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COST-BASED RULES IN THE NEW ECONOMY

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Competition analyses often require a calculation of costs. One measure of market power is the degree to which the defendant's prices exceed cost.¹ Predatory pricing requires proof that the defendant has priced below some measure of cost.² Some tests for bundling and loyalty discount programs also involve a comparison of prices and costs.³

Traditional competition analyses base most of these price-cost comparisons on the defendant's marginal cost or on other measures of incremental cost thought to be reliable proxies for marginal cost – of which the most commonly used is average variable cost.⁴ But the appropriate measure of cost is always a difficult issue, and that is especially true in industries where marginal costs are close to zero. While there are many “old economy” industries, such as pharmaceuticals, where this problem arises, the problem is especially common for “new economy” products, such as software and various online product offerings.

During the time of the *Microsoft* case, Microsoft and some of its followers suggested that the solution to this conundrum was to abandon antitrust enforcement altogether or at least to

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¹ *E.g.*, *Sheridan v. Marathon Petroleum Co.*, 530 F.3d 590, 594 (7th Cir. 2008) (“*Monopoly* power we know is a seller's ability to charge a price above the competitive level (roughly speaking, above cost, including the cost of capital) without losing so many sales to existing competitors or new entrants as to make the price increase unprofitable.”) (Posner, J.).

² *Brooke Group v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

³ *E.g.*, *Cascade Health Solutions v. PeaceHealth*, 503 F.3d 895, 906 (9th Cir. 2007).

⁴ *See, e.g., id.* at 909.

curtail it dramatically.⁵ But over the ensuing years, whatever support that suggestion once had quickly disappeared. The bipartisan Antitrust Modernization Commission rejected the idea unanimously.⁶ No serious analyst proposes today that we just jettison antitrust enforcement in low marginal cost industries.

Deciding that we will continue antitrust enforcement presents but does not resolve the issue. We still need a way of analyzing market power and a means of determining whether various pricing practices are exclusionary when marginal costs are trivial. Cases such as the recent decision in *Meijer, Inc. v. Abbott Laboratories*⁷ present the issue starkly. There are no “answers” to these questions. But we can consider a number of approaches. Perhaps the answer lies in one of those solutions or in some combination of them.

Low marginal cost industries

Many industries, especially new economy industries, are characterized by low marginal (or incremental) costs in contexts where the relevant time measurement is short. In the production of software, for example, there are significant research, development, engineering, and testing costs that go into new products (or even new versions of older products), but, once the product is created, the added cost associated with each incremental unit is essentially zero. Even most support and updating/bug fix costs are typically considered “fixed” rather than variable in a traditional accounting.

⁵ See *United States v. Microsoft Corp.*, 253 F.3d 34, 49 (D.C. Cir. 2001) (“We decide this case against a backdrop of significant debate amongst academics and practitioners over the extent to which ‘old economy’ § 2 monopolization doctrines should apply to firms competing in dynamic technological markets characterized by network effects.”); David S. Evans & Aliliano J. Podilla, *Competition Policy in the New Economy: Is European Competition Law Up to the Challenge?*, 2001 E.C.L.R. 156.

⁶ ANTITRUST MODERNIZATION COMMISSION, REPORT & RECOMMENDATIONS 31-47 (2007).

⁷ 544 F. Supp. 2d 995 (N.D. Cal. 2008).

The implications of these low incremental costs can be important for antitrust purposes. If market power is measured by the excess of price over marginal cost, then any price over zero would appear to imply some measure of market power. At the same time, if incremental cost is zero, prices may not be considered predatory unless the product is being given away. Both of these propositions seem intuitively doubtful. But what solutions are available?

Market power assessment

In many cases, analysis of market power is important, not to determine whether power exists in the abstract, but to ascertain whether a given course of conduct is likely to increase whatever market power may have existed before the conduct or transaction occurred. In these contexts, the measurement baseline – which may or may not depend on the level of the defendant’s costs – is less relevant. As the *Merger Guidelines* indicate, market definition and power can be assessed using the prevailing (current) price, rather than a measure based on cost.⁸ In a merger case we care about the ability of the merged company to raise prices. The measure of pre-merger market power is less of a concern. If a merger allows a firm to increase price, the analysis should not hinge on whether the initial price is close to or far from marginal cost. The key issue is the size of the increase and how it relates to efficiencies, likelihood of entry and other forward-looking factors.

In past conduct cases, similarly, the issue generally is whether the prior conduct did in fact increase or maintain prices at a level above what would have occurred in the absence of the challenged conduct. Here again the measurement baseline is less important. The real question is whether prices were increased (and, if so, by how much).⁹

⁸ U.S. DEP’T OF JUSTICE & FEDERAL TRADE COMMISSION, MERGER GUIDELINES §1.1 (1997).

⁹ See Jonathan B. Baker, *Market Definition – An Analytical Overview*, 74 ANTITRUST L.J. 129, 159-60, 170 (2007).

In both these contexts, court decisions (and, with section 7, the statutory language) generally require that a market be defined.¹⁰ Using the widely-accepted hypothetical monopolist test avoids the zero marginal cost problem where the baseline used is the current or prevailing price. In past conduct cases, the best analog for prevailing price is normally the price in effect before the challenged conduct began.¹¹ Use of that methodology, again, avoids reliance on the variance between price and cost as a means of determining power.

Efforts to use a cost-based baseline in these contexts are problematic. Using a cost-based standard may imply market power where no meaningful power can plausibly exist. It may also obscure the key issue – whether the conduct or transaction in issue has increased or will increase prices or otherwise harm consumers. The problem is only compounded by uncertainty as to the specific costs that might be used.

The bottom line is that, in assessing market power, cost-based standards should be avoided. In most cases, they can be without much difficulty.

Predatory pricing

Predatory pricing, unlike a market power determination, is an area in which the courts have said, fairly definitively, that pricing is subject to condemnation if and only if it is below an appropriate measure of cost.¹² There have been various proposals over the years for evaluating

¹⁰ See *FTC v. Whole Foods Market, Inc.*, 548 F.3d 1028, 1036 (D.C. Cir. 2008); *Heerwagen v. Clear Channel Communications*, 435 F.3d 219, 227-28 (2d Cir. 2006).

¹¹ See *Baker*, *supra* note 9, at 159-60, 170.

¹² *Brooke Group v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993). For a critique, see Aaron S. Edlin, *Stopping Above-Cost Predatory Pricing*, 111 *YALE L.J.* 941 (2002).

predatory pricing without reference to a cost-based test, but none has gained any real traction – and, in any case, the legal precedent appears clear.¹³

The analytical problem in low marginal cost industries is serious. Pricing at anywhere near marginal cost may drive out any and all efficient rivals. The facts of the recent *Meijer* case illustrate the problem. The claim there was that the defendant, Abbott, was “bundling” the sale of two HIV drugs, ritonavir and lopinavir, by their inclusion in the combination drug, Kaletra. Applying the Ninth Circuit’s “discount attribution” analysis in *PeaceHealth*, the attributed price for lopinavir was \$1.64 per dose – far less than the price at which an equally efficient rival could sell a comparable product.¹⁴ The average variable cost associated with lopinavir, however, was trivial – probably \$0.05 per dose or less. A strict application of the average variable cost standard, therefore, would allow the defendant to exclude equally efficient rivals.¹⁵

The court recoiled at, and rejected, this approach:

But at such a price, competitors would have to sell an equally effective product for \$0.05 or less in order to compete with Kaletra. Common sense dictates that no newly developed [drug] could ever be sold profitably at such a price, because the manufacturer would never be able to recoup its huge research and development costs. If the [average variable cost] rule were applied in this context, it would stifle competition; even a competitor who could produce an equally effective drug for only \$0.01 per pill would be excluded from the market. Thus, as applied here, the [average variable cost] rule does not achieve its stated goal of prohibiting pricing that results in the exclusion of equally efficient competitors.¹⁶

¹³ See, e.g., Edlin, *supra* note 12; Einer Elhauge, *Why Above-Cost Price Cuts to Drive Out Entrants Are Not Predatory*, 112 YALE L.J. 681 (2003).

¹⁴ *Meijer*, 544 F. Supp. 2d at 1002-03.

¹⁵ *Id.* In fact, there are grave doubts as to whether the case truly involved bundling at all. The action complained of by the plaintiffs was simply Abbott’s unilateral decision to raise the price of ritonavir – hardly an antitrust violation. For present purposes, however, it is useful to assume the validity of treating the case as involving genuine “bundling.”

¹⁶ *Id.* at 1003-04.

The concern expressed by the court in *Meijer* is by no means unique to the facts there. It is equally present in other cases involving pharmaceuticals, and in virtually all cases involving software and similar “new economy” products. In all these cases, the challenge is to develop a standard that affords ample incentives for all firms, dominant or otherwise, to compete through lower prices while, at the same time, preventing the exclusion of efficient firms whose existence would likely yield lower net prices for consumers in the long run.

The *Meijer* court’s analysis suggests that any calculation of cost in a predatory pricing case has to include the minimum costs necessary for an efficient rival to survive a price cutting campaign. Depending on the industry, this may entail the inclusion of some costs traditionally viewed as fixed rather than variable. In many low marginal cost industries, the principal costs that might be excluded from a focus on traditional incremental cost analysis include R&D, marketing, and advertising. Both are critical to the products’ ultimate success but may not vary with short run output. A fair determination of profitability in these industries, in terms both of assessing power and evaluating conduct, would take these costs into consideration.¹⁷

Professor Elhauge has advanced a proposal which addresses directly the need to prevent the exclusion of equally efficient competitors. This approach is to use a measure of cost which, if the defendant’s prices were lower, would exclude an equally efficient rival.¹⁸ That measure

¹⁷ Cf. *Kelco Disposal, Inc. v. Browning-Ferris Indus.*, 845 F.2d 404, 408 (2d Cir. 1988) (“The characterization of legitimately disputed costs is a question of fact for the jury.”), *aff’d on other issues*, 492 U.S. 267 (1989).

¹⁸ Elhauge, *supra* note 13 , at 703 (“defin[ing] ‘costs’ as whatever measure of costs would prevent an incumbent pricing at cost from inflicting losses on an equally efficient entrant or rival that could deter its entry or cause its exit”). The focus of Professor Elhauge (and many others) is on the protection of *equally efficient* rivals. Professor Salop has pointed out, however, that consumers are harmed by the exclusion of rivals who are not equally efficient because their exclusion too may cause prices to rise. Steven C. Salop, *Exclusionary Conduct, Effect on Consumers, and the Flawed Profit-Sacrifice Standard*, 73 ANTITRUST L.J. 311, 328 (2006). We speak here of the exclusion of “efficient rivals.”

will certainly include some component of R&D and advertising costs in cases where effective competition requires that those costs be incurred. The Elhauge approach has one obvious advantage of focusing on the main issue – whether efficient rivals are being shut out. It has the equally obvious disadvantage of being unpredictable and subject to manipulation in litigation.

An appropriate evaluation might also entail some stretching of the relevant time period. Over the long run, all costs are variable. The question is when to draw the line, especially when considering costs such as R&D, marketing, and advertising. Some have proposed a standard of long-run incremental costs.¹⁹ The recent Justice Department report,²⁰ which rejected the standard, provides a useful description of it:

Long run average incremental cost is the average “cost of producing the predatory increment of output whenever such costs [are] incurred.” Unlike average variable cost, it includes all product-specific fixed costs, “even if those costs were sunk before the period of predatory pricing.” That is, long-run average incremental cost by definition includes both recoverable and sunk fixed costs. Long-run average incremental cost has been suggested as the appropriate cost measure when predatory conduct involves intellectual property. The contention is that “the only tenable cost standard” for predatory pricing with regard to intellectual property “must be a long-run cost measure,” because “after the product is developed and launched, [average avoidable cost] or [average variable cost] may approach or equal zero.” In computer software, for example, once the software product has been developed “the short-run incremental cost of a program downloaded from the Internet is nil.”²¹

The LRIC standard would seem to include some portion of R&D and advertising in most cases as well. Like Professor Elhauge’s standard, the LRIC measure is designed to capture those costs that rivals must incur to become efficient suppliers. The LRIC standard appears also to have the

¹⁹ See Patrick Bolton et al., *Predatory Pricing: Strategic Theory and Legal Policy*, 88 GEO. L.J. 2239, 2250 (2000).

²⁰ U.S. DEP’T OF JUSTICE, COMPETITION & MONOPOLY: SINGLE-FIRM CONDUCT UNDER SECTION 2 OF THE SHERMAN ACT (2008).

²¹ *Id.* at 63 (quoting Bolton et al., *supra* note 19).

advantage of greater clarity and predictability. But it has a disadvantage as well – namely, that in some cases it might inhibit pricing that is rational (as loss-minimizing) rather than predatory.²²

Still another potential approach is to engage in a rigorous, formal marginal cost calculation by including a normal rate of return on invested equity as part of the cost equation.²³ If the ROI includes expense such as R&D and advertising, that approach can be used as well.

Conclusion

Whatever cost measure is ultimately used must be sensitive to the underlying substantive issues. An assessment of market power should be based on the legal context in which the assessment is being made. Viewing market power from the perspective of the difference between price and cost will miss the mark unless all relevant costs are captured and measured adequately. Using prevailing (or pre-conduct) prices in a hypothetical monopolist paradigm avoids these problems and generally generates defensible results.

An assessment of whether pricing is exclusionary should focus on whether the pricing is likely to exclude efficient rivals. Again, allowing pricing at or near zero because costs such as R&D are excluded in a short-term incremental cost calculation would miss the mark in many cases. But theory appears to offer no universally-applicable solution to this problem at the present time.

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²² The DOJ Report makes this point: “Because long-run average incremental cost includes all product-specific sunk fixed costs, a firm pricing below that cost could generate a positive cash flow (i.e., cover its variable costs and make a contribution to its already-sunk fixed costs) and thus would not necessarily be better off by discontinuing or reducing production.” *Id.* at 63-64.

²³ *Sheridan v. Marathon Petroleum Co.*, 530 F.3d 590, 594 (7th Cir. 2008).