
4 allow any optimism for survival of community pharmacists.

5 The problem, frankly, is simple. It's an
6 oligopsony, which means it's a market that's controlled by
7 the few buyers of pharmacy services and that has really
8 focused in the year 1995.

9 These few buyers are a few third-party
10 prescription card companies that control, unilaterally, the
11 reimbursement of upwards to half of the marketplace in
12 United States in prescription medicines and, in some
13 communities like mine, up to about 75 percent.

14 This is just FYI, the prescription card companies
15 that we're talking about are also known as "Pharmacy Benefit
16 Management" companies. And they are the cards that many
17 people in this room probably have in their pocket that
18 they'll use when they go into a pharmacy.

19 And these cards are, even though it's kind of like
20 a Visa card, it may list a number of different banks, it's
21 still a Visa card. And these cards are owned by a few
22 companies that are very, very large. And they basically
23 control the price of everything electronically and also
24 control the -- or also influence the manufacturers -- the
25 pharmaceutical manufacturers, too. So they control the

1 price to us, and they control the price to the
2 manufacturers.

3 This is not isolated to the Eastern United States.
4 According to the May 8th issue of Forbes magazine:

5 "The growing power of these plans to dictate the
6 price of prescription drugs has slashed retail pharmacy
7 gross margins to 25 percent, from 35 percent in 1989" --
8 and, indeed, from 35 percent over the last 2-1/2 decades.
9 That, according to Forbes, "is \$5.5 billion carved right out
10 of the operating profits" of community pharmacists.

11 An APhA Trustee polled her associates in Virginia
12 this week and found that, even pharmacies with the ability
13 to earn significant wholesale discounts, have gross margins
14 in 1995 that are now down to 22 percent. So from the Forbes
15 article of 25 percent, we're now showing 22. And I've
16 brought with me information -- if you're interested, and I'd
17 be happy to pass it around; I didn't include it -- but just
18 stuff from 11-2-95 from our practice which would show you,
19 from one of the large plans that we are now down with that
20 plan to a "take it or leave it" operating margin of 7 to 11
21 percent.

22 Most galling is the fact that small business
23 pharmacists are not allowed to negotiate collectively --
24 that is, from any position at all, not even a position of
25 roughly equal power -- with the oligopsonist, the

1 third-party plans.

2 Only large pharmacy chains have been legally free
3 and economically powerful enough to just say no to what they
4 call substandard PBM contracts. And even the chains are
5 hurting today with this.

6 Federal antitrust policy leaves small businesses
7 vulnerable to the PBMs that cut deals with the employers and
8 then inform patients and pharmacists of their decision on a
9 "take it or leave it" basis.

10 In the past, the FTC has been an ally of the
11 American Pharmaceutical Association members on some of the
12 most important issues affecting the pharmaceutical
13 marketplace.

14 For example, when APhA championed the use of
15 generic products over a 20-year period, FTC proved a
16 powerful ally in weighing in with its reports on barriers to
17 generic drug use.

18 More recently, FTC has attempted to rein in
19 Pharmacy Benefit Management firms, PBMs, which too often
20 seem to serve as an unregulated marketing arm of several
21 large pharmaceutical companies.

22 As you may or may not know, many of the largest
23 PBMs in the country that we're talking about are actually
24 now owned by pharmaceutical manufacturers.

25 Because of this past and because small business

1 people are entrepreneurs at heart, pharmacists understand
2 and appreciate the Commission's dedication to free and fair
3 competition. And what I would sincerely like to convey to
4 the Commissioners today is just how far from fair and free
5 competition the marketplace has strayed and how important it
6 is for the FTC to weigh in on the side of small pharmacy
7 businesses.

8 In brief, America's pharmacists are seeking the
9 following help from the Commission:

10 1. FTC should undertake a study of the changing
11 prescription drug marketplace to understand the role the
12 Commission is inadvertently, I'm sure, playing in
13 facilitating the demise of the small community pharmacy
14 businesses.

15 2. FTC should exercise greater discretion in
16 determining whether to prosecute those few pharmacists who
17 join together to attempt to refuse inadequate reimbursement
18 offered by third-party health care payers, which are rapidly
19 consolidating into conglomerates of unprecedented scale and
20 indifference to our local communities.

21 3. FTC should support efforts in Congress to
22 amend the antitrust laws that will permit pharmacists and
23 other health care professionals to form provider service
24 networks to argue over and against these oligopsonists.

25 3. FTC should no longer permit manufacturers to

1 maintain drug product pricing structures that discriminate
2 in the wholesale prices offered to different, quote,
3 "Classes of Trade," without regard to performance of
4 individual members of the class.

5 Just to explain what I mean by that, if I am an
6 HMO, I can buy an inhaler that someone may use for asthma
7 for \$12; and the community pharmacist -- my community
8 pharmacy and others -- buy it from the same company -- from
9 the same wholesaler at usually around \$24. So the HMOs and
10 the other classes of trade beyond the retail class of trade
11 are able to buy things and then they're out competing with
12 us in the marketplace, which is, obviously, a distortion in
13 our perspective.

14 So I will elaborate on some of these as I go
15 along.

16 Survey the marketplace. We would hope that FTC is
17 an important player in the pharmaceutical marketplace by
18 virtue of its actions to regulate Pharmacy Benefit
19 Management firms, particularly those owned by the drug
20 manufacturers, its acquiescence to manufacturer Class of
21 Trade pricing distinctions and its lawsuits to break up
22 pharmacy negotiating groups.

23 Small pharmacy businesses believe that the FTC
24 must gain a better understanding of the growing domination
25 of this market by the third-party purchasers and the reality

1 that these payers are wiping out small pharmacy businesses.

2 This hearing is a good start. But FTC should
3 undertake a major study of the changes occurring in the
4 market. On the scale of the FTC's influential and
5 ground-breaking study of the generic drug market.

6 Consider the evidence of this radical
7 transformation of the prescription drug marketplace: Fully
8 55 percent of out-patient prescription drugs are now paid by
9 third parties.

10 This is more than twice the market share held by
11 third parties just 10 years ago. Reliable projections place
12 over 90 percent of this market firmly in the control of
13 third-party payers by the end of the decade. And most of
14 those are now transferring into the PBMs, or the three --
15 the oligopsonists, as we call them.

16 But just as important as the power accrued by
17 these payers by virtue of their market share is how they use
18 their power and for what purpose. I would like to offer
19 some evidence that will permit the Commission to distinguish
20 between actions of powerful players that appear to create
21 efficiencies and the innovative activities of small pharmacy
22 businesses that actually improve efficiency, health care,
23 and create value in the marketplace.

24 Pharmacy Innovation in Drug Therapy Management: I
25 will begin with a description of the need in our

1 communities.

2 Americans have, for some time, been suffering from
3 an epidemic of failed drug therapy. Numerous peer-reviewed
4 studies over the past 20 years have estimated that between 3
5 and 25 percent of hospitalizations each year result from
6 medication misadventuring or drug therapy that went awry.
7 And this has to do with preventable adverse drug affects and
8 patient non-adherence or non-compliance.

9 Several years ago a group of physician experts
10 empaneled by the Rand Corporation identified drug therapy,
11 morbidity and mortality as one of the top five greatest and
12 most preventable maladies afflicting older Americans, right
13 after major killers like congestive heart failure, cancer,
14 hypertension, and pneumonia.

15 Year after year, mismanaged drug therapy is the
16 most common category of malpractice litigation against
17 physicians. In July a study published in the Journal of the
18 American Medical Association revealed that the leading cause
19 of medical injury in the hospital setting was the use of
20 drugs.

21 The most common cause of these errors was
22 prescribing errors that appeared to be due to deficiencies
23 of knowledge of the drug and how it should be used. Other
24 scientists have determined that each adverse drug event
25 added about \$2,000 to the cost of hospitalization, excluding

1 the malpractice costs.

2 And just last month, in the beginning of October,
3 a study that was published in the Archives of Internal
4 Medicine, by Lyle Bootman and their group from Arizona,
5 estimated that the drug-related problems in the ambulatory,
6 or the out-patient, population cost the nation \$77 billion
7 last year and over 100,000 lives.

8 Consider that in the perspective of, we spent last
9 year, if you think of a health care pie that's about the
10 size of a trillion dollars, the pie -- give or take a few
11 billion here and there -- we spent \$75 billion on drugs.
12 And what the Bootman study showed is that we spent another
13 \$77 billion on cleaning up the problems associated with
14 those drugs. And most of it was preventable
15 hospitalizations, office encounters, and emergency room
16 visits.

17 There's something wrong with that picture: \$1
18 causing \$1 of problem.

19 These figures exclude the cost of drug
20 misadventures occurring in the hospital, the Bootman figures
21 do, and the indirect costs due to worker absenteeism and
22 lost productivity. Even so, for every dollar spent to
23 purchase drugs, Americans spent another dollar to clean up
24 the problems.

25 Pharmacists and pharmacy faculty in the 75 schools

1 of pharmacy in this country are undergoing a profession-wide
2 re-engineering that started in 1989 to reposition the entire
3 profession of pharmacy to serve as members of the health
4 care team that truly manage health care and intervene in
5 these issues.

6 And we have a name for it. It's called:
7 Pharmaceutical Care. And the entire profession is in a
8 major transformation, the third of its kind in the 300-year
9 history of being here in America. The first one was
10 hypothecaries. Then we became compounders. Then we became
11 dispensers or distributors. And now we're moving into the
12 pharmaceutical care era where our focus is on outcomes and
13 optimizing the use of therapy for patients.

14 Pharmacists have proven over and over in studies
15 published in the peer review literature that the one-on-one
16 time that we spend with our patients produces better
17 outcomes at lower costs.

18 I have appended to this testimony, on the last
19 page, a summary of several studies illustrating the value of
20 pharmaceutical care. But let me summarize these studies by
21 stressing that I am not talking about giving patients a
22 piece of paper about the drug that they just bought or
23 initiating a quick computerized scan of past drug purchases
24 to identify obvious medication errors.

25 And I know this is difficult, perhaps, a stretch,

1 or a reach, for those of you who may be in the Beltway; but
2 this is not way the entire country is here, and
3 pharmaceutical care is catching on in many, many parts of
4 the country. And pharmacists are re-engineering their
5 sites, their systems, and what they do. And you may or may
6 not be seeing here yet, but it's out there, and it's
7 catching on nicely. Our goal is to help 45,000 pharmacists
8 re-engineer to provide pharmaceutical care by the year 1998,
9 which is a third of the practitioners.

10 Let me skip down to the center of this page.

11 So we're not talking about giving a piece of paper
12 about the drug or a computerized record. And that's the
13 standard level of service that our society will receive if
14 the industry continues the way it is now. That is being
15 taken over by the mail order and centralized PBMs.

16 Yet, neither a piece of paper nor a software
17 program can identify untreated hypertension. Neither a
18 piece of paper nor a software program can provide one-on-one
19 personal help and understanding the benefits of proper
20 compliance with instructions for use in the medicine and the
21 risks involved in improper use. Neither a piece of paper
22 nor a software program can call the patient to ascertain how
23 he or she is doing with their new antibiotic or their new
24 medication. Neither a piece of paper nor a software program
25 can check a diabetic person's blood sugar, review an elderly

1 person's entire drug regimen, teach an asthma patient how
2 and when to use their inhaler or call a patient's physician.

3 Pharmacists and community pharmacies can and
4 increasingly do these things.

5 Oligopsony versus Innovation. This brings me to
6 two questions. And I would remark that I didn't see Boyd's
7 testimony before mine about this innovation thing; but what
8 solutions do the big health care intermediaries and payers
9 offer to these drug therapy problems? It's an atrocious
10 problem in our country. Do the oligopsonists recognize the
11 value pharmacists add to the market?

12 In May, the Blue Cross/Blue Shield Association
13 described how it had recently saved the Federal Employees
14 Health Benefit Program some \$327 million in drug benefit
15 costs. Did they accomplish this by working with pharmacists
16 or paying pharmacists to meet one-on-one with chronically
17 ill enrollees to manage hypertension or diabetes, catching
18 dosage errors, and recommend missing drug therapy? No.

19 Sixty percent of those savings, about \$200
20 million, came from what they call " pharmacy discounts,"
21 which simply is a euphemism that means they took the money
22 from reduced reimbursement to pharmacists. Payers this
23 large (gesturing) can control the marketplace and dictate
24 payment rates electronically to small pharmacy businesses.

25 I don't know if you understand; but what happens

1 is when you go into a pharmacy with one of those cards, it
2 gets processed in the computer and electronically it goes
3 somewhere -- Arizona or somewhere -- and comes back within 8
4 seconds, it's supposed to, and tells you what they're going
5 to pay you for it. It tells the pharmacist: This is what
6 we're going to pay you for this. You can't negotiate with a
7 computer. And then it triggers the production of a label
8 receipt for the patient that will identify a \$5 copay or
9 whatever it might be for that particular patient. It's
10 electronically controlled.

11 The pharmacy leaders would like to speak out for a
12 united refusal by pharmacists of these inadequate payment
13 programs but are not permitted by antitrust laws to organize
14 such a campaign. Payers like Blue Cross/Blue Shield are
15 taking advantage of their clout to engineer a
16 disproportionate hit on small pharmacy businesses.

17 Pharmacists account for less than a third of the
18 cost of the average prescription but bore the burden of
19 nearly two-thirds of the cost cutting accomplished by Blue
20 Cross/Blue Shield, the largest federal insurer.

21 By way of comparison, the Blues got 21 percent of
22 their drug benefit saving by tapping the pharmaceutical
23 manufacturers for price discounts, even though the
24 manufacturers accounted for over 70 percent of the cost of
25 the prescription.

1 Most important, Blue Cross/Blue Shield and the
2 federal administrators overlooked the potential of
3 addressing their enrollees' costly drug related problems,
4 myopically focusing on squeezing a few more pennies from the
5 pharmacists' slim margins.

6 Nor is this a strategy restricted to the past.
7 The big payers keep focusing on grinding down pharmacy
8 payments rather than on managing and improving care.

9 This week, we learned that Blue Cross/Blue Shield
10 implemented a new federal drug benefit program. This scheme
11 will charge retirees, who account for two-thirds of the drug
12 payments, a 20 percent co-payment on any prescription they
13 fill in a community pharmacy. There will be no co-payment
14 if the prescription is filled by a mail order service, who
15 -- as I mention -- with the class of trade differential can
16 buy the thing at much, much less than can the community
17 pharmacy.

18 Obviously, a large number of retirees are going to
19 shift to mail order and away from their community pharmacy.
20 This will hurt pharmacy, but it will also hurt those elderly
21 retirees who get a piece of paper in the mail to replace the
22 lost professional services of a pharmacist.

23 APhA recently discovered that another large PBM,
24 with which FTC has more than a passing acquaintance, PCS,
25 has entered into a contract with AARP under which retiree

1 members will be given a card that entitles them to deep
2 discounts at the community pharmacy. This card does not
3 confer on the AARP member any insurance coverage for
4 prescription drugs. Instead, the card will be useable in
5 any pharmacy included in the network of pharmacists which
6 have agreed to accept a contract with PCS. It will entitle
7 the consumer to computerized scanning of their recent
8 purchases. We don't know what it will entitle PCS to
9 receive.

10 Pharmacists who refuse to contract will lose the
11 business of these cash-paying retirees. Either way,
12 pharmacists will see their already tiny margins further
13 erode. As a practical matter, this payer is practicing
14 price fixing.

15 But once again, antitrust laws apply only to the
16 pharmacist leaders who would like urge pharmacists to reject
17 or at least be able to negotiate some of these contracts.

18 What can FTC do and, we would think, should do?
19 I've taken a few minutes to describe the respective
20 contributions of pharmacists and payers to a solution for
21 drug misadventuring -- that's a major problem in our society
22 -- because FTC is a consumer protection agency. FTC should
23 be as well schooled in the services provided by pharmacists
24 as it is in the pricing and distribution of drug products
25 through pharmacies.

1 If Commissioners view pharmacists as just one more
2 method for distributing costly commodities, the Commission
3 may welcome the market confrontations between tiny community
4 pharmacies and gigantic mail order houses and third-party
5 payers as a way of ensuring more efficient distribution of
6 drug products.

7 FTC should not follow payers into an intellectual
8 blind alley in which prescription drugs can only be seen as
9 costly commodities and pharmacists as costly distributors of
10 these commodities.

11 This is the dominant view of today's oligopsonists
12 who are blind to innovation by small pharmacy business.
13 Their lack of vision is driving value out of the marketplace
14 and driving people into the hospital emergency rooms.

15 APhA would ask the Commissioners to consider that
16 the pharmaceutical market is already heavily weighted in
17 favor of the purchaser and that the purchasers are doing
18 little or nothing to create efficiency or value in the
19 marketplace.

20 We ask for certain FTC policies to be reevaluated
21 -- we kind of plead for it -- to help redress this
22 imbalance.

23 First, we urge the Commission to undertake a
24 serious study of the oligopsonistic marketplace in which
25 today's pharmacists are seeking to practice innovative

1 pharmaceutical care and reevaluate the antitrust laws and
2 their enforcement, in light of the findings of this study.

3 Second, before the Commission initiates any
4 further antitrust action against another pharmacy
5 association, Commissioners should reflect on the impact FTC
6 has when it enters such a marketplace and prevents
7 pharmacists from undertaking concerted action to refuse to
8 accept inadequate payments. Under the prevailing market
9 circumstances, intentionally or not, FTC is acting as an
10 accomplice pinning pharmacists' arms behind their backs
11 while third-party heavyweights pound away in a frontal
12 assault.

13 Third, we ask that the FTC support changes to
14 federal law now pending in Congress which would grant
15 limited antitrust protection to pharmacists who form
16 networks for the purpose of negotiating with these large
17 private payers that accept risk for Medicare enrollees.
18 Similar policies should be adopted in the private sector.

19 Fourth, APhA is asking the Commission to
20 reevaluate its policy that accepts Class of Trade price
21 differentials without looking below the surface. Too often,
22 discounts are provided to all members of a Class of Trade
23 without regard to the individual purchaser's specific
24 performance in moving market share, in purchasing in volume,
25 in generating physician or consumer brand loyalty, or in any

1 way earning the discount.

2 Small Pharmacy businesses can accept the fact that
3 they must earn wholesale pricing discounts; but it is
4 unacceptable that others can gain access to these prices
5 simply by virtue of being -- fill in the blank, an HMO or
6 hospital or mail order -- and the rest of us are stuck in
7 this thing that we call this "Retail" Class of Trade.
8 Equally distasteful to pharmacists are the oligopsonists'
9 contracts that divert manufacturing discounts away from the
10 pharmacy.

11 And I did bring some of these things to show you
12 that we're just not making this up. I mean this is the
13 brand new contract from PCS that every pharmacy in the
14 country must sign by the 15th of November. And it says in
15 here: "PCS shall have the right to submit all prescriptions
16 related to this agreement to manufacturers in connection
17 with PCS manufacturer rebate programs or any similar
18 programs. Providers shall not be able to submit any of the
19 prescriptions relating to this agreement to any manufacturer
20 for the purpose of receiving any rebate, discount, or the
21 like except as authorized by PCS in writing."

22 I also brought in copies of the PCS and Paid
23 contracts, two of these real heavyweights, just to show you
24 again that you cannot talk to these people. This contract
25 says right here before you sign it -- and I would be happy

1 to pass these around if you want to see them -- that you
2 are, by simply signing below, the provider -- it says that
3 you've read it and so forth and that you agree to it, quote,
4 "...without any modification, deletion, or additions of any
5 such agreements." So they don't want to hear from you. You
6 can't call them up and say: Let's talk about this.

7 The one from Paid Prescriptions is equally odious.
8 It says in this one -- this is Paid Prescriptions, which is
9 another one of the large PBMs. The one sentence says:
10 "This letter of agreement may be executed by one pharmacy
11 for itself or by a company of chain pharmacies on behalf of
12 the chain pharmacies under the same ownership," but it can
13 only be -- I can't get together with anybody and talk about
14 things.

15 America's small business pharmacists believe that
16 the cumulative impact of aggressive tactics of payers, the
17 FTC's prohibition against collective action by pharmacists
18 to refuse further payment reductions, and FTC's acquiescence
19 to Class of Trade price discrimination is the reason that
20 last year over 1200 neighborhood pharmacies closed, unable
21 to survive; and this year, 1995, over double that amount
22 have already closed in 1995.

23 We are asking the Commissioners to answer this
24 question: If the net effect of FTC's current ordering of
25 its priorities is to reinforce oligopsony and the decimation

1 of the ranks of America's most accessible health care
2 professional, exactly what advantages will FTC have secured
3 for the public?

4 Far from representing a step forward on the road
5 to a more efficient marketplace, each time one of those
6 community pharmacies closes its door, that community lost
7 readily accessible infrastructure and professional service
8 proven to improve quality and save money and lives.

9 Time is not on the side of small pharmacy
10 businesses. We are asking FTC to be part of the solution
11 before it is too late.

12 Thank you for your consideration and listening to
13 this somewhat emotive plea.

14 COMMISSIONER STEIGER: Well, Doctor, it sounded
15 very well reasoned to me; and it looks like an awful lot of
16 effort went into compressing information into the time frame
17 that you were allowed here. There were some very
18 substantial points from your perspective, and we are
19 grateful for them.

20 I wanted to start with a couple of questions, and
21 I see my colleagues up here are chomping at the bit to join
22 in; so if you will bear with us patiently, you have raised
23 issues that interest us greatly.

24 Could you go back to the provider service network
25 point and tell me what barriers, from your perspective,

1 there are to provider service networks and what you mean by
2 some relaxation to allow expansion. I am not clear on that
3 point.

4 MR. KNOWLTON: What we would like to see occur is
5 the ability for providers, whether it's the Epic group in
6 Virginia or other groups in the country of pharmacists
7 providers to able to get together, regionally or some way,
8 and to at least sit down to the table with the PBMs and
9 negotiate some of our fees. And that's, pure and simple,
10 what we would like to have occur.

11 We have not been permitted to do that by law, and
12 we have examples of places in the country where the FTC has
13 come in and broken that up, I guess before it got started
14 really.

15 But the provider networks would be just that,
16 where pharmacists would be able to get together and dialogue
17 back and forth and negotiate with some of these powerful
18 PBMs.

19 It was different when there were so many buyers of
20 pharmacists' services. You know you had cash patients, and
21 then you had, oh, a number of third-party plans and
22 different things. And now, since it's been collapsed into
23 just a few that control over half of the marketplace, it's
24 really pressed upon us.

25 In years past, we did a dastardly thing in health

1 care -- and pharmacy did it just like everyone else -- it
2 was that thing called "cost shifting." And so we would
3 accept the low fee from a small company like a PCS or Paid a
4 year ago, which only controlled a very, very -- a single
5 digit amount of the marketplace -- and we would cost shift
6 it. Right or wrongly, we would cost shift it to our
7 patients that paid cash so that your margins would stay
8 around the operating margin you needed to pay your employees
9 and your taxes and all, which is about 30 percent for
10 community pharmacies.

11 And now that inability, obviously, as they've
12 grown and grown, is not there. So we are appealing for some
13 redress, some way to sit down with people to negotiate a
14 price. And the provider service network is what we have the
15 most current jargon, I guess, of those things that are out
16 there.

17 COMMISSIONER STEIGER: You envision that such a
18 network would involve some form of shared financial risk by
19 its members?

20 Or are you talking simply about independent
21 competitors being able to negotiate?

22 MR. KNOWLTON: It could actually be either way. I
23 mean, it could be a shared risk type of arrangement.

24 My sense is what it would really be, probably, is
25 a performance-based arrangement so that if pharmacies in

1 X Group can produce a certain performance on persons with
2 asthma -- you know, that, because they're taking their
3 medicine right, they're on the right stuff, they know how to
4 use it properly and all that -- in fact, one of the papers
5 that I quoted in the appendix gives reference to one of the
6 studies where that just did occur in the beginning of this
7 year.

8 So performance-based network based on health
9 outcomes is really where we're trying to go with this. We
10 would like to be in an integrated system that's going to be
11 there. We would like to be able to set up some
12 performance-based networks, or provider service networks, I
13 guess you would call them, using performance as the
14 indicator.

15 So it may be capitation; it may be shared risk; it
16 may be performance, whatever.

17 COMMISSIONER STEIGER: May I pursue that just a
18 little further?

19 In trying to envision a performance-based or
20 outcome-based network, given the very large range of
21 prescription medications, how would you see a performance --
22 realizing that this is a new idea -- but how would you see a
23 performance-based network?

24 Would it cover all of the major prescription
25 categories?

1 MR. KNOWLTON: Most of the people that are working
2 in that arena now are working with diseases that are the big
3 hitters, shall we say, you know, the ones that are causing
4 the most amount of absenteeism at work or going to work and
5 only working at half speed, you know, being non-productive
6 and/or hospitalizations. And so it seems to be driven by
7 the marketplace, the insurers and others, who would like to
8 attack these large problems first.

9 Whether it would work on the young child that has
10 a hot ear infection, you know, I'm not sure. That's not at
11 least where the large dollars seem to be. So it would
12 probably be more disease management or disease specific.

13 COMMISSIONER STEIGER: One more question for me,
14 and then I will let our experts pursue their avenues of
15 interest.

16 The issue of classes of trade, I think one example
17 you gave was that an HMO might be provided an inhalant,
18 asthma treatment, for \$12; a small independent might pay
19 \$24.

20 You later say that you believe that there are
21 discounts being given without regard to volume, growing a
22 brand, if you will, or other performance.

23 In that example, do you think that volume had no
24 affect on the particular price of that device?

25 MR. KNOWLTON: Yeah, that's right. There will be

1 -- there are volume discounts and performance discounts on
2 both sides.

3 So the \$24 inhaler -- and I don't mean to pick on
4 inhalers -- but the \$24 inhaler and the \$12 inhaler both
5 would then have taken from that a volume and performance
6 discount; so if you bought more, you may get a couple cents
7 off; if you would pay your bill ahead of time or a
8 concurrent payment, you would get a couple cents off. So
9 that would apply to both.

10 The issue is the base price, the 24 versus the 12.
11 And it's independent of volume. It's only dependent on a
12 class of trade.

13 I have some friends, for example, that have
14 pharmacies that are what we call "close shop." I mean,
15 pharmacists will also take advantage of this because, you
16 know, they are trying to compete, desperately.

17 So they will have pharmacies that do not have any
18 patients walking in off of the street. They are not, quote,
19 a "retail" or "open pharmacy." They just provide services,
20 for example, to a nursing home. And that's what we call
21 "close shop" pharmacy. And they will buy the medicine for
22 the \$12, and I will be up the street buying it for the \$24
23 and even though we both do the same volume.

24 So it's independent of volume. It's dependent
25 upon the class of trade, which has really been distorted.

1 There was a good reason for it a long time ago, because we
2 wanted non-profits to get good prices and things, you know,
3 because they're religious hospitals and stuff.

4 COMMISSIONER STEIGER: You're very patient.

5 Now who wants to start?

6 I think Michael perhaps.

7 MR. ANTALICS: Let me just ask you, on the
8 question of cooperative buying, do you envision any
9 limitations on the size of these groups or market power?

10 Is there some sort of a market power assessment?

11 How would you envision that working?

12 MR. KNOWLTON: You know, my cognate area in my PhD
13 was in economics, so I have all these words in my head that
14 I think about that I shouldn't be thinking about.

15 But the oligopsonists, the way to fight an
16 oligopsonist is with an oligopoly, you know. And I don't
17 think that's the right way to do it either. Right? Just my
18 gut feeling. I don't want to see that happen where you have
19 three big pharmacy groups in the country fighting these
20 three big drug manufacturer-owned PBM's.

21 I think creative minds have to think of a
22 different way to do it. I would hope it would be like
23 health care is on more of a regional/local basis so you
24 really can respond to a local marketplace, because the needs
25 are different throughout the country.

1 So somehow I would hope for that, that there would
2 be some type of a localization and not forming -- not the
3 American Pharmaceutical Association, for example, going to
4 Arizona and beating on PCS's door and fighting them. I
5 think that's just not what we're asking for.

6 MR. ANTALICS: Well, within a more local market,
7 would you envision just having one group of pharmacists? Or
8 would there be, essentially, competing pharmacists?

9 MR. KNOWLTON: I think there would probably be
10 competing groups, I would think. And that's what we're
11 seeing happening. To be honest with you, the way the market
12 is shaking out now is the way that the -- and this is just
13 my opinion -- but the way I see it shaking out is that the
14 chain pharmacies are going into regions of the country and
15 attacking certain regions so they will control. So it will
16 be two or three chains in a region, and then they will have
17 the power, hopefully, as an oligopsony to negotiate with
18 these others.

19 So I would see it as competing forces in a region
20 probably is the best way to do it.

21 COMMISSIONER STEIGER: Susan?

22 MS. DeSANTI: I wanted to pursue with you a little
23 your argument about the drug misadventures that are ongoing.

24 As I hear what you're saying, it seems to me
25 you're saying there's real potential value to be added by

1 pharmacists who can make sure that that extra dollar doesn't
2 need to get spent because of a drug misadventure. And so
3 you don't need to be cutting margins here. You need to be
4 taking care of the overall, we're spending \$2 when we should
5 be spending \$1 is the problem.

6 If that's the case, can you explain why health
7 care insurers haven't been more focused on that problem?

8 Do you see any trend towards a greater focus on
9 that problem?

10 What are the dynamics of that transition?

11 MR. KNOWLTON: The two bookend studies that
12 started to identify that. And remember this
13 population-based stuff only started with the advent of
14 computers, really, starting to track things.

15 So the bookend study on the one hand was the Kohl
16 study in 1990 that showed that 28 percent of the
17 hospitalizations of the elderly in the country were due to
18 drug misadventuring.

19 And then the other bookend was the one we quoted
20 in here which was the Bootman study that showed that, on the
21 out-patient basis, you know, it's costing \$77 billion.

22 The PBMs that have all this power that they have
23 amassed believe that they will solve the problem with what
24 they call "population-based pharmaceutical care." They will
25 do it through some electronic means. And that's okay. And

1 they can argue that way.

2 What we are arguing as a profession is that we are
3 in a transition that's going to take us 12 years -- we're
4 about four years into it, four and a half years into it; and
5 by the year 2000 we'll be three -- and we are positioning
6 pharmacists to help solve that terrible societal problem.
7 And no other profession is probably equipped from a
8 medication understanding perspective to solve it and
9 interested in solving it.

10 The incentives have been misaligned, probably, for
11 us to even think about that. It's kind of like if you go in
12 and get your oil changed in the car and they see a dent in
13 the hood, they don't fix the dent, you know, because the
14 incentives are to change the oil.

15 The incentives in pharmacies have been to dispense
16 prescriptions and stuff. We're changing. We're seeing
17 changes in that occur. Washington State just passed
18 legislation where they're going to start paying pharmacists
19 to do this kind of stuff. We see a lot of stuff in the
20 Midwest happening along those lines. I have a lot of pocket
21 anecdotes I could tell you about.

22 So we do see stuff happening. What we're
23 concerned about, frankly, is that, as we have time to go
24 through this transition and if we have another year like we
25 have in 1995, there won't be enough of us around to worry

1 about it by 1997, because it's just -- the money is just
2 getting siphoned off, billions of dollars getting siphoned
3 off right into this -- what we believe is by this entity
4 that doesn't provide any value but they've captured the
5 data.

6 MS. DeSANTI: Thank you.

7 COMMISSIONER STEIGER: Doctor, you have been very
8 patient with us, and we thank you for this contribution to
9 our record. You leave us with a number of complex issues,
10 and we are the better for having heard your testimony.

11 MR. KNOWLTON: Can I just tell you, this has
12 almost been serendipitous to us to receive this call to come
13 here, and we really appreciate it.

14 We were arguing this a couple of weeks ago at the
15 FDA, trying to see if we could get them to help us with some
16 of this stuff. And we just really appreciate this
17 opportunity.

18 And if you would like to take a photocopy of any
19 of these documents I'm holding here or look at them, I would
20 be glad to share them with you.

21 MS. DeSANTI: Yeah, I think we would like to
22 follow up and get some of that on the record.

23 MR. KNOWLTON: Thank you.

24 COMMISSIONER STEIGER: Thank you.

25 We will take a brief 10-minute recess now to allow

1 our court stenographer to change the tapes, and we will
2 resume to hear the testimony of Dr. Heckman.

3 Thank you, Doctor.

4 (Whereupon, a brief recess was taken.)

5 COMMISSIONER STEIGER: Our next speaker is Carey
6 Heckman who teaches technology law at Stanford Law School
7 and co-directs the Stanford Law Technology Policy Center.

8 He is also a co-director of the Cyberspace Law
9 Institute, which is a co-venture of Georgetown Law Center
10 and Stanford law School.

11 He's a member of the board of directors or board
12 of advisors of several computer software private companies.
13 He was the general chair of the Fifth Conference on
14 Computers, Freedom, and Privacy.

15 Before joining the law school faculty at Stanford,
16 Professor Heckman was Vice President, Senior Corporate
17 Counsel, and Assistant Secretary and Director of messaging
18 products marketing at Novell, Inc., a leading supplier of
19 network operating system software.

20 Currently, Dr. Heckman serves on the board of
21 advisors of the Software Forum, an organization of
22 independent software developers. He has authored several
23 articles on technology and law-related topics too numerous
24 to mention and, of course, spoken before various trade
25 groups.

1 And today he is lending his wisdom to us. And a
2 warm welcome to you, sir. We are very pleased you would
3 join us.

4 MR. HECKMAN: Thank you, Commissioner, for your
5 generous introduction. I appreciate this opportunity to
6 appear before the Federal Trade Commission this morning.

7 For the record, let me add that my testimony
8 reflects my personal opinion. I am not speaking today for
9 the Stanford Law School, the Stanford Law and Technology
10 Policy Center or any other entity.

11 But I also wish to applaud the Commission for
12 undertaking these hearings. Throughout history, governments
13 have too often struggled only after the fact to tackle the
14 changes caused by new technologies. We almost always suffer
15 from this tardiness. The Commission's willingness to devote
16 time to study these questions more proactively represents,
17 in my view, a great improvement.

18 My testimony this morning concerns how large
19 technology companies have used intellectual property rights
20 to bludgeon smaller technology companies.

21 In sum, I appreciate and generally applaud the
22 Commission's exploration of how antitrust enforcement might
23 be relaxed to accommodate the needs of high technology
24 industries. However, the Commission should also remember
25 how competition suffers from the intellectual property

1 problems larger companies inflict on smaller companies.

2 In general, I believe these problems have much
3 more to do with the painfully slow and even more painfully
4 expensive procedures for resolving intellectual property
5 disputes rather than violations of antitrust laws.

6 I, therefore, don't urge the Commission to
7 increase antitrust enforcement intervention; but I do
8 contend that an informed and vocal Federal Trade Commission
9 has an essential role to play if new technology companies
10 are to have a reasonable opportunity to compete and to
11 succeed.

12 So how do small competitors suffer in the world we
13 have today?

14 My example of the problems come primarily from my
15 12 years of private in-house, legal practice before I came
16 to Stanford Law School and my recent experience involving
17 high technology start-up companies. This is, of course,
18 primarily anecdotal evidence; but I believe it's indicative
19 of what smaller competitors face.

20 When I counsel or talk to CEOs of new and smaller
21 technology companies, I typically hear one or more of the
22 following eight questions:

23 Can my former employer interfere with my starting
24 a new company?

25 How should I name my new company and its products?

1 Why shouldn't I sign their standard
2 confidentiality agreement?

3 Why won't they sign our standard confidentiality
4 agreement?

5 What will it take to get the technology we need to
6 add to our own technology?

7 Do we make our products as planned and make them
8 compatible with theirs?

9 Will we be able to get certification that our
10 product is, in fact, compatible?

11 And what could be bad about joining a consortium
12 or a joint venture?

13 One of the first problems the founder of a new
14 technology company often confronts is the possibility of
15 intellectual property claims for his or her former employer.

16 Nearly all companies insist that employees sign
17 what's known typically as an "Invention Assignment" and
18 "Confidentiality Agreement." These agreements typically
19 give the employer ownership of all intellectual property
20 rights to everything the employee creates while an employee.

21 A few states, such as California, have statutes
22 that limit the scope of these agreements. But even in
23 California, the employer can demand ownership to everything
24 that the employee conceives related to the employer's
25 current business or the employer's actual or demonstrably

1 anticipated research and development. In other words, it's
2 quite broad.

3 Note that an employee with strategic planning
4 responsibilities has an especially severe burden since even
5 plans for an independent new business could arguably belong
6 to the employer.

7 The Invention Assignment agreements let a former
8 employer intimidate and even strangle new companies. In the
9 mid-1980s a friend of mine and his teammates resigned from
10 one software company to form their own software company in,
11 basically, the same field.

12 The former employer was incensed and launched a
13 no-holds barred lawsuit, complete with exhaustive scorched
14 earth discovery. The lawsuit dragged on for over a year.
15 Venture capitalists were reluctant to fully fund the new
16 company with the litigation pending.

17 Although the suit eventually settled --
18 essentially on the terms offered by the new company almost
19 from the start -- the new company's injuries from legal
20 expenses, delayed funding, and management distraction proved
21 fatal soon thereafter; and the new company went out of
22 business.

23 Another challenge early in a new company's life is
24 its choice of a company name and the names for its products.
25 Larger companies have used extreme aggressiveness in

1 charging new companies with trademark infringement.

2 A large computer company sent a cease and desist
3 letter to a new Northern California software company not too
4 long ago because the first three letters of the new
5 company's name were the same as the abbreviation used by the
6 larger company for itself and some of its products.

7 Only after a direct appeal from a member of the
8 board of directors of the new company to his business
9 acquaintance, who happened to be the president of the large
10 company, did the new company get permission to keep its
11 name, provided it agreed not to use all capital letters for
12 the first three letters of its name.

13 I can recall responding for a client to a letter
14 from a large company in which the large company claimed it
15 owned the exclusive right to use the letters "PC" in a
16 product name.

17 In 1987, Microsoft sent a cease and desist letter
18 to Pacific Micro Software Engineering, a two-employee
19 company specializing in software for paint manufacturers.
20 Microsoft claimed the words "Micro" and "Software" in the
21 small company's name violated Microsoft's trademark rights.
22 The new company changed its name because it could not afford
23 to defend the lawsuit.

24 Third, as the Commission has already heard from
25 others, technology companies need to talk with other

1 technology companies about non-public information. Many
2 technology products have to inter-operate to work together
3 with another company's products; and pre-released disclosure
4 allows timely development and testing.

5 Technology companies typically build their
6 products by using technology tools from others. For
7 example, a software company uses a programming language
8 compiler from another company. Early access to the
9 up-coming versions of these tools is very important.

10 Small companies depend on other companies even
11 more since their limited resources force them to do less
12 themselves. Disclosure of this vital information takes
13 place under confidentiality agreements to preserve secrecy
14 and trade secret protection under state law.

15 The larger companies have increasingly tried to
16 achieve other arguably anti-competitive goals by taking
17 advantage of the smaller company's need for this
18 information.

19 In early 1994, Microsoft's confidentiality
20 agreement for the pre-released version of what is now called
21 "Windows 95" included a provision barring anyone working on
22 "Open Doc," which competes against another Microsoft
23 product, from examining the pre-released copies of the new
24 Windows program for three years, even though Microsoft was
25 publicly pledging commercial shipment of the new Windows

1 product by the end of that year.

2 While this provision was aimed at larger companies
3 -- Lotus, Borland, WordPerfect -- ancillary restraints of
4 this kind have been appearing in confidentiality agreements
5 from other companies.

6 Smaller companies typically lack the bargaining
7 power and resources to negotiate these provisions out of the
8 agreements, and so they are stuck with them.

9 On the other hand, smaller companies seeking to
10 protect their own trade secret rights frequently find larger
11 companies unwilling to sign the necessary confidentiality
12 agreements. Among the most difficult issues in the
13 formation of Sematech, a consortium of the semiconductor
14 industry, was the refusal of some large semiconductor
15 manufacturers to sign the confidentiality agreements
16 proposed by the much smaller semiconductor equipment and
17 materials companies.

18 The larger companies said they felt unable to
19 police their own employees and feared litigation over
20 confidentiality disputes. These large companies would only
21 sign agreements that covered confidential information when
22 in tangible form but not intangible. In other words, a
23 recipient with a photographic memory was free to tell the
24 world everything he or she could remember. The smaller
25 companies ultimately relented and accepted this much more

1 limited confidentiality.

2 By the way, it's quite normal for large companies
3 to have two forms of confidentiality agreements: the ones
4 that they will insist upon if they're giving you
5 information, and the only ones they will sign if they're
6 receiving information. And, obviously, there are
7 significant differences between these forms of agreement.

8 Fifth, many products and services today -- and
9 many more in the future -- are, in fact, combinations of
10 more than one company's technologies. And the process of
11 combining the technologies usually require still another
12 company's technology.

13 For example, a software application might require
14 another company's operating software and still another
15 company's database software and be built by using yet
16 another company's programming language software.

17 Consumer demands for compatibility can require
18 that a new company license what are known as "Application
19 Program Interfaces," sometimes for a company with whom the
20 new company may also compete.

21 This complexity is likely to get even greater as
22 more use is made of what is known as "object-oriented
23 technology," which breaks programming down into subprogram
24 models.

25 For computer software companies, the more liberal

1 issuance of software patents has been, in a word, traumatic.
2 I know that in late September, the Commission urged the
3 Patent and Trademark Office to avoid granting overly broad
4 patent protection, so I won't belabor this point. But I do
5 want to note that what I believe most deeply chills software
6 developers is not just the breadth of software patents but
7 these newer companies' frustration in not being able to know
8 in advance whether they are violating someone else's patent.

9 A copyright infringer knows he or she is copying.
10 A trade secret infringer knows he or she is disclosing
11 confidential information. But software developers currently
12 have no way of identifying potential software patent
13 hazards. And that makes life very uncertain.

14 Getting the right technologies in reasonable terms
15 can be daunting for a new company. In virtually all likely
16 circumstances, the new company has no legal right to obtain
17 a license to these technologies. The essential facilities
18 doctrine is unlikely to apply, leaving to one's eye the
19 mixed theoretical support for that doctrine anyway.

20 And as with confidentiality agreements, some firms
21 have started including ancillary statements in their
22 licensing agreement. For example, in 1994, Borland released
23 a new version of a programming language compiler. For the
24 first time, Borland insisted that programmers apply for a
25 separate patent license each time they wanted to distribute

1 a total of more than 10,000 of a program compiled by that
2 version of the software.

3 Programmer reactions to Borland restrictions were
4 swift and intensely angry. Borland responded that the
5 requirement was only aimed at litigious competitors. Quote:
6 "If you are not a litigious competitor, then the restriction
7 doesn't apply to you," closed quotes.

8 That's what they said.

9 Some would point to Borland's withdrawal as proof
10 of the lack of Borland's market power, which prevented from
11 making its restraint stick.

12 Fair enough. But we should also recognize the
13 extent to which some programmers have to take time and
14 energy from their real work to fight Borland, the emotional
15 drain from the prospects of Borland refusing to back down,
16 and the initial sense of frustration and impotence at being
17 so much at one company's unilateral, arbitrary action like
18 this.

19 But wait. There's more. The Borland agreement
20 included another provision that barred the licensee from
21 compiling and distributing programs, quote, "generally
22 competitive with or a substitute for any Borland development
23 product or the Borland product you used to create your
24 programs," close quotes.

25 Ultimately, Borland eliminated or whittled down

1 these provisions as well to a level acceptable to
2 programmers. But perhaps in the future a larger and
3 stronger company than Borland would not have had to be so
4 responsive.

5 Whether a new company needs to make a product
6 compatible with another company's, it also wants to signal
7 customers the product is, in fact, compatible. To
8 accomplish this, the new company wants to get whatever
9 compatibility certification the other company is willing to
10 offer.

11 If a software start-up today, for example, creates
12 an application that runs on Windows 95 and wants the right
13 to use the Microsoft design for Windows 95 logo on its box,
14 it must meet Microsoft's requirements for that right.

15 Naturally to get the certification, the
16 application must run reliably on Windows 95. But Microsoft
17 also insists that the application run on Windows NT, a
18 different Microsoft operating system product; and further,
19 that the application be compatible with Microsoft's Old 2.0
20 Object Oriented Technologies.

21 These additional requirements can represent
22 tremendous additional costs to smaller companies and, yet,
23 are not directly related to the purpose of the compatibility
24 certification.

25 Finally, new companies can feel pressure to join

1 industry consortium or joint ventures. But in some cases,
2 that membership becomes yet another avenue for larger
3 companies to use intellectual property rights against
4 newcomers. I've seen some large companies use what could
5 best be called an intellectual property bear hug. The small
6 company is enticed to join a consortium or joint venture and
7 then gets strangled to a stand-still by a web of
8 confidentiality obligations.

9 As an aside, let me note that despite the tendency
10 to praise consortia and joint ventures as indispensable
11 technological progress, the actual performance of many of
12 the consortia with which I am familiar tells a somewhat
13 different story.

14 For one thing, consortia frequently result from
15 one company seeking to turn its product into an industry
16 standard or to commoditize the products on which it relies
17 or, in some cases, simply to slow or dumb-down a product
18 area so its more advanced competitors lose their advantage.

19 Participation in a consortium or trade group can
20 be overwhelmingly resource intensive for a small, new
21 company.

22 And to date, really very few of these consortia or
23 joint ventures have had all that much success.

24 Fortunately, most standard-setting trade
25 associations and consortia have rules prohibiting or

1 restricting the adoption of standards incorporating patents
2 and technology.

3 However, as the Commission discovered from its
4 recent ground-breaking investigation in Dell Computer
5 Corporation and its VL bus, the standard-setting processes
6 can be abused. And that is definitely a problem.

7 So what's going on here with all these examples?

8 I actually, again, would categorize little or none
9 of what large companies are doing as an antitrust violation.
10 Nor am I convinced they should be treated as antitrust
11 violations. These situations are technically typically not
12 about market power. Market power, in its technical sense
13 can rarely, if ever, be established in these situations,
14 especially given the inherently global and dynamic nature of
15 technology industries.

16 Indeed, most examples I have discussed have
17 counterparts where the roles are reversed, and it's the
18 smaller company using intellectual property rights to
19 frustrate or bludgeon a larger one.

20 So what is going on?

21 First, the technology advance represents a much
22 greater financial investment now and a much greater
23 potential financial reward than in the past. Companies have
24 more to lose if they don't enforce their intellectual
25 property rights.

1 Second, larger companies have emerged in high
2 technology industries; and larger companies can afford legal
3 department infrastructure to acquire, perfect, and enforce
4 the entire panoply of intellectual property rights.

5 The private practice of intellectual property law
6 has grown considerably, making misrepresentation more
7 accessible to smaller companies. So a lot more companies
8 are taking advantage of these rights and, therefore, coming
9 into conflict over them.

10 Third, across the board awareness of intellectual
11 property rights seems to have increased radically.

12 And during my flight out here yesterday for these
13 hearings, I read in the airline magazine about the
14 Dallas/Fort Worth "Tour 18 Golf Course." It has replicas of
15 famous golf holes such as the "Blue Monster from Dural" and
16 "Amen Corner" from Augusta.

17 The article said the designers used aerial
18 photography and computer modeling to create these
19 reproductions. But then I disgusted myself, and I realized
20 my first reaction to this was not to think of the fun of
21 playing these replica holes but rather reflect on whether
22 the courts might enforce some sort of design patent for a
23 look and feel copyright theory against the "Tour 18"
24 concept.

25 Fourth, structural disincentives for enforcing

1 rights have decreased. Photocopying 20 pages of a newspaper
2 article for your clients and colleagues was too hard to
3 track and caused too little economic harm to justify taking
4 legal action. But today, any of us in this room on the
5 Internet can send a copy of an article to 30 million people
6 or more with as little effort as is required to push the
7 "return" key.

8 Fifth, some intellectual property doctrines lack
9 reasonable wiggle room. With more than little
10 justifications, many large companies feel they must
11 methodically enforce the intellectual property rights or
12 risk losing them as to all the world for all time. This
13 leads some legal counsel to become quick to send out cease
14 and desist letters and other threats of legal action.

15 Sixth, more rigid intellectual property rights
16 enforcement is looking to me at least all the more analogous
17 to the introduction of barbed wire in the West at the end of
18 the 19th Century in the death of the open plain.

19 Those who own the rights appear more entrenched
20 indefinitely. And those who do not own rights appear to
21 have far less opportunity to advance into the world. In the
22 barbed wire situation, armed conflict resulted, such as the
23 Johnson County war. Worst of all, resolving intellectual
24 property disputes takes too much time and money and opens
25 the door to procedural blackmail.

1 Intellectual property litigation can take six or
2 more years in industries with six-month product life cycles.
3 Like Pacific Micro Software, many small companies must cave
4 in when they receive demands of larger companies rather than
5 stop to take their stand.

6 So, how should the Commission respond?

7 Well, as I stated at the outset, it's not clear to
8 me that any additional antitrust enforcement would be useful
9 or appropriate.

10 What is vital, in my view, is that the Commission
11 stay informed so that its actions remain consistent with
12 technological change.

13 I hope hearings of this kind occur periodically
14 rather than just once. And I especially encourage
15 conducting these hearings in the West and other locations
16 outside of Washington so that a wider range of new
17 technology entrants could be heard and can better understand
18 the Commission's perspectives.

19 It's a two-way street. And it's important for
20 smaller companies to know what the Commission can do and
21 about its interest in these issues as well as for the
22 Commission to have a chance to hear from these companies.

23 And, third, I think the Commission should continue
24 making sure other government agencies, especially the Patent
25 and Trademark office and the Registrar of Copyrights,

1 appreciate the affects their decisions have on competition
2 as well as possible creative incentives.

3 Oftentimes I think these agencies, in particular,
4 have tended to focus on one side of the ledger and much less
5 on the other. They need your help in better appreciating
6 the two sides.

7 In conclusion, let me repeat my belief that the
8 problems of large companies using intellectual property
9 rights against smaller companies has much more to do with
10 the painfully slow speed and even more painfully burdensome
11 expenses of resolving intellectual property disputes rather
12 than violations of antitrust laws.

13 I, therefore, do not urge the Commission to
14 increase the antitrust enforcement intervention. But I do
15 contend that an informed and vocal Federal Trade Commission
16 has an essential role to play if new technology companies
17 are to have a reasonable opportunity to compete and to
18 succeed.

19 Thank you very much.

20 COMMISSIONER STEIGER: Doctor, I for one envy your
21 students.

22 MR. HECKMAN: Thank you.

23 COMMISSIONER STEIGER: That was very succinct in
24 its breadth, mind boggling presentation, in just about 18
25 minutes.

1 What do you do with the other 31 minutes in a
2 49-minute teaching hour?

3 MR. HECKMAN: When you have students like at
4 Stanford Law School, they do more than enough to fill it
5 with their questions, which often challenge me greatly. I
6 learn a great deal from my students.

7 COMMISSIONER STEIGER: We are all in your debt. I
8 am tempted to ask you to leave the answers to those eight,
9 highly provocative, most frequently asked questions at the
10 door for all of us. But I'm terrified to do so because I
11 don't know if your intellectual property rights are
12 protected.

13 I appreciate, first of all, the distinctions you
14 draw between what it is that antitrust may do in these kinds
15 of situations. You made a very clear delineation. You
16 certainly lend support to a program that we have had here
17 for many years, and that is a "Competition Advocacy Program"
18 where we do, to the best of our ability, comment to sister
19 agencies and to other government entities who ask for our
20 opinion as to the effect of competition on various standards
21 or legislative initiatives. And I'm pleased to hear that
22 you think we could perform an additional useful function
23 there.

24 But I did have one question beyond, perhaps, the
25 base question; and I will ask it in layman's terms.

1 Is the problem facing the intellectual property
2 community that in very high tech areas there may be a
3 building block and innovations are, indeed, stepping stones
4 on that building block and there is a lack of clarity as to
5 how far the initial protective intellectual property right
6 extends from the building block?

7 And, number two, once a device, a program, an
8 innovation reaches market, is there a role for antitrust in
9 ensuring some sort of open access to the technology?

10 And at what point do you see antitrust as an
11 influence in that situation?

12 I realize that is a hopeless question, but I have
13 the feeling you're used to hopeless questions.

14 MR. HECKMAN: I like hopeless questions.

15 It's tough to characterize or to give it a simple
16 answer, because one of the enjoyable things about technology
17 and technological change is just how multi-faceted and
18 multi-dimensional and, in a sense, polyphonic it is in
19 working -- I mean, different themes carrying on at the same
20 time. And in the very same area, you have, concurrently,
21 people who are exploiting older technologies while other
22 people are advancing new technologies and still other people
23 who are developing brand new technologies; and they're all
24 going on at the same time and weaving this tremendously
25 complex pattern of what's happening.

1 So it doesn't come in nice, neat sequences in
2 which there is a new development, it's used, it's exploited,
3 it has its day, and it passes. Sometimes there is an
4 attempt to portray technological developments in these nice
5 steps in which one thing happened and then that led to
6 something else and led to something else.

7 In fact, it's a much more multi-dimensional kind
8 of thing. And so it's hard to say in a particular area
9 whether -- it's simply a question of getting the rights to
10 take advantage of a development and build on top of it. It
11 also depends on what business you are in. Just as in any
12 other arena, there are some people who are focusing on -- a
13 former boss of mine referred to it as the "exploiters" and
14 other people. There are the pioneers. There are the
15 farmers. And then come the exploiters.

16 And so there are people who tail end, who come in
17 only for price competition kind of basis and would want to
18 -- and from the perspective of the early developers would
19 say would want to rip off my technology, take advantage of
20 it, and go to school on it and to free ride.

21 On the other hand, there are new developers who
22 would say that it's really ridiculous to have to start from
23 scratch. We all have built -- we have all stood on the top
24 of the shoulders of our predecessors, as Newton said; and so
25 there is that aspect to sort of play with.

1 So I'm not quite entirely sure how to respond or
2 to characterize what's going on. I think, again, overall,
3 the big problem, as in all of these arenas, people just
4 aren't sure what is owned by somebody else.

5 And when the processes do take so long to figure
6 those things out, then and it throws, I think, a big monkey
7 wrench into the process of planning, of wanting to undertake
8 technological achievement. It really tends to discourage
9 people from doing a lot of things because of that level of
10 uncertainty about whether they could be hit by something.

11 And especially given the greater aggressiveness of
12 those who have legal establishments to call upon to make
13 life miserable for you. As was mentioned at the beginning
14 of today's program, the tendency tends to be to back off and
15 not to do it at all, not to take the risk, not stick your
16 nose too close to the machine and risk getting entangled in
17 one of these things, even if, ultimately, you'll be proved
18 right. It's not a question of being right. It's a question
19 of: How do you survive six years of litigation, \$400 an
20 hour lawyers as opposed to simply going on and doing
21 something else?

22 In terms of the role of antitrust in this arena, I
23 think there actually -- in some ways, I would say
24 unfortunately there might be. I say unfortunately because
25 that suggests the presence of market power, at least by and

1 large represents the presence of market power in the
2 industry, either together or through individuals. And I,
3 typically, would rather see the industry remain one in which
4 that has not been as much of it.

5 I think some of the history of the industry
6 suggests that it does tend to be happily the kind of place
7 where market power doesn't survive very long.

8 Often times, market power is actually the seeds of
9 your own destruction. And that's been true in a number of
10 situations which larger companies have managed, basically,
11 to topple on their own, from their own weight, as opposed to
12 requiring a government influence to cause that to happen.

13 On the other hand, I think, characteristically, we
14 need to keep track of is that there are companies who now
15 have increasing market power who come from roots of being
16 the small, scrappy fighter. And my general sense is that
17 they don't appreciate their new responsibilities or their
18 new role because it's not something that's developed over a
19 long time period and they've not been historically leaders
20 in this sense but still view themselves as being the
21 underdog. They still act like the bottom-fishing kind of
22 aggressive company, even though they are, perhaps, on top of
23 the heap and are in a position, even within their sector, to
24 do rather nasty things to people.

25 But they still act like they're from the streets

1 as opposed to having had a little bit of the sort of,
2 noblesse oblige, a little bit of the sense of deference that
3 would make them behave a little more kinder and gentler, to
4 use an older term, towards other people in the segment or
5 towards their customers and towards their suppliers.

6 But it's a tough thing to actually portray or be
7 sure of; and, yet, I think when you actually get down and do
8 the technical analysis and say: Do the antitrust laws
9 really apply to those players? it gets awfully hard to come
10 out with an answer. Even in your heart you'd say: Gee,
11 they're not acting very nice. I wish there was some way to
12 spank them.

13 But in reality, the antitrust laws turn out to be
14 the wrong paddle. It's not a paddle that really works. And
15 so you're forced to kind of back off and say: I guess we
16 can't spank them. Because, realistically, it's not really
17 an antitrust thing they've done wrong. They just haven't
18 been very nice. But not being nice is not an antitrust
19 violation, as far as I know.

20 You may disagree. But the last time I checked, it
21 was not.

22 COMMISSIONER STEIGER: Well, antitrust enforcers
23 are always accused of not being nice. So I guess we'll
24 leave that half of it on the table for your consideration as
25 well.

1 I'm sure there are many questions.

2 Let's start with Mike.

3 MR. ANTALICS: Yeah, you highlighted some of the
4 limitations of the antitrust laws and the intellectual
5 property area here because we're dealing largely with
6 vertical-type restrictions with cross-licensing technology.

7 Do you see, from your experience, horizontal
8 problems or problems with any inter-firm coordination with
9 respect to intellectual property rights, whether it be
10 cross-licensing or similar arrangements?

11 MR. HECKMAN: Actually, in some ways I wish there
12 were more cross-licensing, not in the patent pool sense,
13 which, obviously, would be a bad thing. And I know you're
14 also active in setting those types of issues.

15 But this industry has historically been lousy at
16 working together with each other. They're really pretty bad
17 at cooperating as opposed to really good at it. When you
18 get three of them in the room, you will get six different
19 opinions. And the reasons why they're entrepreneurs -- and
20 even the larger companies have, particularly, strong
21 entrepreneurial roots is because they don't do things other
22 people want to do and don't share the same perspective and
23 have a very headstrong kind of sense.

24 It's different than other industries I think that
25 have a century or something of establishment and, therefore,

1 operate based upon, "to get along, you have to get along"
2 kind of basis. These are people whose roots are often that,
3 if I don't like the way you're thinking, I go out and form
4 my own company.

5 And so I would say, generally, horizontal-type
6 issues have not been the big play.

7 Other things that happen through natural
8 economic-kind of issues -- I mean, let's use the personal
9 computer arena, definitely, you know, some things sort of
10 happen between the blessing for IBM for the Intel
11 microprocessor and the blessing for the Microsoft operating
12 system -- that it's important to remember that in 1981 when
13 this occurred, IBM was not the big player in personal
14 computers. In fact, it didn't really intend to become a
15 player in the area.

16 So even when those things were carved out, they
17 were not with the intention of: We can create a whole new
18 world order. The people who were doing it for IBM were
19 simply trying to scramble to get a product together as fast
20 as possible and put together what, for IBM, was an unusual
21 transaction of calling upon other suppliers to build a
22 product. It just turned out that, for a variety factors, it
23 became an incredibly important product and gave those other
24 companies tremendous leverage into the marketplace, which
25 they have been very intelligent and adroit at utilizing and

1 taking advantage of.

2 But I would also say, I mean, there are a lot of
3 people who bash Microsoft and Intel; and I think it's not
4 unusual for people who understand antitrust doctrines and
5 also sort of how things work to sort of, on the surface,
6 say: These are mean companies.

7 But I don't think you should lose sight of the
8 fact that, honestly, they are also very smart companies who
9 are doing very good work and who are, much to their
10 competitor's dismay, staying ahead of the pack and actually
11 are not behaving the way larger companies -- although, there
12 are still some large companies in other technology arenas,
13 and even in this one -- that sometimes behave this way who
14 are not seeking to slow people down or throttle the change.
15 They're racing as fast forward pretty much as anybody else
16 is. I don't really see them in that kind of a capacity.

17 Anyway, to get back to your question, as I said,
18 the horizontal part, to be honest with you, I don't
19 typically see very much. People are pretty skittish about
20 the antitrust laws along those lines. Besides the natural
21 tendency not to want to do that, there isn't a lot of that
22 kind of behavior that I'm familiar with.

23 MS. DeSANTI: I just want to note for the record
24 that we're lucky to have Mike Antalics, who was the leader
25 of the Dell investigation that you just referred to in your

1 testimony, with us this morning.

2 A lot of what you were talking about had to do
3 with the interface between competition and protection of
4 intellectual property rights as spurs to innovation.

5 And one case that raises those issues is the Lotus
6 v. Borland case that the Supreme Court has just granted
7 certiorari on.

8 I was wondering if you had any views or insights
9 into that case that you would be willing to share with us?

10 MR. HECKMAN: Well, only that I think it's a good
11 example. I mean, the case has been pending for an
12 extraordinarily long time. It has cost both parties a lot
13 of money and a lot of attention.

14 Certainly, Borland's position today is
15 substantially weaker in, at least no small part, I think
16 because of the cost that that proceeding has taken,
17 regardless of kind of how it comes out.

18 It also pinpoints a tricky issue, I think, a very
19 difficult balance between -- and it goes back to
20 Commissioner Steiger's question, I think, about on the one
21 hand a company that came along and said -- one company that
22 developed a product and became the leading product and said:
23 Don't I have the right to exploit that? I came here and
24 cleared the land first and created my farm. Don't I have
25 the right to gain the benefits, the fruits of my labor?

1 And another party that came along and said: Hey,
2 farming over here seems to be good; and you've already
3 pointed the way to me. I'm going to take advantage of that
4 and utilize some of the same things we even -- you know,
5 we'll share the brook or I'll take advantage of your water
6 supply to do what I'm doing as well.

7 And that would the form of Borland, who came along
8 and wanted to live off of the interface that, in some
9 extent, that Lotus had made popular. So it's a very hard
10 question as to which is better for competition and which is
11 the better role. And there are those who would say that,
12 you know, poor Lotus deserves to have a chance to use what
13 it's helped develop. Others would say that Lotus -- it got
14 to the point where it was too important in the industry, and
15 they shouldn't have been allowed to, then, control the world
16 just because they happened to do it first and that there
17 ought to be an avenue through which competitors could be
18 added to the market.

19 So, I mean, I think in terms of copyright law
20 doctrine, from my personal sense, again it's my personal
21 sense that Judge Keaton did not get it right, and that the
22 First Circuit was correct in reversing, that it was not the
23 correct analysis that -- the Ninth Circuit's analysis of
24 these kinds of cases tends to be better.

25 My own general sense is that we've undergone a --

1 the pendulum went way too far on the look and feel kinds of
2 cases; and, therefore, from a competition perspective,
3 tended to suggest that people could be entrenched, could
4 actually develop a very rigid position, and once you got
5 there, and as long as you got to the top of the mountain
6 first, nobody could, then, come up the trail to even knock
7 on your door. And that would be a bad thing for
8 competition.

9 So I'm happy to see the courts retrenching back
10 from that stand about intellectual property in such a firm,
11 rigid way that would get these 10 foot walls around these
12 kinds of developments and these kinds of products.

13 As I said, it does remind me a lot of what
14 happened when barbed wire became available to the West. And
15 instead of having the open plain, where there was a fair
16 amount of, at the fringe, in particular, people playing with
17 borders and people sort of making use of -- the kind of
18 sharing that was going on. And, instead, you got the kind
19 of boundary line that couldn't be crossed. And it,
20 therefore, really divided private property and segmented
21 things in a very rigid way. And I think it tended to
22 stabilize the West economically and developed haves and have
23 nots.

24 And in the technology area that could be nasty.

25 COMMISSIONER STEIGER: One last question for me.

1 And that involves the rather complex area of standard
2 setting.

3 MS. VALENTINE: That's what I --

4 COMMISSIONER STEIGER: Did I steal it?

5 MS. VALENTINE: No. Well, let's see. Go ahead.

6 COMMISSIONER STEIGER: You go ahead and ask it.
7 That will be the way to do it.

8 MR. HECKMAN: Commissioner, when you do it, it's
9 not stealing.

10 MS. VALENTINE: We may well have different
11 questions.

12 COMMISSIONER STEIGER: They all sign that
13 agreement.

14 MR. HECKMAN: That's right.

15 MS. VALENTINE: We've got this great covenant not
16 to compete here.

17 No. You may well have a separate question. But
18 one thing we have been asked by several other people who
19 have come to testify is that we look at the law in a joint
20 venture and standard organization area and perhaps attempt
21 to rationalize it with some of the way we approach the
22 analysis of mergers. And some people have gone so far as to
23 suggest that we have a safe harbor for joint ventures.

24 And what I was wondering is whether you are seeing
25 any sort of either exclusionary or strategic behavior in the

1 joint ventures and consortia or standard-setting bodies as
2 they affect your industry that would, perhaps, caution us to
3 think otherwise than creating safe harbors right off the bat
4 as a generic matter for joint ventures?

5 MR. HECKMAN: As I say, I tend to have a fair
6 amount of skepticism about most of these. Well, it seems to
7 me the established end is making kinds of bodies which have
8 been around for a long time and do great stuff and are part
9 of an ongoing effort to do things, especially the ones do a
10 good job of being grassroots kinds of organizations and do
11 have the due process processes in place.

12 Probably, to the minds of a lot of technology
13 people, it tends to be very slow and only create standards
14 when, in fact, there actually are standards anyway. And so
15 all they're really doing is codifying what already exists.

16 That's sort of one flavor of this type of
17 behavior.

18 Another flavor may be at the other extreme, which
19 I think we're past to some extent -- but for a while there
20 was a great flurry of, it was very much the fad, at least in
21 Northern California -- particularly was that a company had a
22 product and it decided that the way for it to win market
23 share was to establish that as an industry standard.

24 And so they would seek to convene a standards
25 making body under some artificial name around sort of

1 themselves. Basically, they would spearhead it. Other
2 people would join. And you ask: Well, why would they join?
3 And the answer was, first of all, you hate to sort of miss
4 the party. So you sort of see what's going on. It was a
5 way of getting a straw into somebody else's ear is what they
6 were doing. And you were kind of afraid that you would miss
7 out, that the party would go away without you and that you
8 would be left totally out the door.

9 So you kind of grudgingly got involved. But it
10 typically was one company's thing; and they were trying to,
11 basically, embody their technology. And that way their
12 customers would then be buying the standard as opposed to --
13 and to some extent the Dell inquiry -- I think it reflects
14 some of that kind of behavior but went, obviously, one step
15 too far with the deception of the -- or at least the
16 misscommunication, shall we put it, about what patent rights
17 would be asserted or would not be asserted.

18 And I think there is some middle ground of efforts
19 to be involved in this kind of behavior that takes place
20 and, perhaps, to moderate the growth of change and to try to
21 slow things down in certain fashions.

22 I certainly have -- in fact, I've personally been
23 involved, or have been dragged into, standards making
24 situations. And it would seem very clear to me that the
25 prime movers were people who were behind in the technology

1 and saw this as a means of distracting consumers as to the
2 advantages of things that were not -- that were outside of
3 what standard was being proposed by these people and to see
4 this as a way of kind of slowing down the show until they
5 could get caught up with their own products by making the
6 claim that other people's things were not standards or were
7 not open or things like -- that's been a very popular phrase
8 of late is about open products which would suggest that they
9 are -- actually it was a distinction of what is open and
10 what is proprietary and things like that.

11 And on another level that I think it's important
12 to think about is that, from a customer's perspective, there
13 is definitely a lot of uncertainty and confusion about
14 these. The information flow is definitely a problem we face
15 in this industry, especially as in areas such as the
16 personal computer market where a more mainstream consumer is
17 entering the marketplace. There's a lot of opportunity for
18 incomplete communication or reliance upon abbreviations or
19 summary terms to affect buying decisions.

20 And so that's why certification marks I think have
21 become so much more popular. It really goes back to the
22 18th century and having a sign on your door. The consumer
23 doesn't really know if something is good or not, so it looks
24 for that symbol and uses that as its indicator and says:
25 I'm not sure if this thing is good or not, but it has this

1 nice looking seal on it; and that says they've approved it;
2 I guess it guarantees it's going to work; so I will buy it
3 on faith based upon that symbol.

4 And the same would be true about these standards
5 making, that there seems to be this belief amongst the
6 people who buy the software that their lives will be a lot
7 easier -- if everything would just simply get done with
8 standards, then this all would be so much easier; and we
9 wouldn't have to worry about anything any more. We wouldn't
10 have to study different kinds of products.

11 And as people are concerned about competition and
12 about technological development and progression, I think the
13 Commission would look with a little bit of a jaundiced eye
14 to that kind of laziness on the part of buyers. But it is
15 out there. You have to realize maybe the message to send
16 out to some of these is: You're going to have to do the
17 work. We don't want to snap everything down and lock in
18 technology as it is perhaps today or before.

19 I often reflect back on the late -- I wasn't alive
20 at the time -- but the late '40s when the Federal
21 Communications Commission was looking at color television
22 and actually managed to lock in a mechanical wheel. It was
23 a color wheel with three filters for generating color TV.
24 There was tremendous lobbying from CBS to accomplish this.
25 In fact, CBS, fortuitously, had a friend of CBS who became

1 Chairman of the Commission and may well have been part of
2 the decisionmaking.

3 There are a couple of things that intervened that
4 prevented that from being. If you look at your TV set
5 today, you don't see a color wheel spinning. You may ask
6 why that happened.

7 One thing that happened is that David Sarnoff and
8 RCA, who were the leading marketers in television at that
9 point, were pretty clever and before the Commission's
10 decision really got going, they flooded the market with
11 black and white sets that were incompatible. And so it got
12 higher. The cost of switching to the system, which was
13 incompatible with the existing black and white, became too
14 high.

15 And the other, which is unfortunate, was the
16 Korean War. When the Korean War came at a time -- and so a
17 television set was really declared non-strategic and the
18 result was that the manufacture was halted during in time.

19 And during that time period RCA was able to
20 improve color TVs, and by the end of the Korean War, the FCC
21 conceded, as did CBS, that the electronic version of color
22 TV was a better way to go than the mechanical wheel.

23 But the point of the story really is just how
24 premature standards making of this nature can cause us to
25 lock into something that is the wrong answer. And it's

1 awfully hard, I think, to make those kinds of decisions.

2 COMMISSIONER STEIGER: Doctor, thank you. I'm
3 considering a move to the West Coast. What's the tuition
4 these days?

5 You don't have to answer that.

6 MR. HECKMAN: Well, the tuition is too high. But
7 the temperatures are in the low 70's.

8 COMMISSIONER STEIGER: Thank you.

9 Our final speaker today -- and we are also honored
10 to have him with us -- is Dr. Chickery J. Kasouf. He is the
11 Assistant Professor in the Department of Management at
12 Worcester Polytechnic Institute. He's in the Department of
13 Management, as I noted. And he's been there since 1990.

14 He is also a Director of Management Research at
15 the Carl Gunnard Johnson Powder Metallurgy Research Center.

16 And before joining the current faculty, he taught
17 at LeMoyne College in Syracuse and at Syracuse University.

18 His teaching interests are wide-ranging. They
19 include marketing management, marketing research, and
20 industrial marketing.

21 And he, too, has written so extensively that we
22 cannot list his papers in this brief introduction on
23 industrial marketing and management issues, including
24 inter-firm relationships.

25 He's a member of the American Marketing

1 Association, the American Powder Metallurgy Institute, and
2 the Institute for Operations Research and Management
3 Sciences.

4 Dr. Kasouf has some transparencies for us, and I
5 believe we all have copies.

6 So would you lead off for us, Doctor.

7 MR. KASOUF: Thank you. And I appreciate my
8 colleagues' flexibility with my travel plans being sent awry
9 with the weather. It's kind of embarrassing coming in from
10 Worcester and coming in late when somebody from Palo Alto
11 makes it on time.

12 I'm going to talk about metallurgy. Unlike
13 pharmaceuticals, almost nobody knows what powder metallurgy
14 is. I've got some sample parts here that people can look at
15 since every time I do a presentation to a new group they
16 say: What's this powder metallurgy stuff.

17 I want to start by noting when I was asked to come
18 down, I had sent some papers to Susan that I did on behalf
19 of the Sloan Foundation and requested those -- or indicated
20 that we were doing some studies in this area.

21 I'm not an attorney. My law background is limited
22 to three hours of business law in my MBA program. But we
23 spent a lot of time dealing with this industry. And my
24 perspective is not an official industry perspective in the
25 sense that I represent Metal Powder Industry Federation or

1 IEPMI.

2 But we have done some empirical work in the
3 industry. We've had a lot of access to firms. And the
4 conclusions -- I think the data are -- I'm confident that
5 the conclusions are our own.

6 Just very quickly, what powder metallurgy is it's
7 a metal forming technology that takes metal powder, which
8 looks like dust, like sugar and presses it in a die into a
9 form what we call "near net shape." And then that form is
10 sintered for strength. Then there might be subsequent
11 treatment like secondary heat treating, tumbling to get
12 burrs out and so on. It uses 97 percent of starting raw
13 material, which makes it a rather environmentally friendly
14 process. Typically parts of less than 5 pounds; although,
15 now we are seeing 30 and 35 pounds.

16 Okay. One point I want to make about the
17 industry, which is one of the things that attracted me to it
18 being somebody with a background in marketing, there's not a
19 whole lot of interest in gears before I came to WPI. But
20 it's a fragmented industry, which is kind of an interesting
21 phenomenon because there's a lot of fragmented industries in
22 the United States that are supplying large industries like
23 auto, steel, and so on.

24 In a fragmented industry, no firm has the power to
25 affect industry events. And this is a classic -- it's a

1 small fragmented industry, \$2 billion in total sales.

2 And you're looking at the largest firm in this
3 industry having sales of about \$100 million a year. When
4 you get down to about the fourth company, it's about \$70
5 million. So we're not dealing with large companies.

6 The implication of this, I think, is how did these
7 firms start to deal with some of the pressures of more
8 sophisticated engineering and R&D that they're going to be
9 facing over the next year?

10 Their customer base is 73 percent automotive. And
11 I've been reading for a while now the suggestion is to try
12 to diversify out of that, but the industry likes to have,
13 you know, the long production runs that auto gives you; and,
14 you know, it's hard to get away from that type of volume
15 when you're so heavily in the process.

16 And if you look at the industry trends in auto,
17 which is the main area, in the last 12 years, from '80 to
18 '92, we've gone from 17 pounds a vehicle to 25. We're
19 looking at some vehicles right now with 40 pounds. So
20 there's a lot of conversion of these parts from grid iron
21 casting, from stamping, into P/M parts.

22 But not all firms are likely to participate in
23 this growth; and I'll talk about why that is in just a
24 second.

25 What I would like to do is talk about automotive

1 suppliers, because the challenge is for automotive
2 suppliers.

3 We're looking at an evolution in this industry --
4 and I would refer any reader to the Susan Helper items that
5 I cited in the handout that you got.

6 But what we're looking at now is conflicting
7 pressures between price reduction -- and I think that's very
8 well documented in the popular press -- and the pressure
9 today to generate more service requirements, which we also
10 will document in a few minutes in our studies.

11 Basically, the auto suppliers went from
12 independent suppliers, that existed before automotive
13 companies, to being vertically integrated into automotive
14 companies then to having more of an out-sourcing
15 relationship. And, in fact, some -- General Motors just
16 spun off a company. So vertical integration really inhibits
17 innovation. There's a lot of fixed costs there associated
18 with that.

19 Suppliers can affect price. They can affect time
20 to market. If you look at the Chrysler Neon, one of the
21 reasons that car was such a success in the product
22 development phase is that Chrysler worked very, very closely
23 with their supply base in order to get the car out quickly.
24 And they cut about six months off the typical product
25 development time. And a lot of that was because of supplier

1 relationships.

2 And a new phenomenon that we're looking at is, you
3 know, the global manufacturing of the big three is resulting
4 in more pressure for even small supply firms to be dealing
5 with the global market, which, then, typically, a lot of
6 these companies were regional companies.

7 Now, one of the studies at WPI on inter-firm
8 relations, attitudes towards relationships with customers
9 with suppliers and with other firms in the industry.

10 And we were motivated to do that because we looked
11 at the changing requirements and we also looked at the
12 limited resource where you've got tight margins and let
13 there be some motivation for these firms to cooperate, in
14 R&D, perhaps joint buying, or whatever.

15 And did two phases, a questionnaire and a case
16 study. I'm going to focus a little bit more on the
17 questionnaire design.

18 What we found -- and if you look on page 5 of the
19 testimony -- you'll see the specific items. Basically
20 valued added engineering is important in this industry and
21 will be more important in the future.

22 So what we're looking at is a higher degree of
23 service required. And these companies perceived that. So
24 they see that there's more engineering expertise required to
25 get contracts. They see that there's going to be multiple

1 contact points between different parts of the organization
2 and that they're going to have to work more closely with
3 their customers to develop the part.

4 And that was consistent with a piece I read in the
5 Wall Street last year by Krystal Miller, you know, that a
6 lot of manufacturers have cut back on their engineers to
7 push a lot of that engineering back into the supply base.

8 Now, if we look at the benefits and barriers to
9 inter-firm relationships, that was -- we had a number of
10 items in our questionnaire where we asked people to evaluate
11 the benefits of barriers and the risks that are associated
12 with getting into relationships with other P/M car
13 producers.

14 Basically, the greatest benefits we're seeing is
15 in efficiency and also in market access. But the biggest
16 fear was losing proprietary technology. And that solution
17 reduced to four factors, and the detail of that is in the
18 testimony handout, if you'd like to take a look at the
19 factor loadings.

20 Now, what we did is we picked on another phase and
21 looked at what we called relationship orientation of
22 perceived importance of inter-firm relationships. And we
23 tried to relate that to perceptions of benefits and risks
24 and also to some demographic variables like size and also
25 expectations about the industry and the perceived rate of

1 change.

2 The three most important variables in
3 discriminating between a high and a low relationship
4 orientation were size, where smaller firms thought
5 relationships were more important. It kind of surprised me
6 at one level. But it looks like the larger firms in the
7 industry -- and they're not that large -- are feeling
8 self-sufficient.

9 Industry expectations, if firms think that there's
10 going to be more firms surviving in the industry over the
11 next 5 or 10 years, they're more likely to get involved in a
12 collaborative relationship because they don't think it's a
13 zero sum gain.

14 And finally the rate of technological change, they
15 saw that as positive. I think there was just a concern
16 there looking at a positive rate of technological change in
17 relationship orientation. People are looking at having to
18 keep up with R&D changes.

19 Now, one thing to bear in mind here is that in the
20 auto industry there has been a lot of conversion in parts,
21 and a lot is driven by technology.

22 I was at one company last year that invested three
23 times the net worth of the company on a part, and the part
24 was a success; but the only reason it was -- well, the main
25 reason it was a success was because of the proprietary

1 metallurgy that went into the part. And, basically, that
2 effectively created a switching cost for the customer. But
3 that could have gone south. It was a real big risk
4 situation, and that could have gone south very quickly.

5 Now, the types of collaboration that we found in
6 the industry, much more often vertical collaboration between
7 the supplier and the P/M part producer, the P/M part
8 producer and the customer, sharing some engineering, having
9 the powder suppliers help you with your R&D to develop
10 powder mixes.

11 And the benefits that we saw tended to be
12 operational rather than strategic. We did not see a lot of
13 evidence of joint research in this industry, which given
14 that about almost 70 percent of the people in the industry
15 who responded to our survey felt that private R&D among car
16 producers was important, we're not seeing the joint R&D.
17 And you're also dealing with firms that don't have the
18 resources to do a lot of R&D on their own.

19 But, basically, they're using alliances primarily
20 as operational, looking at delivery, looking at perhaps a
21 relationship with a press manufacturer to, you know, improve
22 a piece of machinery. But we're not looking at more
23 strategic uses.

24 And what facilitates the relationships were
25 basically effective communication between the companies

1 having some consistency of objectives.

2 Now, just to go back to some of the implications
3 of what we have observed over the last few years, what I've
4 tried to do here is summarize a few studies simultaneously.

5 Global capabilities are becoming more important in
6 this industry for the supplier. If you look in Automotive
7 News I have seen about three or four articles this year that
8 indicated that even small suppliers -- Ford, GM, and
9 Chrysler -- want to see those suppliers having the
10 capability of moving into what they see as the growth areas.

11 I talked to somebody at General Motors; and
12 they're looking at growth in India. They're looking at it
13 in South America. So, you know, what you're looking at here
14 is a desire to see companies move down there.

15 Realistically, when you've got \$50 million in
16 sales, you're probably not going to be building a plant in
17 South America. One company I visited last year was doing a
18 joint venture in Sao Paulo, starting up in January, to
19 continue to supply General Motors.

20 Renault just dropped a million dollars down there
21 as well.

22 Again, the customers' requirements are changing
23 very, very quickly. More engineering is required. And, you
24 know, more service, you know, after sales, more research,
25 and the sales process.

1 And sales and application increases are very
2 likely. There's very little question. Well over 90 percent
3 of our respondents indicated that they felt that there was
4 going to be growth in demand. But not everybody thinks that
5 there's going to be a growth in the number of firms.

6 Typically, if you look at the academic notion of
7 munificence in an environment, you will look at rates of
8 sales growth. Well, sales growth is probably going to
9 continue to grow. But that's no longer, in this industry, a
10 representation of how well an industry is going to be able
11 to support larger numbers of organizations.

12 The shakeout is starting. Ford is cutting back
13 from 32 P/M part producers to 8 in the next year. So you're
14 looking at -- that's typical in the industry right now. And
15 people are looking at Ford 2000 with a combination of, you
16 know, looking at a great opportunity for the people that
17 make it and probably some real problems for those that
18 don't.

19 Some things to think about as we -- you know,
20 customers and policymakers may make collaboration more
21 attractive by creating incentives for cooperation.

22 I'm presenting a paper at the SAE conference at
23 General Motors next month, and that's basically the theme of
24 the paper. General Motors is trying to get parts suppliers
25 to think in terms of developing strategic alliance to enter

1 overseas markets and follow GM.

2 So one of the things that we want to think about
3 is how -- you know, this isn't going to happen without the
4 customers, you know, creating that incentive.

5 Secondly, I think Diran talked about this when he
6 was here back in October, about the maintenance of the black
7 box, that if you do want to have strategic alliances or
8 joint research, these firms have to be able to keep some
9 piece of this proprietary and really not shared with the --
10 so you're always balancing the sharing and secrecy in any
11 strategic relationship.

12 And as I said, cooperation may be a very viable
13 means to develop global capabilities. Now if you look at
14 those parts that I passed around, there's a little --
15 there's a bunch of miniature parts that are in there. Those
16 you can ship. I mean, you can just Fed Ex those things
17 without too much -- I've seen those things go out of Allied
18 Sintering, and they're in boxes like this (gesturing).

19 If you look at larger gears, bearing caps, piston
20 rods, you're not going to ship those and have them shipped
21 in a timely fashion -- you know, scheduling, realistically,
22 you've got to be able to produce, you've got to develop
23 production capacity in the host country. And to do that,
24 you may want to develop a strategic alliance with a firm in
25 that country.

1 And, finally, university-based research
2 collaboration might require some adjustment of expectations
3 and rewards.

4 We found -- and I should report this -- there was
5 not a lot of enthusiasm for university-based research in
6 terms of having joint research projects. They were
7 concerned, our respondents, about the time horizons of
8 university faculty.

9 And having been around a university for five
10 years, I can certainly understand that.

11 And they were also concerned about the publication
12 pressure, because people, not surprisingly, want to get
13 tenure in institutions of higher education; and there's --
14 if you can put something in print before your sponsors would
15 care to have it done, then that could be a problem.

16 What we did at WPI is we got 13 members that pay
17 \$10,000 a year to join our research center. But that took
18 us well over a year to get to the point where we could even
19 begin to ask them for money. We cultivated that
20 relationship over time.

21 When we put the center together, we had agreements
22 with our people when we could release information. So you
23 really have to be thinking about, if you want that kind of
24 private funding, to accommodate that effectively.

25 In summary, powder metallurgy is a small industry,

1 and I would suspect that very few people in this room had
2 heard of it before I came in here today.

3 It's undergoing tremendous change. I mean, you're
4 looking at a growing industry that's going to be shaking
5 out. And you're also looking at an industry with a lot of
6 small firms that's going to have to be producing parts with
7 some substantial engineering expertise. And I think that
8 the next 5 or 10 years is going to create a very different
9 industry.

10 Thank you for your attention.

11 COMMISSIONER STEIGER: We thank you in particular,
12 not only for your extremely helpful remarks, but for the
13 samples.

14 It is rather humbling to compare about a palm size
15 gear with the other products which are barely visible to
16 even the assisted eye. So, obviously, the range of
17 metallurgy is certainly larger than I would have thought.

18 MR. KASOUF: Yeah, the miniature parts are
19 especially interesting. I was at that plant last week.
20 It's an amazing operation.

21 COMMISSIONER STEIGER: Fairly or unfairly, I think
22 one of the questions that is of interest to me is that we
23 appear to be dealing here with an established industry that
24 is on the cusp of substantial innovation.

25 MR. KASOUF: Yeah, I would say that's accurate.

1 COMMISSIONER STEIGER: I am, therefore, interested
2 in the kind of joint venture that you mention as being
3 possible in additional technological developments and
4 application particularly in a global economy.

5 And could you explain a little further for us the
6 "black box" concept and why you think it is critical to
7 further coordination of research and development?

8 MR. KASOUF: Okay. Taking the joint venture, I
9 think you can have a few different levels of that.

10 One that I think is especially important is the
11 potential to have joint ventures to develop overseas supply
12 capability. Not only are you talking in terms of getting
13 parts there on a schedule that I think requires that
14 production overseas, but you're also looking at the pressure
15 to be able to deal with -- to have engineers and the
16 supplier and sales reps dealing with locals in the host
17 country.

18 So putting together a production capability where
19 you can transfer some technology overseas to continue to
20 supply Ford, Chrysler, General Motors I think is really
21 critical.

22 It's attractive for the auto producers as well
23 because once the part has gone through the validation
24 process and that technology is known and accepted, they
25 don't have to pay to do that a second time.

1 So as the vehicle platforms become more
2 standardized, I think that developing those sorts of joint
3 ventures between, say, a U.S. part producer and a part
4 producer in, say, India or China or Brazil adds tremendous
5 potential so that you've got the capacity to increase sales
6 volumes through that type of market presence.

7 In terms of research, I think probably -- you
8 might find smaller pairs of -- you know, trios of companies.
9 But I think research is probably best done through broader
10 types of collaboration. We're one example of that. And I
11 think we've done it quite well. There's also the Center for
12 Powder Metallurgy Technology, which has a larger number of
13 members and a smaller fee.

14 But when you're looking at the necessity to
15 continue to change technically and firms that are dealing
16 with tight margins, I think those sorts of joint ventures
17 make a lot of sense.

18 So those are the two types of ventures that I see.

19 COMMISSIONER STEIGER: You mentioned
20 qualifications. By that I take it to mean an acceptance
21 that the product meets a certain specification and it
22 performs at that specification.

23 MR. KASOUF: The validation process, yes.

24 COMMISSIONER STEIGER: Does this mean that most of
25 the products sold are sold in a bidding model or a bidding

1 framework?

2 And, if so, how much role, if any, do the
3 governments you deal with play in establishing the
4 qualifications that the parts need to be validated for?

5 MR. KASOUF: I'm not aware of the governments'
6 role in this. My experience is that it's typically in the
7 big three, you know, that their engineering staff -- or
8 perhaps a first-year supplier makes sure the part meets
9 specification.

10 Would you repeat the first part of the question?

11 COMMISSIONER STEIGER: I presume these products
12 are marketed or sold based on a bid?

13 MR. KASOUF: Oh, yeah.

14 An established part is often sold on a bid. In
15 fact, one of the problems in the industry over the past
16 couple of years when there was a lot of price cutting is
17 that -- you know, your contract was basically your purchase
18 order. Some customers were sending up products to be rebid
19 on a routine basis.

20 And I talked to people in the industry and they
21 said, well, you know, I got parts and I knew that they were
22 being made by Company X; but, you know, we just didn't want
23 to bid on them because -- you know, the customers were
24 trying to get price concessions by taking established
25 products and getting lower prices.

1 Sometimes you have development contracts where
2 you're trying to develop the part and you agree to do some
3 up-front R&D to see if that part can be manufactured.

4 I know one company did a contract like that a few
5 years ago and they actually got the part to work and put it
6 out, I think, for \$4. And once the technology was
7 established, the customer turned around and started bidding
8 it out. And by the time they got out from under it, it was
9 down to below \$2. They just said, we can't make a living
10 making this part any more.

11 So there is that combination.

12 I know one major -- the company that I talked
13 about that had leveraged -- basically invested three times
14 the net worth of the company to develop a part, they got a
15 three-year contract for the part.

16 But that's a very -- in the industry, that's an
17 eternity.

18 COMMISSIONER STEIGER: Thank you.

19 Susan, did you have something?

20 MS. DeSANTI: Yeah, I wanted to follow up on one
21 of Commissioner Steiger's questions about the joint
22 ventures.

23 I note that you remarked that a concern about
24 giving up proprietary intellectual property rights might be
25 one concern that would make a firm hesitate to join a joint

1 venture.

2 Are there other risks that are perceived about
3 collaboration with competitors that are preventing the kind
4 of joint R&D in this industry?

5 MR. KASOUF: Sometimes there's a concern about the
6 time frames, you know, the inconsistent time frames and
7 establishing consistent priorities.

8 If you look on the -- I think it's on page 7.
9 Yes. Page 7 lists the benefits and the risks that the
10 company has identified.

11 I mentioned the two about universities. But you
12 know, primarily it's giving up proprietary technology and
13 dealing with some of the inconsistencies with universities
14 are the biggest threats.

15 That goes back to the black box, which I believe
16 was another one of your questions. That is not my concept.
17 I don't want to be stealing intellectual property. That was
18 developed by Peter Lorange of I&D, formerly of Wharton.

19 But when you develop an alliance with a company,
20 you're trying to balance your exposure and what you're
21 sharing with something you can take with you that's uniquely
22 yours. And typically that's the downstream application of
23 the technology.

24 You may collaborate on a basic piece of research
25 and then use that research in the marketplace

1 differentially.

2 COMMISSIONER STEIGER: Does this mean reverse
3 engineering, then, of the component of the black box?

4 MR. KASOUF: I guess if you could get in there. I
5 mean, the black box is in your employees' minds and
6 computers. But if you could get access to that, I mean,
7 reverse engineering is always possible. General Motors will
8 go out and rent cars and take them on a test track and bring
9 them back.

10 MS. VALENTINE: Just one quick question. Have you
11 found in this industry that antitrust is not a concern or
12 barrier to the various collaborations that you're seeing or
13 encouraging and that it is far more the concern of the
14 individual firms that they retain their trade secrets
15 business?

16 MR. KASOUF: It's funny, when I was pre-testing a
17 questionnaire, I went to a former CEO of a company in
18 Worcester and on the cover page it said -- I think it was
19 "Collaborative Relationship Study," which was my original
20 name for it. And he said: Chick, have you ever heard of
21 Sherman? Have you ever heard of the FTC?

22 So we changed the cover.

23 I don't hear antitrust coming up a whole lot in
24 this industry, and I deal primarily with the part producers
25 that are very small. I deal some with customers, which are

1 the GM's and the Fords. And I deal some with the powder
2 producers. But I don't hear that often.

3 Basically, this is an industry of a lot of
4 entrepreneurs, a lot of family businesses. And these have
5 been really lone wolf types of people. And for a number of
6 years, you could be very successful at that because the
7 barriers to entry are very low. You get a couple of
8 presses, you know, and you get a sintering machine and five
9 people you could start to produce parts.

10 So I think it's more behavioral than people being
11 afraid of the FTC at this point.

12 COMMISSIONER STEIGER: Well, gentlemen, you have
13 provided us with a very rich intellectual content this
14 morning in a presentation that we are truly, extremely
15 grateful to have.

16 And we're sorry you were fogged in. We hope you
17 don't get fogged out on the way back to the West Coast.

18 MR. HECKMAN: We don't have fog in the West.

19 COMMISSIONER STEIGER: Just high tuition.

20 MR. HECKMAN: Just high tuition.

21 COMMISSIONER STEIGER: But we sincerely thank you
22 all. And we are grateful. And, again, on behalf of the
23 Chairman and my colleagues and the staff, you were an
24 extremely helpful panel. Thank you.

25 (Whereupon, a luncheon recess was taken.)

1 then reassemble and have a discussion where this group here,
2 or anybody in the audience if you fill out a card could
3 submit a question, or any of our panelists; and we would
4 hope that we would have a dialogue and some debate on some
5 of the issues that are raised by our speakers'
6 presentations.

7 If that's agreeable to everyone, I think that's
8 the way we would like to proceed today.

9 Our first witness today is Nicholas Pyle. And
10 Nicholas Pyle is Vice President for Legislation and
11 Environmental Affairs for the Independent Bankers
12 Association.

13 He has been with the IBA for 15 years and worked
14 on a diversity of issues relating to small business matters.

15 I'm familiar with the Independent Bankers
16 Association because I've had the good fortune of addressing
17 them twice in my tenure at the Federal Trade Commission.
18 And I would point out that they're an extremely astute
19 group. I talked to them, principally about our
20 environmental marketing guidelines one time, I think, and
21 then the second time was on our food policy advertising
22 statement. And I found them to be extraordinarily
23 knowledgeable about the kinds of issues that we work on
24 here. And it was a very enjoyable session, and so I am sure
25 we'll learn a lot from Mr. Pyle.

1 MR. PYLE: Well, good afternoon. And thank you,
2 Acting Chairman and ladies and gentlemen of the Commission.

3 My name is Nicholas Pyle, and I appear before you
4 today as Vice President of the Independent Bakers
5 Association for Legislative and Environmental Affairs. I
6 speak today on the impact of slotting fees and particularly
7 their impact on independent bankers.

8 IBA is a Washington, D.C.-based national trade
9 association of over 360 small to medium-sized, mostly family
10 owned wholesale bakers and also allied trades of the
11 industry.

12 The organization was founded in 1967 to protect
13 the interests of the regional, mostly urban, independent
14 segment of the baking industry.

15 The wholesale baking industry sells breads, rolls
16 and sweet goods to institutional food service accounts as
17 well as grocery and convenience stores for resale to the
18 public.

19 The popularity of breads and other grain-based
20 foods have increased in recent years, with a typical bakery
21 now offering bagels, pitas, and other regional and ethnic
22 varietal breads.

23 The growth in varietal breads has led to an
24 explosion of new products in the bread aisle, in store
25 bakeries, and also the freezer case. IBA's membership grows

1 despite a consolidation of traditional white bread baking in
2 the United States as niche and varietal bakers swell the
3 ranks.

4 Beginning in the late 1970s, supermarkets began
5 charging slotting fees for the placement of new products on
6 grocery shelves. We consider a supermarket as a single
7 store or a chain of stores with greater than \$2 million in
8 annual sales. The term "supermarkets" is meant to include
9 conventional, combination, superstore, and warehouse retail
10 formats.

11 Please let it be noted for the record that
12 convenient stores also charge slotting fees.

13 "New products" is a term which we're using here to
14 describe innovative concepts, also brands extension, line
15 extensions, upgrades, replacement and seasonal offerings.

16 To the best of our knowledge, we find that
17 slotting fees originated from the 1970s when there were
18 bidding wars for space to locate branded in-store cigarette
19 point-of-sale devices called "merchandisers." These
20 end-of-aisle cigarette merchandisers placed the
21 manufacturers' products at eye level while a competitor's
22 product is placed on the bottom shelves.

23 It didn't take very long for slotting fees to
24 spread across the grocery aisles to other products and to
25 markets in other areas.

1 The success of supermarkets in collecting these
2 fees from small and some large manufacturers illustrates
3 their power in the marketplace.

4 Food marketers are quick to justify slotting fees
5 as the cost of the competitive store admission process. By
6 charging slotting fees, the retailer is seeking a product
7 from the selection of a grocery item for stock. The
8 retailer profits, again, when the public buys items in a
9 second commercial transaction. Furthermore, retailers
10 typically require volume discounts and substantial
11 advertising promotions to coincide with a new product's
12 entry.

13 These lucrative promotions require discount
14 coupons, in-store demonstrations, radio, television
15 advertising, newspaper co-ops -- that's where they're
16 involved with the retailer in an advertisement -- as well as
17 standalone newspaper advertising.

18 A common retail practice is to set a volume target
19 for six months and then charge the manufacturer a subsequent
20 failure fee if the product doesn't meet sales expectations.

21 Besides the failure fee, the store can discontinue
22 a product after the demonstration period and order the
23 manufacturer to buy back the product. This allows the
24 retailer the opportunity to sell the space again.

25 IBA understands that supermarkets have the right

1 to be selective when deciding which of the 100,000 grocery
2 items mix well in their chain when a large store typically
3 only has room for about 40,000 items.

4 The industry experiences approximately 10,000 new
5 grocery introductions a year, and less than 1-10th survive
6 12 months in the marketplace.

7 The independent segment of the baking industry's
8 chief concern lies with supermarkets that use the highly
9 negotiable and competitive store admission process as a
10 profit center.

11 This is particularly disturbing when 80 percent of
12 the new products are simply minor changes to existing
13 products or line extensions.

14 The rule of thumb for new, innovative product
15 concepts is to provide the chain buyer or store review
16 committee with enough market research to justify the success
17 of a product.

18 No company, large or small, despite the slotting
19 dollars, could get an untested product onto a supermarket
20 shelf unless armed with the most basic of market research.

21 Regional independent bakers have unique problems
22 selling to large chain supermarkets. Baker service grocery
23 accounts with direct delivery of fresh baked goods to all or
24 part of a chain's individual stores. Often a baker finds
25 slotting charges based on national accounts counting all the

1 stores in a chain when, in fact, only a portion will be
2 served, those in the baker's normal delivery area.

3 The slotting charges further stifle innovation by
4 smaller bakers since they cannot afford the slotting charges
5 to launch a new product. Slotting also hurts consumers who
6 don't get the advertising message and coupon incentives to
7 try new products when budgets are stretched to meet the
8 demands for slotting fees.

9 Smaller manufacturers with fewer locations and
10 items at the store also have a difficult time passing along
11 the cost of slotting fees to the real payer, the consumer.

12 Unfortunately, slotting is broadening in the food
13 trade to include costs other than first-time product trade
14 deals and allowances. Besides failure fees, there is a
15 staying fee, which is an annual form of rent charged by some
16 chains.

17 When a major warehouse chain purchased another
18 warehouse retailer in the early 1990s, the latter suppliers
19 received notices from the new owners that they would be
20 asked to pay an up-front fee in exchange for the supplier's
21 right to continue to do business with the company. This
22 type of slotting is defined by industry as "pay to stay."

23 If a smaller manufacturer has a product with
24 potential and marketing research, they will be allowed into
25 the chain for what's called a "free fill." This practice

1 involves the manufacturer supplying the retailer with free
2 product in lieu of the slotting fee.

3 Also we find that bakers are requested to provide
4 a free fill when a chain opens a new store in an area.

5 The amount of money a baker pays in slotting fees
6 depends upon the size of the supermarket chain and the
7 number of products being introduced. If a product features
8 different flavors -- such as a "Plain" and "Onion" bagel --
9 the chain considers these different products, each with its
10 own slotting fee.

11 Slotting fees which, once again, are very
12 negotiable, typically start at about \$3,000 per product for
13 a regional chain and can run as high as several hundred
14 thousand dollars for a national chain.

15 There are press accounts following a 1990 joint
16 industry task force on new grocery product introduction
17 which details slotting charges for new products in excess of
18 \$1 million nationally.

19 It is hard to argue the legality of slotting fees
20 because of the different forms of slotting and the varying
21 industry practices. One thing is clear: There is a legal
22 obligation for the manufacturer that pays a slotting fee to
23 one retailer to then pay the same fee to other retailers.
24 By law, the manufacturer must offer that same discount to
25 the retailer's competitor.

1 The same problem exists for the retailer who
2 requires payment from certain manufacturers for premium
3 shelf space and does not offer the same or comparable deal
4 to competing vendors in the same product category.

5 The following are a few anecdotal slotting
6 reports. Please understand that in all cases, the names
7 have been disguised to prevent identification of the source.
8 As you can see, none of my members were anxious to run up
9 here and testify today.

10 A New England supermarket chain was purchased
11 about five years ago by an individual who used the proceeds
12 of slotting fees to cover the portion of equity for the
13 purchase. A "pay or stay" slotting fee was required for
14 each item in the supermarket.

15 I can't begin to convey the number of leveraged
16 buyouts that have been financed in the grocery store
17 industry by such pay or stay fees.

18 A New York area supermarket chain regularly
19 charges \$20,000 for each new item introduced by a food
20 manufacturer as well as requesting annual contributions to
21 the purchasing manager's Christmas party.

22 A West Coast supermarket chain was solicited and
23 paid a \$1 million fee to change from one food manufacturer's
24 products to another. The justification was the cost of
25 computer reprogramming.

1 A national supermarket chain recently quoted a six
2 figure amount to a specialty baker to carry his items for a
3 single period -- and that was six months -- without
4 assurance of retention.

5 When opening new stores, one Eastern supermarket
6 chain takes a six-month grace period before paying its first
7 invoice. This extended fill gives the new store time to
8 generate cash flow while the baker waits for payment.

9 It is out of the ordinary to have requests of
10 \$200,000 and above for slotting from larger chain stores.
11 If an independent baker cannot afford the fee, they lose out
12 on the business.

13 The issue is growing beyond direct payments for
14 carrying a product. For example, many food manufacturers
15 are regularly forced to purchase space in home shopping food
16 catalogs as well as send representatives from their
17 companies and pay for representatives of the supermarkets to
18 attend food shows and various other trade industry events.

19 More and more retailers are requesting that
20 manufacturers pick up other costs: marketing research,
21 advertising, and so on.

22 In conclusion, IBA members' concerns about
23 slotting fees are sincere. The situation, according to
24 reports from our members, is out of control. In order to
25 stop the proliferation of the more serious practices and

1 prevent flagrant abuse, IBA seeks voluntary efforts between
2 suppliers and the grocery trade for a level playing field
3 for all manufacturers and retailers regardless of size.
4 This might involve voluntary adherence to some form of a
5 supplier/retailers code of ethical standards.

6 Thank you for your interest in this critical issue
7 this afternoon.

8 COMMISSIONER STAREK: Well, thank you for coming
9 and educating us on some of the practices that are ongoing
10 in the market here. And also thank you for an excellent
11 idea on how we will fund the Commission's Christmas party
12 this year.

13 MR. PYLE: We can't afford a fee for Christmas
14 parties.

15 COMMISSIONER STAREK: Our next witness this
16 afternoon is Greg Shaffer.

17 And Greg is an Assistant Professor in the
18 Department of Economics at the University of Michigan, which
19 is a position that he has held since 1989.

20 Until December of this year, next month, Greg is a
21 visiting scholar in the Bureau of Economics here at the FTC.
22 And to show that he doesn't play favorites, in 1990, he
23 worked as a consultant at the Antitrust Division of the
24 Department of Justice.

25 Professor Shaffer, thank you for coming; and we

1 look forward to your remarks.

2 MR. SHAFFER: Thank you.

3 I would like to begin by stating what the problem
4 is, as I see it; what the market response to the problem has
5 been; what the economic effects are; and possible remedies
6 at the end.

7 Basically, the typical supermarket has room for
8 about 25,000; yet there are some 100,000 products available.
9 And between 10,000 and 25,000 items are introduced each
10 year.

11 Retailers are now confronted by more product
12 categories and more brands per category than at any time in
13 the past.

14 Coupled with the growth of retailing chains, this
15 explosion of new products has shifted the balance of power
16 away from manufacturers and intensified their competition
17 for the limited store space.

18 The scarcity of shelf space affects new and
19 established products alike. In many instances,
20 manufacturers are opting to pay retailers for their
21 patronage with up-front money.

22 Manufacturers of new products typically pay
23 "slotting fees" to secure a spot on the retailer's shelf and
24 in its warehouse, while manufacturers of established
25 products offer "pay to stay" fees to remain on the shelf,

1 "facing allowances" to increase their allocation of shelf
2 space or buy improved shelf positioning, "street money" to
3 pay for end-aisle displays, and "market development funds"
4 to subsidize loosely related retailer advertising and
5 promotional programs.

6 The salient characteristics of all these payments,
7 which I lump together under "slotting allowances," is that
8 they're not tied to the quantity sold. This lump sum
9 characteristic of slotting allowances is critical to its
10 analysis, since the economic effects would often be
11 different if the manufacturer were to purchase its shelf
12 space with marginal price breaks such as wholesale price
13 reductions or by offering more generous quantity discounts.

14 Since slotting allowances are typically negotiated
15 on an individual retailer basis, it's not known exactly how
16 much money is involved in the aggregate. But by all
17 accounts, it is substantial.

18 Trade promotions, of which slotting allowances are
19 a major component, annually account for nearly half of all
20 marketing dollars spent by manufacturers, with the rest
21 flipped between consumer promotions and media advertising.

22 Some observers have estimated that the annual
23 amount of slotting allowance runs between 6 and \$9 billion
24 dollars. I have seen estimates as high as \$18 billion.
25 What is not in dispute is that the practice of paying for

1 shelf space has grown considerably in the last decade.

2 The first cut at the analysis of the economic
3 effects of slotting allowances suggests that slotting
4 allowances are neither pro-competitive nor anti-competitive.
5 A lot of money changes hands; but in itself, this may be
6 viewed simply as redistribution of surplus between industry
7 participants with no welfare consequence.

8 Certainly claims that have been made that slotting
9 allowances are nothing more than part of \$30 billion in
10 annual food industry waste are exaggerated.

11 With so many products available and so little
12 space, retailers find themselves in possession of a very
13 valuable input, namely their shelf space. And so not
14 surprisingly, they will seek to be compensated for it.

15 That manufacturers may have to pay for something
16 that formerly was taken for granted may not be welcomed on
17 their part, but it is an inevitable consequence of different
18 market changes in the balance of power within the channel of
19 distribution.

20 Some elements of the distribution channel stand to
21 gain from the monetary transfers, others stand to lose. But
22 in the absence of additional plus or minus factors, there
23 may be little overall effect on consumer welfare.

24 So my remaining remarks today will focus on what
25 some of these plus or minus factors might be.

1 I take as a given that retail shelf space is
2 scarce and that retailers are entitled to use whatever
3 bargaining power that may arise from the scarcity to extract
4 concessions from manufacturers.

5 While I would prefer that retailers sometimes use
6 their bargaining power to negotiate lower wholesale prices,
7 which ultimately inure to the benefit of consumers, as
8 opposed to negotiating lump sum fees for themselves, I do
9 not care who gets the lion's share of the profit surplus.

10 Okay. So the first story is the risk sharing
11 story. It's a pro-competitive story.

12 Retailers often defend their solicitation of
13 slotting allowances by arguing that these payments
14 compensate them for the risks inherent in stocking a new
15 product.

16 One can think of these lump fees, then, as a form
17 of insurance, a way of guaranteeing the retailer a minimum
18 level of return against their opportunity cost of shelf
19 space; that is, how much they could make if they continue to
20 sell the product that they were selling.

21 The risk sharing story can be more rigorous as
22 follows: Consider a scenario in which a retailer must
23 choose between selling an established product that is one
24 whose future sales can be forecasted with a high degree of
25 accuracy, or selling a new product, one whose future sales

1 are unpredictable.

2 Faced with this choice, a retailer will only agree
3 to sell the new product if, after adjusting for risks, it
4 expects the new product to be at least as profitable as the
5 old product.

6 Now, in general, there are two ways a manufacturer
7 of a new product can provide the retailer with surplus. One
8 way is to lower its wholesale price. The other is through a
9 slotting allowance, or a lump sum payment.

10 Both ways may be equally good at transferring
11 surplus to the retailer, that is, increase the retailer's
12 expected profit, but the slotting is far superior in
13 mitigating the retailer's risk of carrying the new product.

14 Thus, the retailers incentives are skewed towards
15 bargaining for a slotting allowance, perhaps at the expense
16 of a lower wholesale price.

17 Indeed, any offer by a manufacturer of a new
18 product to lower its wholesale price may well be rejected by
19 the retailer if it comes bundled with a lower slotting fee.

20 Consumers are affected by this risk sharing in
21 potentially two ways. First, if the retailer is going to
22 stock the new products regardless, then the retail price may
23 be higher as a result of the higher wholesale price. And so
24 consumer welfare may be lower than otherwise would be the
25 case.

1 On the other hand, slotting allowances may be the
2 very thing that induces the retailer to stock the product in
3 the first place. If so, consumers likely benefit from the
4 change in variety. Otherwise, presumably the retailer would
5 have continued to sell the old product.

6 Now, while there's no way to know which of the
7 effects is more likely to dominate in any given case, on
8 balance, I believe the risk sharing story is, at most,
9 probably pro-competitive, especially if there is sufficient
10 competition at the retail level.

11 Second story: Allocating space to the highest
12 bidder, a pro-competitive story.

13 Now suppose that there are several products
14 competing for a limited number of shelf space slots. Since
15 slotting allowances enable a retailer to choose which
16 products to carry on the basis of who will pay the most,
17 these payments can sometimes ensure that the right mix of
18 products gets sold to the consumers. An implicit assumption
19 is that if a manufacturer is excluded from distribution
20 because it's unwilling to pay the going rate for shelf
21 space, then it must produce a less desirable product.

22 So here's one story that can be told.

23 Suppose each manufacturer has better information
24 than the retailer about whether its product is likely to be
25 a success or a failure.

1 Assume also that the manufacturer knows which type
2 of product it has, perhaps because it has previous
3 experience selling the product in other markets or because
4 it has access to test market studies that are unavailable to
5 the retailers.

6 Then, in this situation, the burden is on the
7 manufacturers to convince the retailers that their new
8 products really will sell well. Naturally the retailer will
9 be skeptical of any unsupported claims, claims that can only
10 be made convincing if the manufacturer backs them up by
11 offering to pay a large sum of money up front.

12 Slotting allowances, thus, provide a way for
13 manufacturers to convey to retailers their private
14 information about the likelihood that their products will
15 succeed.

16 Those who are willing to pay the most in slotting
17 allowances signal that their products will be more
18 profitable and, hence, more likely to provide better value
19 to consumers than the alternatives.

20 This story, like the risk sharing one before, is
21 most convincing if the product is truly new as opposed to a
22 repackaged old products or a "me-too" version. Moreover,
23 the story is not a compelling explanation of pay to stay
24 fees for established products, as these products already
25 have a track record recorded for all to see in the

1 retailer's scanner data.

2 Now an anti-competitive story. Again, allocating
3 space to the highest bidder.

4 The presumption that a manufacturer's willingness
5 to pay for shelf space is an accurate measure of its
6 product's value to consumers is not always correct.

7 While such a presumption may seem appealing by
8 analogy to the role played by price in equilibrating supply
9 and demand in final goods sales, the presumption ignores two
10 fundamental aspects which serve to distinguish intermediate
11 goods markets.

12 First, unlike in standard consumer theory where
13 buyers' utilities are independent of each other, a
14 manufacturer's willingness to pay for shelf space will
15 depend, among other things, on the degree of consumer demand
16 substitution among its set of would-be competing brands.
17 The more substitutable are the brands in the eyes of
18 consumers, the more any one manufacturer would be paid to
19 acquire scarce shelf space slots to foreclose its rivals.

20 Second, also unlike standard consumer theory where
21 individual consumers are too insignificant to affect price,
22 the price of shelf space to any one manufacturer is
23 determined, to a large extent, by the amount the retailer
24 could earn from selling its most profitable alternative.

25 This allows manufacturers to be strategic in a

1 sense that each can raise its rival's costs simply by
2 increasing its own offer of slotting allowances, in effect,
3 unilaterally raising the ante.

4 The raising rival's cost story can be made more
5 rigorous as follows:

6 Consider a scenario in which a retailer must
7 choose between selling an established product that's also
8 sold by competing retailers or a brand new product that's
9 not available anywhere else.

10 If the retailer puts his shelf space up for bid,
11 the manufacturer of the established product will often have
12 an incentive to bid more than the manufacturer of the new
13 product. The reason is that it will want to preserve its
14 monopoly in a product category; and, thus, it is willing to
15 share some of its profit with the retailer in order to do
16 so.

17 The manufacturer of the new product will be unable
18 to offer the retailer as much since, if it enters the
19 market, it must compete with an established product that is
20 already entrenched at other neighboring stores.

21 Consumers lose out in the raising of rival's cost
22 story for two reasons:

23 First, monopoly pricing is preserved on the
24 established product.

25 And, second, consumer choice is reduced.

1 But for this story to work, several elements are
2 necessary to work. First, the established product must have
3 power over price; otherwise, it has no monopoly profit to
4 lose.

5 Second, equally good alternative outlets must not
6 be available to the new product.

7 Third, the exclusionist manufacturer and its new
8 product rival must be competing for the same shelf space.
9 Otherwise, the retailer may simply choose to drop an
10 unrelated product.

11 And, fourth, slotting allowances must be legal.

12 The last anti-competitive story I call
13 "Dampening-Retail-Competition." And it relies on the
14 observation that lower wholesale prices tend to get passed
15 to consumers whereas slotting allowances do not.

16 Whenever a retailer has bargaining power and,
17 thus, can extract concessions from a manufacturer, he will
18 often have a choice to make among negotiating a lump sum
19 payment, a wholesale price discount, possibly some of both,
20 or a lump sum payment at the cost of a higher wholesale
21 price, or vice versa.

22 To the extent a retailer bargains for a lower
23 wholesale price, competitive pressures will lead it to pass
24 some of the discount through to consumers, thereby lowering
25 the retail price.

1 The mechanism for this pass through is subtle.
2 For any given retail price, a lower wholesale price makes
3 rival customers more attractive.

4 And so the retailer's own incentive will be to
5 lower its price. Anticipating this response, rivals will
6 also be led to lower their retail prices as well because the
7 competitor they now face is more aggressive.

8 Therefore, lower retail prices result overall.

9 If the retailer were, instead, to bargain solely
10 for a slotting allowance, leaving its wholesale price
11 unchanged, there would be no change in the attractiveness of
12 stealing rival customers. With its incentives unchanged, it
13 would not be led to cut its own price, assuming it was
14 already maximizing its profit. And more importantly, rivals
15 would not be inclined to cut their prices either. As a
16 consequence, retail prices would be unchanged.

17 Last, if the retailer were to bargain for a large
18 enough slotting allowance, its concession would come at a
19 cost of a higher wholesale price. This would make stealing
20 rival customers less attractive; and so the retailer's own
21 incentive would be to raise its price somewhat.
22 Anticipating this response, rivals would also be led to
23 raise their prices as well, resulting in higher retail
24 prices overall.

25 Since retail profits are higher in the second and

1 third scenarios, slotting allowances will be the retailer's
2 concession of choice, both jointly and individually.

3 But consumers lose with this dampening of retail
4 competition story because retail prices are higher relative
5 to what they would be if retailers bargained for lower
6 wholesale prices.

7 In practice, retailers may bargain for some of
8 both, a somewhat lower wholesale price so as not to
9 disadvantage itself relative to rivals and a slotting
10 allowance that does not get passed through.

11 The extent of the consumers' loss will depend on,
12 among other things, the extent to which retailers have power
13 over price. If individual retailers have little control
14 over price, competition will force retailers to negotiate
15 lower wholesale prices to stay competitive. The potential
16 harm from slotting allowances would then be diminished.

17 This story differs from the others in that it can
18 apply equally well to new products as well as established
19 ones whenever retailers have bargaining power.

20 In conclusion, slotting allowances have both
21 pro-and anti-competitive effects. The practice leads to
22 higher retail prices than would otherwise arise,
23 particularly in the short run, absent entry; but this
24 adverse consequence may be offset by improved retailer
25 product selection.

1 Product selection is more likely to be improved
2 when slotting allowances arise for risk sharing reasons and
3 when manufacturers have better information regarding their
4 products' likely success or failure in the marketplace.

5 These motivations for the practice are more cogent
6 for new products. Thus, slotting allowances observed on
7 established products should be viewed with suspicion.

8 Retail prices rise more with slotting allowances
9 when the retail sector is relatively unconcentrated or when
10 there are only a few large buyers. When these initial
11 conditions are not met, slotting allowances may be
12 relatively benign.

13 I have focused on slotting allowances and
14 wholesale price reductions as bargaining substitutes. I
15 have not considered other dimensions of the problem, such as
16 the possibility that trade promotions may substitute with
17 manufacturing advertising to consumers. Nor have I
18 addressed the possibility of retailer entry in response to
19 slotting allowances. These issues are in need of further
20 research.

21 COMMISSIONER STAREK: Well, thank you, Professor,
22 for pointing out that slotting allowances can be both
23 pro-competitive and anti-competitive. I found your
24 presentation extremely interesting.

25 MR. BAER: Mr. Chairman, could I just interrupt to

1 correct the record on one thing?

2 COMMISSIONER STAREK: Sure.

3 MR. BAER: I think when you made your oral
4 remarks, the second to last paragraph of the text, you said
5 "relatively unconcentrated."

6 MR. SHAFFER: I meant "relatively concentrated."

7 MR. BAER: And it probably has some significance
8 to the ultimate conclusion here.

9 MR. SHAFFER: As written, it's correct. My verbal
10 statement was incorrect.

11 COMMISSIONER STAREK: Thank you.

12 Well, now that we know that slotting allowances
13 can be pro-competitive and anti-competitive, we're going to
14 call on a practicing lawyer to resolve this problem for us.

15 Our final witness this afternoon is Bob Skitol.
16 And Bob Skitol is a member of the Litigation Department of
17 law firm of Drinker, Biddle & Reath.

18 From 1987 to 1992, he was a partner at Pepper,
19 Hamilton & Scheetz. And before that, he was a partner at
20 Wald, Harkrader & Ross.

21 Now on to the more important part of his resume.
22 In 1970 and 1971, Bob served as an attorney advisor to the
23 Chairman of the Federal Trade Commission and then served for
24 a year as a special assistant to the director of the Bureau
25 of Consumer Protection here at the FTC.

1 Bob specializes in antitrust and trade regulation.
2 And he has written and lectured extensively on this subject.

3 Bob, thank you for joining us again. I appreciate
4 it.

5 MR. SKITOL: My thanks to you, Commissioner, for
6 the invitation. I'm actually delighted to have this
7 opportunity to talk to the Commission about a subject that
8 has been of some interest to me over a period of years: The
9 proliferation of slotting fees and related arrangements in
10 the grocery industry and elsewhere around the consumer goods
11 sector.

12 Allow me, at the outset, to describe some
13 experience from my practice that underlie my comments. It's
14 been a somewhat unique experience and quite a bit different
15 from most other kinds of things that I do in my practice.

16 On about seven or eight separate occasions over
17 the past five years, a manufacturing client of my firm --
18 and, indeed, a different client each time -- has asked my
19 advice on "what is the law" and "what can be done" about
20 slotting fees of various sorts that the client was being
21 forced to pay just to get onto retail shelves or, in some
22 cases, to get decent space or to stay in the stores.

23 On each of these occasions, the client has told me
24 about heavy handed demands for payments of many kinds and
25 about how injurious all of this was to its business.

1 On each of these occasions, I have reviewed with
2 the client various possible grounds for attacking these
3 kinds of payments under one or another part of the
4 Robinson-Patman Act, under Section 5 of the FTC Act, and
5 even a variety of state law provisions that provide causes
6 of action, in some case, broader than available under
7 federal law.

8 Now, despite my eminently sage and even creative
9 advice on each of these occasions, no client opted to have
10 me proceed with any action on the situation. All of the
11 clients quickly rejected my suggestion of a tough lawyer's
12 letter to the retailers involved. The last thing any of
13 these clients wanted was to be identified as a complainant.

14 Right? Right?

15 And all clients also rejected, interestingly
16 enough, my suggesting that I be authorized to write or even
17 talk to anyone at the FTC on their behalf with a view to
18 urging an investigation, even when I've offered to do so
19 without the client's identity being disclosed.

20 COMMISSIONER STAREK: That's why we don't have any
21 RP cases.

22 MR. SKITOL: Exactly. It's my fault, and I take
23 the responsibility. And the reason is that these clients
24 have expressed to me considerable fear that any
25 investigation would be traced to them, that somehow or

1 another the retailer, subject to the ensuing investigation,
2 would surmise the client's identity and would retaliate in
3 some serious manner.

4 So, in short, I've encountered, over this period,
5 what has seemed to me a remarkable degree of apprehension,
6 amounting to real intimidation with regard to this subject.

7 The bottom line is that despite my long-standing
8 series of encounters of the sort described, this afternoon
9 is my first opportunity to discuss this practice with
10 representatives of this agency. I am here today carrying no
11 client's water and offer only personal observations with
12 best efforts, my prepared remarks say, in an unbiased
13 manner. I suppose I do have a bias that will be revealed by
14 what I have to say on this subject.

15 The term "slotting fee" encompasses such a diverse
16 range of payments and related arrangements occurring in such
17 a diverse range of market contexts that all of us need to be
18 extremely careful about generalizations in this area.

19 Some of the payments are just entry fees, flat
20 payments for a new product's access to retail shelves, X
21 thousands of dollars per store location without regard to
22 purchase volumes, or wholesale prices.

23 Other arrangements entail ongoing payments,
24 monthly or yearly. Some of them include negotiating
25 commitments on the retailer's part for such things as

1 especially favorable shelf location and other forms of
2 special attention.

3 Some retailers attempt to be even handed,
4 extracting these payments in some roughly equivalent manner
5 from all suppliers. Others appear to have no reservations
6 about different policies applied to different suppliers in
7 the same product category, including, quite often, making
8 more onerous demands on smaller than on larger rivals.

9 Turning to the manufacturer side of the equation,
10 some manufacturers make at least a semblance of an effort to
11 offer these payments or purported alternatives on
12 proportionally equal terms on quite an expansive definition
13 of that concept to all competing retailers with which they
14 deal. Most, however, don't have the slightest interest in
15 offering anything of this sort to retailers not powerful
16 enough to demand their due.

17 Some manufacturers at least make a stab at
18 papering their reliance on "meeting competition" from other
19 manufacturers they say are also paying the demanded tribute.
20 Some manufacturers don't even bother going through those
21 motions.

22 Looking at this from a market structure
23 perspective, some payments are made in circumstances where
24 both the relevant downstream retail market and the relative
25 upstream manufacturing markets are reasonably competitive,

1 inviting an assumption that the payments are consistent with
2 efficient distribution and appropriate cost shifting -- or
3 "cost sharing," I guess Greg would say "risk sharing" or
4 "risk shifting" -- with all being consistent with efficiency
5 goals and all being part of a healthy, competitive process.

6 Other payments, however, are occurring in
7 circumstances where both the downstream and upstream markets
8 are quite concentrated, oligopolistic, inviting an
9 alternative premise that there is monopsony power at work on
10 the retailer side and perhaps also market power enhancement
11 on the seller side going on at the same time.

12 The payments may, in fact, be unrelated to and far
13 in excess of associated costs or any other efficiency
14 rationale; and the net impact may well be anti-competitive,
15 entry-barrier-raising, concentration-increasing, imposing
16 disproportionate costs on smaller manufacturing rivals and
17 exacerbating the plight of smaller retailers with ultimate
18 adverse consumer welfare effects.

19 Now I've delineated a disparate picture of the
20 world of slotting fees, a world in which there's a wide
21 spectrum from situations at one end where the practice may
22 be entirely not benign and not deserving of this Agency's
23 attention, all the way to the other end where the practice
24 could be markedly injurious to the competitive process and a
25 proper target for enforcement action.

1 Surely this agency should be cautious about even
2 dipping its institutional toe in this water, hesitating to
3 intervene in complex relationships between retailers and
4 suppliers within rapidly changing distribution systems.

5 Let me, nonetheless, respectfully suggest some toe
6 dipping at or near the end of the spectrum where there is
7 cause for concern. And to be more specific, let me outline
8 a scenario for you.

9 Assume a fairly concentrated regional grocery
10 market with two giants controlling between them 60 percent
11 or 70 percent of all supermarket sales, the rest of the
12 market divided among small players. One of the products
13 being distributed comes from an upstream manufacturing
14 market with two giants controlling between them 60 or 70
15 percent of some nationally advertised product, the rest
16 divided among smaller manufacturers.

17 The two dominant retail chains demand from all
18 suppliers three different kinds of payments, albeit often
19 waived in the course of negotiations with the leading
20 suppliers but never waived or virtually never waived in the
21 case of the smaller competing suppliers: First, a hefty
22 entry fee for every new version of the supplier's product;
23 second, hefty additional monthly payments for premium
24 eye-level space on the shelves; and, third, hefty additional
25 payments in connection with retailer support or simply

1 retailer allowance of any consumer coupon kind of a program.

2 Also assume that each of these fees markedly
3 exceeds reasonably allocable retailer costs associated with
4 the product handling activities involved.

5 Now, the net competitive impact of these kinds of
6 practices in the market setting that I've outlined may not
7 be clear. One would want to know more facts like, for
8 instance, whether or not these fees in this market ever get
9 translated into lower consumer prices on the products
10 involved; whether there is any material diversion of sales
11 from smaller retailers, indeed, any trend of increasing
12 concentration in an affected geographic area as retailers
13 fail and go out of business; and whether there is a parallel
14 concentration trend at the manufacturing level as smaller
15 suppliers find it increasingly difficult to get effective
16 penetration at competitive prices.

17 Given systematic practices of the kind I've
18 described within market structures, both upstream and
19 downstream of the kind I've described, these factual
20 inquiries should be made because there is reason to suspect
21 the conclusion that there is a materially anti-competitive,
22 long-term impact.

23 And, again, the effects could include: increasing
24 concentration at both levels; higher costs of new product
25 introduction and, thus, necessarily higher costs of product

1 innovation; and, of course, ultimately higher consumer
2 prices, less consumer choice.

3 Now, assuming a conclusion that there are such
4 effects, the next obvious question is whether the described
5 payments can be challenged under existing legal authority of
6 this agency. And here I would suggest respectfully that the
7 answer is yes in the following respects:

8 First, the hefty entry fees could be challenged as
9 illegal brokerage for compensation in lieu of brokerage
10 reachable under Section 2(c) of the Robinson-Patman Act.
11 Section 2(c) has historically been used against secret
12 payments to buyer's agents. But it's also useable against
13 payments directly to buyers themselves.

14 Under this long-neglected, broad, and admittedly
15 blunt authority, there is no requirement to show competitive
16 injury or, indeed, to show discrimination; nor is there any
17 meeting competition defense.

18 The "except for services rendered" proviso should
19 pose a problem only if the payments can be shown closely
20 related to retailer costs in connection with actual services
21 rendered, which certainly seems unlikely in many, if not
22 most, of the situations of the kind that have been discussed
23 in the course of the afternoon.

24 Second, the other two payments can be challenged
25 as promotional allowances, reachable under Section 2(d) of

1 the Robinson-Patman Act.

2 Both the provision of favorable shelf space and
3 support for couponing are services that facilitate resale
4 for 2(d), as the Commission itself expressly recognized in
5 its issuance of revised Fred-Meyer guidelines five years
6 ago. Manufacturers' failure to offer the same payments to
7 all competing retailers, including those who purchase
8 through wholesalers, should be rather easy to show.

9 The "meeting competition" defense could pose a
10 problem. But here the Commission would have an opportunity
11 to underline the meeting competition requirements of good
12 faith, reasonable reliance, and meaningful verification as
13 critical to distinguishing bona fide from sham applications
14 of this common rationale for payments of all sorts.

15 These payments, of course, might also be reachable
16 under Section 2(c), as we've already discussed, and
17 conceivably also under Section 2(a) if they effectively
18 amount to indirect discounts on price that translate into
19 lower retail prices.

20 Third, the overall pattern of payments and
21 associated affects could be challenged as an unfair method
22 of competition under Section 5 of the FTC Act.

23 This, admittedly, would be a novel, but I submit,
24 nonetheless, sound application of Section 5 given the facts
25 we are assuming, fully consistent with the historic purpose

1 of this statutory authority as well as with long-standing
2 precedence defining its breadth.

3 It would be an appropriate use of Section 5 to
4 challenge a broad pattern of discriminatory practices that
5 violate the spirit even if not the letter of the
6 Robinson-Patman Act, indeed, as applied to systematic
7 discrimination practiced by dominant retailers in a way that
8 also works to the benefit of dominant suppliers.

9 This theory of Section 5 liability should be well
10 received by antitrust scholars of all stripes: The
11 Populist, the Chicago-School, Post-Chicago-School-
12 Strategic-Conduct-Raising-Rivals'-Cost Guys out there, and
13 even the middle-of-the-road, mainstream folks.

14 This could be the Commission's S&H case of the
15 1990s.

16 Now, having outlined some factual and legal
17 grounds for a challenge to some slotting fees in some market
18 contexts, let me offer two reasons why investment of the
19 Commission's limited resource in this area seems to me
20 warranted.

21 First, from all apparent indications slotting fees
22 have become widespread in the grocery industry, amounts
23 being demanded by powerful chains keep ratcheting up, and
24 the practice is spreading to various other consumer goods
25 industries.

1 For reasons I've already briefly outlined, the
2 practice presents significant potential for anti-competitive
3 impact in some markets.

4 Absent any hint of this Agency's concern with the
5 practice, there is every reason to believe the practice will
6 continue growing and will continue spreading throughout the
7 consumer goods sector, including into markets where the
8 impact will, in fact, be anti-competitive.

9 And let me suggest this second, not unrelated, but
10 independent reason; and that is that it's become equally
11 apparent that a lot of the people involved with this
12 practice -- payers and receivers alike -- believe, rightly
13 or wrongly that it is of highly questionable legality. But
14 that belief is no constraint on what people are doing.

15 People throughout the affected markets are now
16 convinced that adversely affect parties will never institute
17 private suits and equally convinced that the FTC has no
18 appetite for intervention.

19 In short, the consensus is that while the practice
20 seems illegal, there is no risk to its continuation and
21 proliferation.

22 The result, in many quarters, is cynicism about,
23 and even contempt for, the laws that purport to regulate
24 conduct of this sort.

25 The neglect and, perhaps it's fair to say complete

1 neglect of enforcement in this area over the past several
2 years has undermined incentives for voluntary compliance
3 with these laws. And it entirely undercuts the ability of
4 the private bar to counsel appropriately in this area. And
5 by that I mean our ability to encourage lawful and
6 discourage unlawful conduct of this ilk.

7 So in this environment, what more specifically
8 should the Commission do? I have a suggestion.

9 For starters, a serious study of the practice in
10 several selected regional grocery markets and as applied to
11 several selected product categories.

12 The study could elicit detailed information on
13 slotting fee policies of the leading chains in the regions
14 of interest, followed by interviews with personnel from both
15 the retailer and supplier firms involved.

16 Such a study might ultimately generate one or more
17 enforcement actions, but its purpose -- its main purpose
18 would be broader. The end result would be a public report
19 with analysis of apparent competitive effects, good or bad,
20 and an information base useful in the follow-up development
21 of Agency enforcement guidelines in this area.

22 The promulgation of those guidelines would be a
23 critical second step of the program. And it seems to me
24 reasonable to defer enforcement initiatives until after
25 guidelines are issued.

1 The guidelines should be flexible, indeed, I would
2 say exceptionally permissive, making it clear the Commission
3 has no intention to regulate in depth or otherwise meddle in
4 the complex give and take relations and financial
5 arrangements between retailers and their suppliers
6 generally.

7 At the same time, the guidelines would make it
8 clear that there are limits to the kinds and sizes of
9 discriminatory payments that power buyers may extract from
10 their suppliers and that this Agency will use the laws
11 available to it when disregard of those limits threatens the
12 competitive process.

13 Now let me close, if I may, with a reminder to all
14 attendees at this hearing that 1996 will soon be upon us;
15 and 1996 is the year of the 60th birthday of the
16 Robinson-Patman Act.

17 It was this Agency's chain store study in the
18 1930s that led directly to the enactment of this
19 legislation. What better way to commemorate than with the
20 announcement of a new chain store study, this time focused
21 on slotting fees?

22 Indeed, the Commission at this 60-year milestone
23 point might well want to take a hard look at whether this
24 particular depression era legislation, in its present form,
25 is an appropriate part of 21st Century antitrust policy.

1 There are some obvious reasons to believe it is,
2 in fact, not appropriate as it is now written and as its
3 convoluted text has been construed by the courts over the
4 course of six decades.

5 The act inhibits selective price discounting in
6 situations where such a practice would enhance competition
7 and serve consumer interests.

8 At the same time, as we've been discussing this
9 afternoon, the act does not appear to have inhibited
10 pervasive and markedly anti-competitive exercises of
11 monopsony power by dominant retailers, one of the
12 fundamental objectives of this legislation at its inception.
13 That is an objective of continuing importance to our economy
14 today and tomorrow and that warrants this Agency's fresh
15 review.

16 Thank you very much.

17 COMMISSIONER STAREK: Thank you, Bob. Very
18 provocative testimony, very interesting suggestions that you
19 have made. I would like to follow up on them.

20 I think what we need to do now is to take a short
21 break and reconvene. I would say that when we come back, we
22 probably ought to begin with an examination of how this
23 practice -- and we know that we're not talking about one
24 particular practice, but we're talking about an extensive
25 series of practices -- is really harming competition.

1 Professor Shaffer laid out a model where it could
2 harm competition. And certainly Bob and Nicholas have
3 provided us with examples where it appears that maybe
4 competition is being harmed.

5 But the argument on the other side of this, of
6 course, is who are really being harmed here are competitors
7 and not necessarily competition.

8 So I would like to begin with that after about a
9 10-minute break, if that's all right with everyone.

10 Thank you.

11 (Whereupon, a brief recess was taken.)

12 COMMISSIONER STAREK: It looks like we're ready to
13 reconvene. I ran up to my office to check my messages
14 during our break and found my staff huddled around the
15 television set. And, of course, I assumed they were
16 watching the in-house broadcast of these hearings. But,
17 instead, they were watching Colin Powell announce that he
18 will not be a candidate for elective office in 1996.

19 So I guess there are other things going on.

20 MS. VALENTINE: Hard to believe.

21 COMMISSIONER STAREK: I can't imagine why they
22 weren't tuned into Channel 2, which is the in-house channel
23 for these hearings; and presumably folks around the
24 Commission are watching.

25 Well, let's start with the question I posed before

1 the break. With all these different players involved in
2 this process with retailers and wholesalers and
3 manufacturers, where is the harm to competition.

4 Professor Shaffer laid out one model and maybe we
5 should start there.

6 MR. SHAFFER: I laid out two.

7 COMMISSIONER STAREK: Right. You laid out two.
8 Exactly.

9 Maybe we should start there and see just exactly
10 how these practices fit into the models that you described
11 of potential anti-competitive effect with regard to these
12 practices.

13 Does that sound like a good place to begin?

14 MR. SHAFFER: Okay. So there are two models that
15 I laid out in my paper.

16 One essentially is the retailer has a limited
17 amount of space, say this table. The retailer says: I'm
18 going to devote this amount of this table to stocking a
19 certain kind of product. Widgets.

20 So one manufacturer of Widgets comes along and
21 says: Okay. I want three-quarters of it. And as a result,
22 all of my competitors get one-quarter of it. Or maybe I
23 want four-fifths of it, and I'm willing to buy that amount.

24 It's possible that that one manufacturer -- or
25 maybe a couple of them -- could buy up all the space. And

1 that would be excluding rivals. It's a raising rivals'
2 costs story. That's possible.

3 COMMISSIONER STAREK: But why would that be in the
4 retailer's interest to sell off the space?

5 MR. SHAFFER: From the retailer's perspective, the
6 retailer is putting the shelf space up for bid and saying:
7 I will give it to whomever is willing to pay me the most.

8 Its incentive is very clear: It's out to
9 maximize, whatever, how much money it can make.

10 MS. VALENTINE: And this is assuming this is the
11 only shelf space?

12 MR. SHAFFER: Yeah. Now, that theory means -- so
13 there is an incentive for a manufacturer or a couple of
14 manufacturers to crowd out the other products.

15 Now, what that requires, among other things, is
16 that if you say to the retailer: Well, I want four-fifths
17 of this table, what you're really hoping, if you're the
18 manufacturer, is that the retailer, therefore, will not
19 stock one of your competitor's products.

20 So instead the retailer might say: Okay. Well,
21 there's this product down on the other end that's totally
22 unrelated to Widgets and I'm just not going to stock that;
23 but I'll stock your competitors'.

24 Okay? So it better be the case, for this strategy
25 to work on the part of a manufacturer, that all of the

1 manufacturers of Widgets are really vying for the same shelf
2 space.

3 MR. DANIEL: One question I would have to follow
4 up on that, to the practitioners who know the market and
5 know the practices out in the field, is: Do we see those
6 kinds of restrictions in slotting allowance contracts?

7 Because it would seem that it would be relatively
8 easy, absent those restrictions, for a retailer to expand
9 the space to rivals if those rivals had more attractive
10 products than the ones I'm trying to sell down here at this
11 end of the table.

12 And I'm just curious as to whether the contracts
13 between the manufacturers and the retailers have these types
14 of restrictions to provide those assurances.

15 MR. PYLE: I can think of one instance in the
16 southern United States that's specific to that, and it was
17 that captive bakery assets were sold to a large multi-state
18 baker; and as a result, the bread aisles, he had 24 feet of
19 bread aisle. And prior to the acquisition of those assets,
20 that one manufacturer had about four feet of the bread
21 aisle.

22 After the acquisition was completed, they had 20
23 feet of the bread aisle. And all the rest of the
24 competitors were reduced to four feet. They couldn't buy
25 any more or any less in the case of that one retailer.

1 And that's still the case in those markets in the
2 South.

3 MR. DANIEL: And the retailer can't or won't
4 expand the other competitor?

5 MR. PYLE: Has not, no. There is that implied
6 control over the bakery shelf space as a result of the
7 purchase of those bakery assets of the retailer.

8 MR. DANIEL: Interesting.

9 MR. PYLE: I mean that's one example.

10 MS. DeSANTI: I don't mean to divert from what I
11 think Commissioner Starek has focused on. In fact, the key
12 question for this Agency has to be: What's the affect on
13 competition? What's the affect on consumer welfare?

14 It's not part of our jurisdiction to help
15 competitors.

16 But, obviously, I mean it's helpful to have all of
17 you come and talk to us about it. And I'm just somewhat --
18 well, there are sort of two issues I would like to pursue
19 here.

20 One is: How are we going to find out more about
21 this?

22 And part of what we would need for you to take
23 into account when you think about this is, Mr. Pyle, you're
24 telling us you don't have any members who are racing to come
25 down to tell the Commission about this.

1 MR. PYLE: Not publicly.

2 MS. DeSANTI: Not publicly.

3 MR. PYLE: I think behind closed doors they
4 wouldn't have any problem.

5 MS. DeSANTI: Behind closed doors they wouldn't
6 have any problem, if we wanted more information.

7 Mr. Skitol, you have clients who wouldn't even do
8 it behind closed doors. And yet you're proposing that the
9 Commission study this issue.

10 As a practical matter, how much farther can we go
11 if we have -- you know, I'm glad that you think you have
12 some members who would be willing to tell us about this
13 behind closed doors.

14 But, inevitably, if we went farther in terms of
15 doing a study, we're going to then make public the results
16 of that study. If there were likely to be any enforcement
17 action, it would be taken in a public forum.

18 How do we confront this issue that you've both
19 raised to different extents of whether people are willing to
20 speak to the Commission?

21 MR. SKITOL: I think that is a problem that's got
22 to be addressed. There is no doubt about it.

23 My experience has been what I was indicating
24 before, that if the Commission were to commence a study in
25 some major way and then were to ask the bar out there to

1 bring clients in, I would certainly go to my clients, and my
2 clients would say: No, no, no. Let's leave it to others.
3 But I would certainly try again and might or might not
4 succeed.

5 Certainly a place to start would be with the
6 Commission's -- not just commencement of a formal study, but
7 the Commission's use of compulsory process in a non-hostile
8 manner but as part of a Section 6 investigation.

9 There's no secret about who the targets would be.
10 My own bias on this is that the -- one clear line of
11 demarcation is competitive versus non-competitive market
12 structures.

13 I think the answer to the question: Why would a
14 retailer not make more space available? The answer is that,
15 in a competitive market, presumably the retailer is going to
16 be sure to stock products that consumers want. And if
17 Retailer A doesn't do so for this manufacturer or that,
18 there are other competing retailers out there.

19 But my premise is that you've got lots of regional
20 grocery markets that are non-competitive in structure that
21 are concentrated markets where there is monopsony power
22 where retailers have the ability to deny consumers what
23 consumers want and to be sent in other directions.

24 Well, the Commission could certainly -- it's a
25 matter of public knowledge as to which markets -- you know,

1 this region versus that region. If you were going to pick
2 the Washington, D.C., grocery market, there's no secret as
3 to the identity of the leading supermarket chains in this
4 metropolitan area. If the Commission were to decide to
5 study this phenomenon and to pick a half dozen particularly
6 concentrated regional markets, that would be one approach.

7 And in Washington, there wouldn't be any mystery
8 about how to start the investigation. You could start it
9 with Section 6 questionnaires directed at the two leading
10 supermarket chains in this metropolitan area.

11 You would get basic information about slotting
12 policies, about relations with leading suppliers in any
13 number of product categories that might be identified, and
14 you go from there.

15 As a result of initial investigative efforts
16 directed at retailers, you would end up with a list of
17 smaller suppliers that the Commission could take the
18 initiative to contact.

19 And then it's a whole different game. It isn't a
20 matter of a private lawyer trying to lean on his client to
21 take the initiative and become a volunteer. It's a matter
22 of the Federal Trade Commission taking the initiative and
23 going to small manufacturer X, Y, Z; and those small
24 manufacturers, perhaps, going to their lawyers and saying:
25 What should I do?

1 And their lawyers then being in a position to say:
2 Well, look. This is a serious and important inquiry. And
3 my recommendation is that you cooperate with the Agency.

4 MR. BAER: May I follow up?

5 Mr. Skitol, let's assume all of that happened and
6 let's assume you found some retail markets where we all
7 concede that some local retail markets are concentrated --
8 and there probably is a degree of market power that gives
9 them more control over what goes on the shelf than in other
10 markets -- what would you do with respect to slotting
11 allowances in markets where you found that to be a problem?

12 Just so you know, my concern here is I'm not sure
13 what remedy we're heading towards here. I really don't
14 know. And I don't know how that remedy is meaningful. And
15 that's really where I'm going with my question.

16 MR. SKITOL: I think that you've put your finger
17 right on a very challenging aspect of this.

18 I think where would you end up or might you end up
19 that would be a manageable and workable rule of law? Well,
20 it would have something to do with consistency and
21 reasonable relationship to costs.

22 It seems to me that, in principle, there is --
23 Greg was talking about risk sharing, risk shifting. And
24 that's an appropriate thing for all retailers to want to do,
25 whether they be leading retailers or non-leading retailers.

1 And it's a valid business objective in a concentrated and an
2 unconcentrated retailing environment.

3 But there is reasonable and legitimate risk
4 shifting, and then there is totally -- and then there's
5 something else where it may be labeled risk shifting but, in
6 truth and in fact, it bears no relationship to actual costs.

7 The amounts being demanded are so vastly in excess
8 of costs involved and the disparateness of the demands on
9 the inconsistency and the discrimination in the way the
10 policies are applied are such as to completely belie the
11 legitimacy of the rationale

12 So, you know, it's like lots of other things in
13 antitrust law. We have a Section 2 law regime today, the
14 law of monopolization that says that there's lots of
15 conduct, that we regulate conduct on the part of dominant
16 firms by making factual inquiries as to whether or not the
17 particular conduct, whether it be a design decision or
18 exclusive dealing or whatever, whether or not in a given
19 factual context, the manufacturer can show a legitimate
20 business justification for the particular way that its
21 policies have been implemented.

22 And I think you essentially would end up the same
23 way here. The Commission would be serving the public
24 interest and doing good if it got out the message to
25 retailers out there, to the dominant retail chains, that

1 they need to clean up their acts. They don't need to drop
2 the whole idea of slotting allowances, but they need to have
3 reasonable and consistently followed slotting fee policies.

4 MR. BAER: The sum and substance, then, of the
5 relief that you would tentatively posit here -- I realize
6 I'm putting a lot burden on you in a situation where you've
7 just called for a study. So I'll concede that at the
8 outset. But the tentative relief that you would see is,
9 basically, some sort of cost-based requirement imposed on
10 the retailer and some sort of even-handed treatment
11 requirement.

12 And the question I have is: If the fundamental
13 problem here is basically the bargaining relationship
14 between retailer and supplier and there is some market power
15 there on the retailers level, is that really going to solve
16 the problem? Or is this going to be the equivalent of that
17 old study in the late '60s, early '70s when, in order to
18 deal with increasing crime in Manhattan, more police were
19 put on the streets and the result was more crime in the
20 subway; they put the police in the subway, and the stats
21 showed, you know, the crime went back up on top?

22 And I'm not necessarily saying here it's a crime.
23 But what I'm trying to understand is whether -- and maybe
24 Professor Shaffer ought to get into this -- but given that
25 nature of the relationship where there seems to be a bidding

1 war for shelf space going on, what would economic theory
2 suggest is likely to happen if we ban one manifestation of
3 that relation?

4 MR. SKITOL: Let me just add one thing and then
5 turn it over to Greg.

6 I don't think it's so much a question of banning
7 as imposing a reasonableness standard.

8 I don't know if you'll like this analogy or not,
9 but it's similar to where antitrust law and policy is today
10 on the essential facilities doctrine, if you will. You
11 could think of retail shelf space as an essential facility.
12 And there are some dominant firms out there controlling this
13 essential facility.

14 And in some markets there is reasonable
15 even-handed access to the essential facility; and in other
16 markets, the controller of the facility is abusing its power
17 over that facility. And it's a little uncomfortable to get
18 into the -- there's no denying the fact that antitrust
19 courts and agencies are into the regulatory business already
20 in more conventional applications of that doctrine.

21 And what we're talking about here with slotting
22 allowances is a variation on that theme.

23 MR. SHAFFER: Okay. I have two points.

24 First of all, I see it as a fundamental problem of
25 shifting the balance of power that has gone more towards the

1 retailers.

2 In terms of banning the practice, here's the
3 difficulty with that: Suppose if the practice is legal, the
4 retailer says to the manufacturer: I want \$100,000; and, by
5 the way, when you show up with it, make sure it's all in
6 20s, or low denominations, bring it in your briefcase.

7 Now suppose the Agency says that's illegal, you
8 can't take the money and put it on top of the table and you
9 can't put it underneath the table either.

10 That may not solve the problem for the following
11 reason: There are other ways that the manufacturer can
12 funnel money to the retailer which you wouldn't dream of
13 challenging -- or maybe you would.

14 But for example, if the money is tied to services
15 that the retailer provides. So, for example, it's legal for
16 the manufacturer to compensate the retailer for advertising
17 that the retailer does, cooperative advertising.

18 So now if you tell the retailers and the
19 manufacturers that you can no longer -- we will no longer
20 allow these slotting fees, maybe what you'll see is an
21 increase in amount of cooperative advertising that's done;
22 where, in fact, the manufacturer has no intention of
23 verifying to see if the advertising was done and the
24 retailer has no intention of doing the advertising. It's
25 just a way to get around any law that you might write that

1 would say: We're banning slotting fees. So instead, you
2 could channel it into cooperative advertising. Or it might
3 get channeled into payments for end aisle displays. Instead
4 of \$500 per end aisle display, you might have \$3,000, \$5,000
5 for an end aisle display.

6 Or there are a variety of other things that would
7 be ways around the problem.

8 So I guess I'm a little unsure of exactly how one
9 would go about it, even if one wanted to, to ban this
10 practice, because manufacturers and retailers will find
11 other ways around it.

12 The second point that I wanted to make pertains to
13 this cost-based relationship. Now, the relevant costs from
14 an economic point of view is the retailer's opportunity
15 cost. Okay?

16 So the retailer's cost of stocking a new product
17 includes the profit that it would have made had it stocked
18 what it was going to stock. And so you take whatever that
19 turns out to be, that's part of its cost of stocking a new
20 product.

21 So I'm not sure how one could even go about
22 estimating what this is or defining it.

23 Now, sometimes what people mean by cost-based is
24 what I referred to in footnote 6. There are costs, like
25 actual out-of-pocket costs for stocking new products. For

1 example, paying someone to enter new item information into
2 the computers or expenses that are incurred in actually
3 rearranging the items in your warehouse to make room for the
4 new products or notifying individual stores of the new
5 products or maybe you have to redesign your shelves. These
6 are out-of-pocket costs.

7 But on top of that, from the economic perspective,
8 there's also the opportunity cost of the shelf space. And
9 it just doesn't make sense to say that these things have to
10 be cost based, however you define costs.

11 MR. BAER: Can I just ask one more question and
12 throw it back over to Mr. Pyle.

13 And what comes out clear is that your members have
14 a concern that they're not sure they're always getting
15 treated fairly with regard to slotting fees. But at the
16 bottom, you come up with a recommendation not for this
17 Agency to do aggressive law enforcement but for, perhaps,
18 some sort of code to be developed.

19 Now, aside from the usual quite sage counsel that
20 people give their business members -- "don't go near those
21 agencies, you're asking for trouble" -- what is the reason
22 you get up to the line -- you know, you didn't pull the
23 trigger here. I mean, you didn't give us a chance to do
24 anything.

25 MR. PYLE: Well, our members want a chance to

1 council and coalesce in Florida in February at the meeting.
2 That's why I had a litany of very specific recommendations
3 from the tax treatment of the costs, et cetera, et cetera.

4 MR. BAER: Okay.

5 MR. PYLE: Which we want to consider in February.

6 However, I do not want to discourage this body
7 from looking into the question further by any means. We
8 think that, at least from some of the comments from some of
9 the bakers that we got, that that was probably the thing
10 that they wanted the most collectively.

11 But I'm not at liberty to say that that's what we
12 want to do.

13 With respect to your earlier question, what we're
14 looking for is a level playing field. If XYZ Baker is
15 offered premium space for a certain amount of dollars, we
16 want to make sure that ABC Bakery has been offered that same
17 opportunity in sort of a creation of a level playing field,
18 with maybe a plack or a seal of good businessmanship or
19 something of that nature for that purchasing agent to have
20 on his wall.

21 That's what we need. We want a level playing
22 field.

23 MR. BAER: You're not objecting to a bidding war,
24 if I hear you right, as long as it's fair, that is,
25 everybody gets a chance to bid for space.

1 Or is that an over simplification of your remarks?

2 MR. PYLE: I think that's a fair assessment, that
3 what we want is a level playing field.

4 With regard to Commissioner Starek's earlier
5 requests for comments of specific instances of
6 anti-competitiveness because of slotting.

7 I have a lot of bakers that are institutional
8 bakers. They sell to restaurants, hospitals, food service
9 accounts like that.

10 They have found it very difficult to go into the
11 retail side as a result of the slotting fees. You'll see
12 bread offered at smaller delis for sale in retail
13 establishments that may have a deli that you wouldn't find
14 available on the regular bread aisle. At least here in
15 Washington I find that experience.

16 And those same bakers that are available in the
17 small delis and smaller retail slots have not been able to
18 afford their way into the big guys, particularly in this
19 market, particularly for a baker whose trucks you see a lot
20 on the streets here in Washington. But you don't see their
21 bread at Safeway and Giant.

22 COMMISSIONER STAREK: That's because the fees are
23 so high?

24 MR. PYLE: To get into the big guys. But the
25 IGA's is another story.

1 The other is particularly for southern,
2 independent bakers. The smaller regional bakers have a very
3 difficult time competing against the mega regional baker,
4 because they can't service every single one of the chain's
5 stores. They're only able to supply a limited region.

6 Yet, they're asked to base a slotting fee based on
7 what that mega bakery is charging in that region. And so
8 it's very difficult to get shelf space at any price, for
9 that matter, if you can't service all those accounts.

10 So that's where it's a big buy/little guy
11 competition thing, in my opinion.

12 MS. DeSANTI: I would like to follow up, Mr. Pyle.
13 It seems to me that you have an interesting proposal in
14 terms of the voluntary adherence to some form of a
15 supplier/retailer code of ethical standards. That seems to
16 me to relate to Bill Baer's question about: What's the
17 remedy to this situation?

18 Are you at liberty to give us any more information
19 on what such a set of standards might look like?

20 MR. PYLE: I would rather talk among my bakers and
21 get back to you with that in writing.

22 But it would be for an equitable playing field at
23 minimum. Equal treatment.

24 MR. DANIEL: If I could just ask, following up on
25 your hypothetical and your description of the Washington

1 market where we have some, obviously, large supermarkets
2 that do not carry certain products, how can we tell, as
3 enforcement agencies, whether that outcome is the result of
4 the bidding war, in which case there's a limited amount of
5 space in Safeway and Giant, and these are the ones who
6 prevailed in that war, which you presume to be the result of
7 some competitive process, and by contrast an
8 anti-competitive outcome?

9 How would you recommend we parse through that
10 difficulty?

11 MR. PYLE: Through a type of survey like Bob was
12 talking about where you'd be asked -- you would be surveyed
13 by the Commission under its powers of reviewing competitive
14 situations. I don't know the legalese, but you would have
15 to ask and go out and seek that sort of information from the
16 marketplace.

17 Perhaps we could give you some direction in who to
18 ask. But I think they would have to be compelled to offer
19 that kind of feedback to you.

20 I don't think it would be --

21 MR. DANIEL: The question I have is that, suppose
22 that we were to be told -- what it sounds like you're saying
23 is that the small bakers just cannot afford to get into the
24 larger chains, and they say they can't pay the fee required
25 of the supermarket.

1 MR. PYLE: Or they refuse to.

2 MR. DANIEL: Or they refuse to.

3 That is also consistent with the bidding market
4 that you described as a level playing field, that you're not
5 being discriminated against in the sense of being unwilling
6 to be offered that space, but that you're just simply unable
7 or unwilling to pay the price that appears to be necessary,
8 or at least the supermarkets claim, which is the price for
9 the space.

10 I'm trying to get a handle on whatever indicators
11 we might be able to learn from the bakers and others to
12 distinguish between the bidding market and the
13 anti-competitive outcome?

14 MR. PYLE: That's a very good question. I'll have
15 to get back to you on that.

16 MR. DANIEL: We would greatly appreciate it.

17 MR. SKITOL: Can I throw in a comment or two about
18 that?

19 I don't think that a level playing field in and of
20 itself is sufficient. I think it's a necessary but not
21 sufficient solution to this.

22 You can have a level playing field with open
23 free-for-all bidding, biggest pocket book wins. As I
24 understand Greg's anti-competitive examples, one or both of
25 them involved a level playing field, biggest pocket wins.

1 And that's anti-competitive.

2 There's another side of this. It's not just a
3 level playing field in the upstream market. We also need to
4 be concerned about a level playing field in the downstream
5 market.

6 We still have a law violation, and we still have a
7 significant potential for anti-competitive impact where you
8 have a dominant retailer acting even-handedly and uniformly
9 vis-a-vis upstream suppliers but making demands that result
10 in each of those upstream suppliers acting in a manner that
11 discriminates against and undercuts the long-term viability
12 of smaller retailers.

13 In other words, you still have monopsony power
14 being exercised to get a bunch of upstream manufacturers to
15 pay one retailer a whole lot of money, which isn't going in
16 a proportionally equal or anyway at all to competing
17 retailers.

18 If there was some way to add to the level playing
19 field a reasonable relationship to cost standard of some
20 sort -- and I recognize and appreciate what Greg was saying
21 about looking at opportunity costs; I don't know if I agree
22 with him about that or not -- but certainly there is a
23 difference between reasonable relationship to cost and
24 something that doesn't come even close to that.

25 If you adopted a standard of reasonable

1 relationship to cost in some manner or another, you would
2 have something that looks like there's a way to regulate
3 this consistent with existing Robinson-Patman law; and you
4 might also have something that is even acceptable to the
5 retailing segment.

6 MR. BAER: I take it that everybody agrees that,
7 at a minimum, vigorous merger enforcement at the retail
8 levels, especially the supermarket level, is one way to
9 ensure that we prevent accumulation of market power, which
10 effectively, I think is what you're saying; and what you're
11 saying, Mr. Pyle, is give us a level playing field where, if
12 you've got real competition at the retail level, you're in a
13 much better position to have a fair fight to get on some
14 shelves in some stores.

15 MR. PYLE: That's right.

16 MS. DeSANTI: I was interested in following up,
17 Bob, on some of your remarks about the Robinson-Patman Act.

18 On the one hand, you have proposals for potential
19 enforcement actions under the Robinson-Patman Act. And, on
20 the other hand, you have a proposal that maybe this is worth
21 a fresh look because there are some aspects of that act that
22 are, perhaps, as you put it, not appropriate as they're now
23 written.

24 Is there anything you can expand upon in terms of
25 why you think the Robinson-Patman Act might be worth a fresh

1 look?

2 MR. SKITOL: Sure. Sure. And this would be a
3 nice kind of topic for a half-day seminar at the birthday
4 party for the Robinson-Patman Act so we can talk this over.

5 Over the years, I think it's become pretty clear,
6 at least in counseling and doing Robinson-Patman counseling
7 over the years, you really kind of get struck at just how
8 convoluted is the text of the different sections and how it
9 really -- what's come out of six decades of jurisprudence
10 interpreting the different parts; and the defense is really
11 quite a hodgepodge that doesn't work too well together.

12 The act in its inception was primarily aimed at
13 stopping abuse by big buyers. And, in truth and in fact,
14 over the years, it's become far more a statute directed
15 against and used against small sellers than it is against
16 big buyers. And there are a variety of reasons for this.

17 Section 2(f), which is the only part of the
18 statute which expressly applies to buyers, imposes a tougher
19 standard to prove a violation because of a knowing element
20 than does 2(a) and the other sections directed at sellers.

21 Over the years, the meeting competition defense
22 has been interpreted in a way that has created just a huge
23 rationale for, some would say, evading the purpose of the
24 whole statute and others would say that it's, as the Supreme
25 Court has said, that the meeting competition defense is the

1 critical means for making the whole Robinson-Patman
2 apparatus reasonably consistent with antitrust law in
3 general.

4 I don't know if it's proven. It's nice to say
5 that, and the Supreme Court has said that a number of times;
6 but I'm not sure that's exactly right.

7 Certainly where we are in the law today, after
8 A&P-Borden, the knowing requirement for buyer liability on
9 top of what the Supreme Court has done to the meeting
10 competition defense, effectively means that 2(a) and 2(f)
11 are not very useable at all.

12 I don't have any clear, crisp answer to your
13 question except that I think that the statute in its present
14 form could used by this Agency now today more than it has
15 been, if you picked some good cases.

16 On the other hand, there are a lot of anomalies in
17 the statute. And after 60 years of experience, given the
18 right thought put behind it, I think the group of us in the
19 room today could sit down in a room for a couple of days and
20 we could rewrite the statute in a way that we would all
21 agree is more sensible.

22 So one could imagine this Agency, in the aftermath
23 of a study and so forth, making some respectful
24 recommendations to Congress for updating and refining the
25 statutory language.

1 MS. VALENTINE: I have one -- oh, you want to go
2 ahead? Because mine's going to be starting a new question.
3 So if you want to direct something back --

4 MR. BAER: Go ahead.

5 MS. VALENTINE: Okay. This is actually returning
6 to, I think, one of the initial thoughts that Commissioner
7 Starek left us with at the break, which was trying to focus
8 on at what level some of this is taking place.

9 And I think some of the things that we've been
10 talking about now have been assuming that the problem in the
11 concentration in the power, if there is a problem, is at the
12 retailer level.

13 I was simply wondering about whether you have ever
14 encountered instances when your competitors, your rivals,
15 have made your costs higher along -- or the pro-competitive
16 story, perhaps, if the problem is competition at the
17 retailer level.

18 Did you encounter any instances where competitors
19 of yours were effectively raising your costs by making these
20 payments without the retailer starting the bidding war, so
21 to speak, and making it impossible for you to come in as a
22 new entrant?

23 MR. PYLE: No. There are large manufacturers who
24 refuse to pay slotting fees, and they are public in that
25 announcement; and grocery stores still carry their products.

1 They feel compelled to.

2 What's been reported in the media about Proctor &
3 Gamble and Campbell's Soup don't pay slotting fees. And a
4 grocery store would leave a lot to be desired in the soup
5 aisle or in the soap aisle without the products from those
6 two manufacturers.

7 So maybe this is sort of the reverse of what
8 you're looking for, but there are instances when someone is
9 so big that they just refuse to pay slotting fees.

10 COMMISSIONER STAREK: Let me follow up on that.
11 And, Bob, you also alluded to this in your testimony, where
12 you mentioned that, often, the demands are more onerous on
13 the small suppliers than they are on the larger rivals.

14 Is that the case? In other words, let's take
15 soap. Okay? P&G doesn't pay any slotting allowances, but
16 we all know that P&G products are carried.

17 Would retailers still charge slotting allowances
18 to the other competitors then for the shelf space that
19 they're not going to allocate to P&G?

20 MR. PYLE: Assuming that P&G was not part of the
21 picture?

22 COMMISSIONER STAREK: No, no. P&G's in the store.
23 They're on the shelf and they've got 25 percent of the shelf
24 space for laundry detergent. Right?

25 What about these non-P&G folks? Would retailers

1 charge slotting allowances for the other 75 percent of that
2 space and everybody knowing that P&G's not paying slotting
3 allowances for their 25 percent of the space?

4 MR. PYLE: I would think if a manufacturer was
5 seeking to put a product into that soap niche that they
6 would have to pay dearly to get in there.

7 COMMISSIONER STAREK: Oh, I see. A new product?

8 MR. PYLE: A new product, yeah.

9 COMMISSIONER STAREK: Professor, do you know about
10 this?

11 MR. SHAFFER: I don't have specific examples. But
12 you wouldn't necessarily want everybody to be paying
13 slotting allowances.

14 There are two ways that a retailer can get
15 profits. It can get it through when somebody gives you a
16 lump sum payment up front. Or it can get it through the
17 markup that it has on every unit that it sells.

18 If Proctor & Gamble's product sells tremendous
19 volume, the retailer can get profit that way. So there's no
20 reason why Proctor & Gamble should have to pay, necessarily.
21 A retailer may well be getting enough profit to cover,
22 essentially, its opportunity cost for the shelf space that
23 way without Proctor & Gamble having to pay.

24 Where some of these smaller brands, they don't
25 have the volume, they've got to pay up front.

1 COMMISSIONER STAREK: Good point.

2 MS. VALENTINE: That's a very different story from
3 what --

4 MR. SHAFFER: There's no reason to require all the
5 manufacturers to pay the same amount, because the volume is
6 going to be different for each brand.

7 MR. SKITOL: Yeah, I've heard the story
8 articulated along the same lines that there's a reasonable
9 and an unreasonable explanation for disparate treatment.

10 If you accept that risk shifting or cost shifting
11 is legitimate, then when it comes to the risk of failure on
12 a new product, there's something to be said for the notion
13 that when Proctor & Gamble comes out with a new soap and
14 backs it up with mega consumer advertising, the risk of
15 failure from the retailer standpoint is less than the risk
16 of failure when it's a small regional advertising. And that
17 risk differential can appropriately be treated through
18 differential slotting expectations.

19 And to my mind that's a plausible, legitimate
20 differentiation. The problem is that that plausible,
21 legitimate explanation gets twisted all out of shape.

22 See, my suspicion is, if the Commission looked at
23 this, if the Commission studied what is actually going on in
24 a competitive market and then what's happening in a
25 concentrated market, you'd probably find in the competitive

1 market that there are differentials and so forth; but you'd
2 probably find in a concentrated market that the
3 differentials are quite extreme.

4 MS. VALENTINE: "Concentrated market" you're
5 talking about is concentrated at the retailer level now?

6 MR. SKITOL: Well, mainly at the retailer level,
7 but I'm really thinking in terms of the real problem the
8 bilateral -- what some people talk about as the bilateral
9 oligopoly structure, where you've got a very concentrated
10 retailing segment dealing with some very concentrated
11 manufactured product categories, and you've got the
12 potential for two things happening simultaneously: a
13 monopsony power down below, which is also enhancing market
14 power above at the same time.

15 COMMISSIONER STAREK: I have one last question.

16 Given that this seems to be working quite well for
17 the large retail groceries, does anybody know if this is
18 expanded into other consumer product industries or whether
19 it's likely to expand?

20 I mean, if I were running a department store, I'd
21 sure give this a lot of good thought.

22 Does anyone know?

23 MR. PYLE: It certainly has stepped down from the
24 larger commercial grocery stores into the convenience store
25 market.

1 COMMISSIONER STAREK: But it's still, as far as we
2 know, just limited to food and other products?

3 MR. SHAFFER: Hardware stores.

4 COMMISSIONER STAREK: Hardware?

5 MR. SHAFFER: Yeah.

6 COMMISSIONER STAREK: No kidding?

7 MR. SKITOL: You can certainly -- there's no
8 apparent reason why this would not work just fine and,
9 indeed, wouldn't work in a perfectly anti-competitive manner
10 in the retail distribution of PC's, and given what's
11 happening with increasing concentration in mass
12 merchandising of computer products.

13 COMMISSIONER STAREK: But you think, Greg, it's
14 going on in hardware stores?

15 MR. SHAFFER: I believe so.

16 COMMISSIONER STAREK: It wouldn't surprise me.
17 You know, I noticed in one that I frequent has completely
18 eliminated a major brand of light bulbs. In other words,
19 you can't even find the General Electric light bulb in this
20 place, whereas, it used to sell them all the time. And I'm
21 sort of curious when I go in there why don't they carry
22 General Electric light bulbs.

23 Maybe the answer has to do with slotting. I don't
24 know.

25 MR. SHAFFER: It could be. Or maybe whoever's

1 light bulbs are being sold purchased an exclusive. I don't
2 know.

3 COMMISSIONER STAREK: Yeah.

4 Well, all right. If there are no more questions,
5 I certainly want to thank everybody. It's been very
6 illuminating for me. I learned a lot. You have posed some
7 interesting suggestions about further studies.

8 We'll look forward to hearing more from the bakers
9 after they rendezvous in Florida for their annual meeting in
10 February.

11 And I would just like to thank everybody for a
12 very interesting and educational afternoon.

13 Thank you for coming.

14 (Whereupon, at 4:05 p.m., the hearing was
15 recessed.)

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C E R T I F I C A T E

DOCKET/FILE NUMBER: P951201
CASE TITLE: GLOBAL AND INNOVATION-BASED COMPETITION
HEARING DATE: November 8, 1995

I HEREBY CERTIFY that the transcript contained herein is a full and accurate transcript of the notes taken by me at the hearing on the above cause before the FEDERAL TRADE COMMISSION to the best of my knowledge and belief.

DATED: November 8, 1995

SIGNATURE OF REPORTER

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(NAME OF REPORTER - TYPED)