Exclusion and Antitrust

Thomas G. Krattenmaker and Steven C. Salop

ANTITRUST LAW is often viewed as a lengthy series of complicated, specialized rules. In fact, however, the basic proscription of antitrust is relatively simple: Firms should not be permitted to obtain or exercise the power to raise prices above competitive levels by undue collusion among competitors or by unjustifiable exclusion of rivals. Antitrust concerns collusion and exclusion.

At present, much academic and legal antitrust work centers on exclusion. A consensus is emerging that the antitrust rules as applied in the 1950s and 1960s tended to protect competitors rather than competition. The old crusades against some potentially exclusionary acts—such as tie-in sales, exclusive dealing arrangements, mergers between purchasers and suppliers, and organized boycotts—have been criticized by some for addressing a chimera: that profitable, anticompetitive exclusion by such devices is possible. Some would even treat such vertical integration as legal *per se*. We do not share the view of the critics. We believe that exclusionary behavior is frequently observed, is socially harmful, and is properly an antitrust concern. The rules against it need only be reformulated to ensure that they operate solely to the benefit of consumers.

In this article we present a two-step analysis for evaluating allegations of anticompetitive exclusion. We believe it meets the challenge to devise rules that permit competition that is beneficial to consumers while deterring exclusionary conduct that is harmful to consumers.

Thomas G. Krattenmaker is professor of law and Steven C. Salop is professor of economics and law at Georgetown University Law Center.

Identifying Anticompetitive Exclusion

The analysis we offer is not complicated. When exclusion is alleged, one first should ask whether the challenged conduct unavoidably and significantly increases the costs of competitors. If so, one then should ask whether raising rivals' costs enables the excluding firms to exercise market power—that is, to raise prices above the competitive level. In other words, we inquire into injury to competition as well as injury to competitors.

The paradigm of exclusionary conduct that raises rivals' costs is burning down rivals' factories in an attempt to gain a monopoly. Of course, such extreme examples are rare. More common are practices such as vertical restraints, mergers, and exclusionary agreements with competitors or suppliers. Exclusion may entail either control over scarce public resources like government permits and licenses, or control over private inputs like retail distribution networks, oil pipelines, or computerized reservation systems.

A classic example is *U.S.* v. *Aluminum Company of America*. In 1914 Alcoa allegedly contracted with a number of electric utilities to withhold electrical service from rival aluminum producers. Alcoa did not buy electric power from these utilities, it bought *market* power—the power to raise prices above the competitive level. With rivals' costs higher, Alcoa could increase the price of the aluminum it produced.

More recently, in the 1983 case of *MCI Communications Corporation* v. *American Telephone and Telegraph*, AT&T was found liable for raising the costs of entrants into long-distance service by denying them equal access to the local telephone network. This conduct injured consumers as well as rivals by reducing competition in the long-distance market.

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Virtually all claims of anticompetitive exclusion involve the same basic allegation: the conduct consists of the creation and purchase of *exclusionary rights*, that is, rights to exclude competitors from equal access to significant factors of production. In certain cases, by raising costs or otherwise disadvantaging competitors, these rights can endow their purchasers (the excluding firms) with market power.

This type of exclusionary conduct is different from predatory pricing and more likely to succeed. Raising rivals' costs can be profitable even if the rival does not exit from the market; it is not necessary to sacrifice short-run profit for uncertain future benefits. Rivals with higher costs cut output immediately. In contrast to predatory pricing, where the dominant firm loses money in the short term faster than its smaller victims, these strategies can raise rivals' costs disproportionately. Citing Judge Robert Bork in *Antitrust Paradox:*

> By disturbing optimal distribution patterns one rival can impose costs upon another, that is, force the other to accept higher costs. This may or may not be a serious cost increase, but if it is (and the matter can only be determined empirically), the imposition of costs may conceivably be a means of predation.

The basic formulation of our test can be stated simply: Exclusionary conduct creates or enhances market power when the conduct raises rivals' costs and endows the excluding firm with power over price. Unless that conduct can be justified as the only way to achieve overriding efficiency benefits, both consumer welfare and economic efficiency are served by prohibiting the conduct. For cost-raising strategies, proof of consumer injury (that is, market power) would always involve the following two-step analysis.

First, are competitors injured? Is the excluding firm able to raise rivals' costs materially by its purchase of exclusionary rights for inputs? For example, in *Alcoa*, if the competing aluminum companies could have purchased sufficient electricity from either established suppliers or new entrants without suffering a cost disadvantage, then those rivals would not have been injured. In this case, neither would consumers.

Second, is competition injured? Assuming success in raising rivals' costs, is the excluding firm able to gain market power to raise its prices and increase its market share, or can remaining competition maintain competitive prices? For example, even if some aluminum companies' costs had been raised, if there had been ample competition from other, nonexcluded aluminum companies, imports, or aluminum substitutes (stainless steel, for example), then Alcoa could not have raised its prices. Thus consumers would not have been injured.

Proving that alleged exclusionary conduct raises rivals' costs and gives excluding firms power over price involves a tightly structured analysis of both the input and output markets, an analysis very similar to that conducted in merger cases. This analysis requires asking questions about market definition, market concentration, ease of entry, and the fraction of capacity foreclosed, as well as questions about the size of the cost increase itself.

Efficiency Justifications

Assuming that the plaintiff proves both that rivals' costs are raised and that the excluding firms gain power over price, the defendants may try to justify their practices on efficiency grounds. Assuming the court permits this defense—and many courts will not, except in extreme circumstances—the court would ask whether the conduct generated significant, offsetting efficiency benefits that could be achieved only by permitting the exclusionary practices. If so, these benefits might lead to lower prices and increased consumer welfare, in which case the conduct would be justified.

A court, for example, might ask whether Alcoa gained sufficient cost savings from its exclusionary rights over electricity to offset the power over price gained by Alcoa. It might be hard to devise a convincing efficiency benefit for this "naked" exclusionary right, when Alcoa bought no electricity. But in other cases, efficiency claims might be more credible.

It is not clear that a court concerned with consumer welfare would or should allow an explicit efficiency defense, except in extreme cases. The dominant view of antitrust law always has been that where anticompetitive effects are probable, efficiencies are no defense. Where market power is proved, courts have not upheld practices on the grounds that the consumer harm is outweighed by cost savings to the firm adopting the practice. Even if a bank embezzler can earn a higher rate of return than the bank, this fact does not legitimate the theft. If a practice benefits stockholders by $1,000 while injuring consumers by $800, why should an antitrust standard based on maximizing "consumer welfare" protect that conduct?

Market Power in Exclusion Cases

Where firms raise competitors' costs and thereby gain power over price, they have achieved market power. It is not necessary that they also have the ability to raise price by restricting their own output. As first recognized by Joseph Bain and Gordon Tullock, a firm also can exercise market power by raising competitors' costs and thereby inducing *them* to restrict production, which in turn causes the market price to rise. This type of market power is the "power to exclude competition" that was identified as suspect by the Supreme Court in the *U.S.* v. *du Pont* cellophane monopoly case.

This distinction between the power to raise price by restricting output and the power to raise price by raising the costs of competitors is important when successful pricing coordination among excluding firms is unlikely or when market shares would not satisfy the traditional thresholds for monopolization.

For example, consider the recent controversy surrounding computerized reservation systems (CRS) owned by major airlines, notably American Airlines and United Airlines. The Civil Aeronautics Board found that the scheduling information displayed by these systems was biased in favor of the carriers owning them. It also found that this bias raised competitors' costs of attracting passengers, reduced competitors' market shares, and generally decreased competition in the market for air transportation.

The national market for air travel is relatively unconcentrated. However, the conclusion that the CRS bias is anticompetitive would not require a finding that American and United individually or collectively had the power to raise prices in the air travel market by restraining their outputs. If the CRS bias raises the costs of competitors, then the prices consumers pay for air travel may increase nonetheless. The CRS bias in effect creates a barrier to entry into the air transportation market.

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A second distinction arises in cases where power over price does not involve price increases but instead entails preventing future price decreases by engaging in exclusionary practices that prevent competitors from reducing their costs. Preventing price decreases reduces consumer welfare just as surely as does implementing price increases. For example, exclusionary conduct by the airline owning the major CRS might prevent airline prices from falling by forestalling the entry of more efficient potential competitors or by raising their costs. An excluding firm's inability to raise prices above the existing level by restricting its own output unilaterally is irrelevant to consumer injury.

Mergers and Exclusion. A rival challenging a horizontal merger among its competitors is faced with a double-edged argument. If the merger will harm competition by facilitating collusion, the challenger will benefit. Only if the merger will increase the efficiency or reduce the costs of the merging partners will the challenger be hurt. But, in that case, consumers will benefit from the merger. Thus, critics argue, competitor suits to block mergers should be viewed skeptically or competitor standing should be denied altogether.

But the merger of competitors can harm a rival firm not by increasing competition, but by giving the merged firm the ability to purchase exclusionary rights. In this case consumers would be harmed too. This exclusion could arise, for example, if the merged firm raised the distribution costs of rivals by purchasing exclusionary rights from dealers and distributors, if it induced input suppliers to discriminate against rivals, or if it purchased inputs strategically to drive up rivals' costs.

Objections to Our Approach

A number of objections have been raised to this approach to exclusionary conduct. In our judgment, these criticisms rest on a misunderstanding of how markets work.

"Naked" Exclusion is Rare. Our theory of exclusion is strongest where the exclusion involves "naked" exclusionary rights. But, the critics charge, the *Alcoa* practice is rare and there are few examples of firms burning down rivals' factories. Where exclusionary rights are bundled with the purchase of inputs, advocates of laissez-faire argue that efficiency benefits are far more likely or more important than any anticompetitive harms.

Pure exclusionary rights, unrelated to input purchases, are indeed rare. Aside from *Alcoa*, the naked exclusion cases mainly involve misuse of government processes—for example, petitioning a regulatory agency to drive a rival out of the market or to prevent entry. However, it does not follow that the bald assertion of efficiency benefits ought to immunize firms from potential liability for exclusion. For one thing, this would give firms complete latitude to exclude rivals, as long as they could bribe an input supplier and enlist an economic consultant to help.

Moreover, preventing exclusion seldom requires a significant efficiency loss. What usually causes the anticompetitive effect in exclusionary rights agreements is a single provision of the contract giving the input supplier the duty to exclude rivals of the purchaser. Therefore, simply by invalidating only the exclusionary provision, the court often can eliminate the consumer injury while preserving the cost savings.

Efficiency claims are prone to abuse, especially if unproved allegations are permitted to counter rivals' claims of exclusion. As stated by Judge Frank Easterbrook ("On Identifying Exclusionary Conduct"):

> Often the only way to tell what is efficient is to look at what survives in competition. Then we *invent* hypotheses to explain the survival.

This is an area in which balance clearly is needed. Only by requiring plaintiffs to *prove* that alleged exclusion is likely to injure consumers by raising rivals' costs and conferring power over price can we protect against a law that would deter efficient vertical agreements. Similarly, only by requiring credible evidence on real cost savings can courts prevent "fairy tale" efficiency claims from justifying anticompetitive exclusion.

Only One Monopoly Profit. Another line of criticism stems from the argument that only one monopoly profit is possible in a chain of production. The argument is that a firm that monopolizes one market cannot increase its profits by extending, or "leveraging," that monopoly into another adjacent market.

This criticism misconceives our theory by assuming the existence of a monopolistic input supplier. Alcoa purchased exclusionary rights from a number of electricity suppliers, not a national electricity monopolist. By effectuating a partial merger or supply restraint, exclusionary rights strategies can generate market power that would not exist otherwise. In short, our theory shows that exclusionary vertical agreements can have *horizontal* effects—those between competitors—and create the type of *horizontal* market power condemned by antitrust commentators.

Rivals Are Not Defenseless. The fact that a firm might try to induce suppliers to exclude its competitors does not prove that it will succeed. If competitors always could protect themselves from attempted anticompetitive exclusion, and failed only when exclusion was efficient, then antitrust prohibitions on the practices would be unnecessary. This is true, but we think such a laissez-faire attitude is unwarranted.

Competitors can, in principle, protect themselves in two ways. First, they can sometimes easily find substitute inputs that are equally cost-effective. Where this substitution is possible, of course, the plaintiff will fail to prove the first part of the two-step test—that rivals' costs are raised. However, easy substitution is not always possible. Product markets are not boundless.

Second, rivals might attempt to counter the exclusionary rights strategy with a counter-strategy of paying suppliers to *not* exclude them. The excluded rivals may offer to purchase these exclusionary rights themselves, to escape the exclusion. This contention misses the point: if rivals must pay suppliers additional fees to avoid the cost increases from exclusion, the fees themselves will serve as the cost-increasing devices. Rivals faced with higher costs still would have an incentive to reduce their output or exit the market. Indeed, if anything, these blackmail payments could reduce the cost of the strategy to the excluding firm.

The most extreme version of this criticism states that firms usually can compete on an equal basis for the rights to exclude each other. This criticism misses the point for two reasons. First, competition is a public good like defense. Much of the injury flowing from exclusion of rivals is not borne by the rivals themselves, but by consumers, who typically would not be involved in the competitive bidding for exclusionary rights. Second, competition to achieve a monopoly by bidding for exclusionary rights does not provide consumer benefits similar to competition in the market for goods and services. This is because exclusionary rights are "bads," not "goods." They are purchased by the excluding firm to reduce competition, not to provide consumers with a better, less expensive product.

Input Suppliers Will Not Deal. A related criticism focuses on the incentives of suppliers to sell exclusionary rights. This criticism has two parts.

First, in the short run, if input suppliers cut off their customers, they will lose revenues. In the long run the situation will be even worse. If the exclusion succeeds, the suppliers soon will find themselves selling to a monopsonist. Anticipating this, they will take a long-run view and refuse to sell exclusionary rights.

Second, there is a hold-out problem. If some suppliers cut off their customers, excluded rivals will be willing to pay a premium to any remaining "hold out" input suppliers. If this possibility is foreseen, every supplier will have an incentive to hold out, or demand a higher fee for its exclusionary rights.

We deal with these two issues in order. If any revenues knowingly are sacrificed, the exclusionary rights purchaser surely must compensate the suppliers to succeed in its strategy. However, the required compensation often will be small and can be financed out of the resulting monopoly profits of the excluding firm. This is because the fact that customers are dependent on suppliers does not imply that suppliers are dependent on customers. The suppliers may have many other potential buyers for the excess inputs. For example, the electric utilities in *Alcoa* could have continued to sell electricity to steel companies, automobile manufacturers and municipalities. Only aluminum companies were excluded. By the same token, if suppliers have sufficient alternative customers, they need have little fear of creating a monopsony in the long run.

Moreover, in cases where a monopsony is possible, it is unlikely that the individual profit-maximizing decisions of competitive input suppliers would prevent it. Each individual supplier would have the economic incentive to accept even a small premium as an exclusionary rights payment even though, when all suppliers act likewise, monopsony will result. Again we argue, competition is a public good. For the same reason, society does not rely solely on the self-interest of customers to prevent price fixing.

The hold-out problem simply sets two constraints on the efficacy of exclusion, but neither of these constraints implies that anticompetitive exclusion is unlikely or that it creates no public policy concern. The first constraint is merely that exclusion to a complete monopoly—100 percent of the market—is unlikely. This follows because as fewer suppliers hold out, the benefits of holding out grow larger. The second constraint is that successful exclusion is more likely when the excluding firm has a large initial market share: the gains from exclusion are larger for such a firm since the monopoly price is collected on more units.

The Cure Is Worse than the Disease. According to this critique, our analysis is too "highfalutin" to be useful to practitioners and judges unaccustomed to rambling in the wilds of economic theory. Instead, a rule of *per se* legality would eliminate the need for lengthy trials while ensuring the proper outcome most of the time. This is, of course, just the old argument for *per se* illegality, with the names changed to protect the innocent (or, should we say, the guilty).

The answer also is the same. Our analysis does not require open-ended trials inquiring into every nook and cranny of industrial history. Our analysis allows a tightly structured rule of reason inquiry, no different than the type of analysis now routinely carried out in merger enforcement. *(Continues on page 40)*

will be decided under general rules that are themselves based on estimates of costs and benefits. For example, courts need not ramble in the economic wilderness to apply the general rule that contracts will be enforced; but that rule itself is based on a prior reckoning of social advantage.

On its face, the Krattenmaker-Salop test would subject to antitrust scrutiny many, perhaps all, arrangements and court decisions that permit parties to charge higher prices by enforcing property rights claims in their favor. This is hardly cost effective. Most such cases would be utterly insignificant from an antitrust standpoint. Moreover, since their test does not treat costs and benefits equally, it provides no clear guidance to decide the many cases it would apparently raise. Its ability to provide standards to decide cases is further impaired because of the reciprocal nature of property rights: if one claim to property rights is granted its reciprocal must be denied. Someone's costs will be higher no matter how the case is decided. The simple fact is that the Krattenmaker-Salop test provides no means for preferring one claim of property rights over another.

Conclusion

Like other cases, antitrust cases involve choices between competing claims to property rights. The choice is grounded in a tradeoff of costs and benefits. The relevant costs in antitrust cases are the losses in allocative efficiency that result from increased market power. The relevant benefits are cost savings or other increases in productive efficiency. Current antitrust law, using the rule of reason, can identify those costs and benefits and effect a satisfactory balance between them. Krattenmaker and Salop have neither identified a serious problem with current antitrust doctrine nor have they provided a useful solution to the problem they think they have found. □

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Courts now are much more willing to award summary judgment to a defendant if the plaintiff does not provide a plausible theory of consumer harm. Not only does this procedure prevent abuse of the Sherman Act, our theory provides the standards to judge the validity of the allegations of exclusion.

Some might object as a matter of principle to any analysis that serves to revitalize exclusion theories. That view may be more firmly rooted in the market realities and judicial shortcomings of the past than the present. Both the market and legal environments are very different today. In the past a highly restrictive merger policy prevented very significant market share concentration. Therefore it was unlikely that many firms would achieve the power necessary to exclude competitors; those that did were likely to be more efficient. That is no longer true. The current highly permissive merger policy allows significant industry concentration even absent evidence of significant efficiency benefits.

Conclusion

There are valid claims of anticompetitive exclusion and they can be tested against rigorous analysis. The analysis presented here is no more complicated or error-prone than the methods now used to test claims of anticompetitive mergers. Our formulation permits courts to focus upon those exclusionary practices likely to harm consumer welfare, and to structure their inquiries to be both rigorous and manageable. There is more work to be done to refine and clarify aspects of our theory, including the efficiency defense. But we believe we have provided a useful way to structure the analysis in antitrust exclusion cases. While perhaps not perfect, this approach is superior to any other presently available. □

Selected Readings

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