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THE FIRST PRINCIPLES APPROACH TO ANTITRUST, *KODAK*, AND ANTITRUST AT THE MILLENNIUM

STEVEN C. SALOP*

I. INTRODUCTION

In this essay, I reflect on an important contribution to the development of antitrust reasoning and law that arises out of the Supreme Court's decision in *Eastman Kodak Co. v. Technical Services, Inc.*[1] In particular, I discuss the decision's relationship to what I have termed the "first principles" approach to market power and antitrust. In my view, one reason that *Kodak* is important is that it does not take a wooden approach in its economic reasoning. Instead, the opinion nimbly applies the basic principles of competitive analysis to a difficult dynamic context. This enables the majority to avoid rigid adherence to a single brand of economic orthodoxy, a strength demonstrated by the opinion's evaluations of market definition and market power. This willingness to adapt to the continuing advances of economic analysis arising from new market conditions and new intellectual insights suggests that antitrust law is less likely to become an anachronism that will be superceded by some other form of governmental oversight.[2]

Let me briefly note one issue that I will not discuss in this article. One controversy surrounding *Kodak* has centered on whether or not the

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* Professor of Economics and Law, Georgetown University Law Center. This essay builds on the analysis in Steven C. Salop, Kodak *as Post-Chicago Law and Economics*, CRA PERSPECTIVES, Apr. 1993. I also have benefited from two recent articles: Benjamin Klein, *Market Power in Antitrust: Economic Analysis After* Kodak, 3 SUP. CT. ECON. REV. 43, 72 (1993); Gregory J. Werden, *Demand Elasticities in Antitrust Analysis*, 66 ANTITRUST L.J. 363 (1998). I would like to acknowledge the helpful comments of Jonathan Baker, Joseph Brodley, Robin Feldman, Luke Froeb, George Hay, Alfred Kahn, Thomas Krattenmaker, Michael Riordan, Richard Taranto, Gregory Werden, and Christine Wilson.

[1] Eastman Kodak Co. v. Image Technical Serv. Inc., 504 U.S. 451 (1992).

[2] For example, we have now learned from the prequel to the trilogy, that the Star Wars depicted in the George Lucas films apparently started with a dispute over monopolized trade routes. Perhaps if the Jedi warriors of the Galactic Republic had developed a stronger and more credible antitrust policy, the resulting violence, high prices, and deadweight losses could have been avoided.

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plaintiffs stated a proper antitrust claim, as opposed to a contract claim or a commonplace marketplace imperfection. Critics also have argued that the plaintiffs' claim should have been dismissed because the installed base of locked-in customers is so inherently vulnerable to monopolization by the firm that sells them equipment that the customers should not be protected by the antitrust laws. In his dissent, Justice Scalia recommends just such a hands-off approach towards this "wretched class" of consumers that suffers "the supposed misfortune of being 'locked in' to Kodak equipment."[3] He states that "[w]e have never suggested that the principal players in a market with such commonplace informational deficiencies . . . exercise market power in any sense relevant to the antitrust laws."[4] The majority opinion, however, held that even if manufacturers have "inherent" market power, "it is not clear why that should immunize them from the antitrust laws."[5]

My concern in this article, however, is not whether *Kodak* was rightly decided or whether the "wretched class of consumers" has a right to be protected by antitrust law. Instead, this short essay addresses the analytic framework for evaluating market power and competitive effects as illustrated by *Kodak*. Although the *Kodak* plaintiffs' installed base opportunism theory of anticompetitive harm and the factual conditions under which the theory could be satisfied are relevant to the issues raised here, the main focus of this essay is on what I call the *first principles* approach to antitrust analysis. The first principles approach centers on an examination of the competitive effects of the conduct at issue. This is appropriate because competitive effect is the true core of antitrust. Although market power and market definition have a role in antitrust analysis, their proper roles are as parts of and in reference to the primary evaluation of the alleged anticompetitive conduct and its likely market effects. They are not valued for their own sake, but rather for the roles they play in an evaluation of market effects.

Market power and market definition, therefore, should not be analyzed in a vacuum or in a threshold test divorced from the conduct and allegations about its effects. Instead, market power should be measured as the power profitably to raise or maintain price above the competitive benchmark price, which is the price that would prevail in the absence of the alleged anticompetitive restraint. The competitive benchmark may be the current price, the perfectly competitive price, or some other in-between price, depending on the particular allegations of anticompeti-

[3] *Kodak*, 504 U.S. at 499 n.3.

[4] *Id.* at 496.

[5] *Id.* at 479 n.29.

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tive effect being asserted. This integrated approach to antitrust analysis is the first principles approach.

The first principles approach can be contrasted to one advocated by Judge (then Professor) Easterbrook, who suggested that courts should carry out a threshold analysis of market power at an early stage to use as a preliminary "filter" to evaluate antitrust claims.[6] Unfortunately, Judge Easterbrook's threshold test approach is fraught with potential for error. It is impossible to evaluate market power accurately without understanding the conduct and effect claims at issue and analyzing market power in the context of those claims.

The first principles approach provides a framework for carrying out a more accurate analysis. By following this more careful approach, courts can maintain logic and consistency while avoiding analytic traps and factual errors.[7] These traps include not only the well-known *Cellophane Trap,* but also the *Marginal Cost, Price-Up, Threshold Test,* and *Unilateral SSNIP Traps.* In addition, overly inclusive or incorrectly defined relevant markets can be avoided. Indeed, it will often be possible to avoid useless quibbling over the exact scope of the relevant market and focus instead on the actual factual disputes over the likely effect of the conduct on consumer welfare.

II. *KODAK* AND THE FIRST PRINCIPLES APPROACH

The aspect of the *Kodak* opinion that gives the greatest cause for optimism is its approach to the analysis of market power (and its building block, market definition). Market power is a key antitrust concept; it is, therefore, essential to get the analysis right. In this essay, I discuss the difficulties involved with identification of the proper competitive benchmark for measuring market power. I advocate reliance on what I call the first principles approach to market power and anticompetitive effects analysis.

In standard microeconomic models, market power and monopoly power are synonyms. Market (or monopoly) power is the ability of a firm to maximize profits by charging a price in excess of its marginal

[6] Frank E. Easterbrook, *The Limits of Antitrust,* 63 TEX. L. REV. 1, 14–16 (1984).

[7] A number of these points have been made in recent articles, including Lawrence J. White, *Wanted: A Market Definition Paradigm for Monopolization Cases,* 4 COMPUTER INDUS. 1 (1999); Gregory J. Werden, *Market Delineation Under the Merger Guidelines: Monopoly Cases and Alternative Approaches,* 16 REV. INDUS. ORG. 211 (2000).

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cost.[8] A "monopolist" may be viewed as a firm with a high degree of market power. This basic approach was followed in the *Kodak* opinion.[9]

Many judicial opinions and commentators view market power as a threshold test in which market definition is the necessary first step. Unfortunately, when market power is viewed as a threshold test in this way, the analysis can become divorced from the alleged anticompetitive conduct.[10] For example, Justice Scalia took the view in his dissent that Kodak lacked market power in parts and service because an increase in the prices of those aftermarkets would be equivalent to an increase in the price of equipment. Because Kodak was assumed to lack market power in equipment, Justice Scalia concluded that it, similarly, could have no market power in parts and service.[11]

This way of stating the argument, however, is totally disconnected from the *Kodak* plaintiffs' theory of anticompetitive effect. Defining the relevant market and gauging market power in such a vacuum is flawed because it may or may not lead to a proper evaluation of the conduct at issue. After all, market definition and market power are not valued for their own sakes. In a rule of reason analysis, market power and market definition are important because they provide evidence that is useful in evaluating the alleged anticompetitive effects.

Separating the evaluations of power and effect is not generally a problem in most merger analyses. The conventional approach to market definition is consistent with the standard competitive concern raised by most mergers—that the merger will lead to an increase in price above the pre-merger level by eliminating competition between the merging parties.[12] The key issue in such circumstances is whether the acquisition

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[8] To keep the exposition simpler in this essay, I generally will use the term market power, even in discussing Section 2 allegations.

[9] 504 U.S. at 480.

[10] For an earlier treatment of a number of the ideas in this section, see Thomas G. Krattenmaker, Robert H. Lande & Steven C. Salop, *Market Power and Monopoly Power in Antitrust Law,* 76 GEO. L.J. 241 (1987). The market definition discussion of price-down cases there, however, is superceded to some extent by the analysis in this essay. For a general approach that is similar to the first principles approach described here, see also A. Douglas Melamed, Exclusionary Vertical Agreements, Speech Before the ABA Antitrust Section (Apr. 2, 1998), available at <http://www.usdoj.gov/atr/public/speeches/1623 .htm>.

[11] In a tying claim, proof of distinct products and market power in the tying product market are required. In his dissent, Justice Scalia argued that replacement parts (the alleged tying product) and service (the alleged tied product) are not distinct products because all service may involve the installation of parts. *Kodak,* 504 U.S. at 495 n.2. Kodak itself argued that there is no demand for parts separate from service. *Id.* at 463.

[12] As discussed below, analyses of merger cases can be problematic when the relevant anticompetitive allegation is that the merger will prevent prices from falling in the future.

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permits the acquiring firm to achieve or enhance its market power. In other cases, however, where the competitive concern at issue is a different restraint or price effect, the use of a threshold test disconnected from the conduct and effect allegations can lead to a variety of "traps" that can cause analytic missteps and erroneous conclusions.

Market definition and market power should be evaluated in the context of the alleged anticompetitive conduct and effect, not as a flawed filter carried out in a vacuum divorced from these factors. The first principles approach fulfills this goal because it is centered on a direct evaluation of the competitive effects of the conduct. It does not proceed by relying on imperfect and indirect proxies for market power, which then are used as proxies for the likelihood of anticompetitive effects. Only by analyzing market power and market definition as part of and in reference to the economic analysis of the alleged anticompetitive conduct and its market effects can logic and consistency be maintained and errors be avoided. Similarly, only in this way can relevant markets properly be defined.

Some of the reasoning in *Kodak* provides an introduction to the first principles approach. For example, consider the *Kodak* plaintiffs' monopolization theory. According to the plaintiffs' "installed base opportunism" theory of monopolization, for several years Kodak had permitted independent service operators (ISOs) to purchase replacement parts that they needed to service equipment in competition with Kodak, and consumers bought equipment on the expectation that this competition would continue. However, Kodak allegedly later adopted a new policy of refusing to sell parts to the ISOs. As a result of this unanticipated change in conduct and the new restraint, the installed base of equipment owners could no longer purchase service from the excluded ISOs. Because they were locked-in to the equipment they already owned, these customers were forced to purchase service from Kodak or service their machines themselves. According to the plaintiffs, Kodak's service was more expensive than the ISOs', and self-service was an inferior alternative for many customers. Thus, the plaintiffs argued that the locked-in installed base of customers was harmed by Kodak's change in conduct.[13]

This statement of the anticompetitive theory identifies the group of consumers allegedly harmed by the change in conduct as the owners of the installed base of Kodak equipment at the time of the change in conduct. It also identifies a tentative market in which the alleged harm occurred. To connect power and effect, the question is whether or not

[13] 504 U.S. at 456–59, 480–85.

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Kodak could exercise market power in this product market as a result of the exclusionary conduct. The plaintiffs alleged that Kodak's change in conduct provided it with the power profitably to raise or maintain a noncompetitive price of service charged to the installed base.[14]

Kodak presents a particularly complicated case because three related markets (i.e., parts, service, and equipment) are relevant to analyzing the conduct at issue. This complexity illustrates the importance of the first principles approach. It is difficult even to identify the relevant market, let alone analyze market power correctly, without reference to the conduct itself and the alleged anticompetitive effects. When the alleged anticompetitive conduct and effects are used to anchor the analysis of market power and market definition, however, the analysis is rendered more transparent and more likely to be correct.

In a first principles economic analysis of exclusionary conduct, proof of anticompetitive effect generally involves proof of both injury to competitors ("power to exclude competitors" or "raising rivals' costs") and injury to consumers ("power over price").[15] If this analysis is applied to the theory asserted in *Kodak*, the plaintiffs would first need to demonstrate that Kodak had the power to exclude its competitors. If the ISOs were able to find equally good alternative sources of equally good parts after Kodak's change in conduct, then Kodak's alleged anticompetitive strategy would fail. Second, the plaintiffs would need to demonstrate that consumers were injured. If consumers could substitute equally efficient self-service or could make an even-up trade for alternative equipment, they would not have been injured by the refusal to deal and again Kodak's alleged anticompetitive strategy would fail. In that case, Kodak would not have power over price.

I have described these two steps in terms of the proof of anticompetitive effect. However, the evaluation of market power in the service market is also clearly incorporated into this economic analysis, although not explicitly labeled as such. If the ISOs or the installed base of customers could substitute without injury or disadvantage, then Kodak would be unable profitably to raise or maintain a noncompetitive price of service to the installed base. Thus, the market power inquiry is part of the analysis of anticompetitive conduct and effect.

The new equipment market also enters the first principles analysis, although again not necessarily explicitly. The new equipment market is

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[14] *Id.* at 482.

[15] For a more detailed analysis of this two-step approach, see Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Gain Power Over Price*, 96 YALE L.J. 209 (1986).

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considered through the analysis of the profitability of Kodak's change in conduct. When Kodak changed its policy and began to refuse to sell parts to the ISOs, the installed base was forced to pay a higher cost for service. Kodak would not suffer an immediate loss of sales of new equipment to the installed base because that installed base is locked-in as a result of its ownership of Kodak equipment. In contrast, future non-captive new purchasers of new equipment might be less willing to purchase Kodak equipment as a result of Kodak's change in policy. In particular, Kodak claimed that many, if not all, of these customers would buy competing equipment with lower life cycle costs. If enough new customers would substitute, then Kodak's refusal to sell parts, and any implied increase in the cost of service, would be unprofitable. Thus, it would follow that Kodak lacked market power in the service and parts markets because of constraints created by the new equipment market. This logic is essentially a more detailed statement of Kodak's position. Kodak focused on the effects of its restraint on non-captive new customers, not on the effects on the installed base of locked-in customers.

In the *first principles* approach, the parties' competing positions are made clear because the focus remains centered on anticompetitive effect. The approach also reaches the market power controversy in a logical and straightforward way. It reveals that the parties' real disagreement concerns the facts relevant to estimating the magnitude of the substitution by non-captive new equipment purchasers and its impact on the profitability of the strategy. Kodak claims that it would lose enough new equipment customers to render the alleged anticompetitive restraint unprofitable as a result of the higher life cycle costs and the reputation loss it would suffer as an opportunistic seller. The plaintiffs claim that any loss of new equipment purchases would be minimal for two reasons. First, Kodak could immunize new equipment purchasers from the price increase by reducing the price of equipment or by offering low price service contracts in order to keep their life cycle cost from rising. Second, Kodak's elasticity of demand for new equipment may not be sufficiently high to render the strategy unprofitable, despite its lack of market power in the sale of new equipment and any reputational effects that would result from the restraint.

The *Kodak* opinion was framed in terms of market power. Indeed, in its analysis of the per se tying offense, the opinion treats market power in the tying product market as a threshold test. Under the per se rule, anticompetitive effect need not be proved but may be inferred from the other elements as a matter of law. Nonetheless, even the opinion's analysis of market power in the tying product market was not carried out in a vacuum. The decision actually analyzes the potential competitive

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effects of the conduct in order to reach a conclusion about market power in the tying product market.[16] Indeed, its evaluation of market power is virtually equivalent to an analysis of profitability and anticompetitive effect in the tied product market. The opinion essentially concludes that Kodak could have market power in parts because tying service to parts could be profitable as a result of the lock-in of the installed base.[17]

III. MARKET POWER TRAPS

The *Kodak* opinion's integration of market power and market definition with effects analysis is significant because it avoids a number of common analytic and factual errors that can occur when the evaluations of market power and market definition are carried out without the anchor of an analysis of the alleged effect of the specific conduct at issue. These errors can be summarized as the following analytic traps:[18]

(1) ***The Marginal Cost Trap:*** Mistaking a firm's inability to profitably raise price above its marginal cost for an inability to exercise market power by excluding rivals; and vice versa, that is, mistaking a firm's ability to profitably raise price above its marginal cost for an ability to exercise additional market power by adopting alleged anticompetitive restraints.

(2) ***The Cellophane Trap:*** Mistaking a firm's inability to exercise market power by raising price above the current price for an inability to have already exercised market power by raising price up to the current level, thereby mislabeling a completed anticompetitive act as a lack of market power.

(3) ***The Price-Up Trap:*** Mistaking a firm's inability to profitably raise price above the current level for an inability to exercise market power by preventing competitors' conduct that otherwise would reduce price below the current level, thereby mislabeling a maintenance of market power as a lack of market power.

(4) ***The Threshold Test Trap:*** Mistaking a firm's inability to profitably raise price above the current level because of current competitive constraints from certain rivals for an inability to exercise market power even after those rivals are excluded.

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[16] The Court also pointed out that the inquiry could be framed in terms of either market power or market definition. *Kodak*, 504 U.S. at 469 n.15.

[17] *Id.* at 477–78.

[18] All of these traps also could be applied to analyses of the collective market power of a group of firms.

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(5) ***The Unilateral SSNIP Trap:*** Mistaking a firm's inability to profitably raise price above the current level unilaterally (i.e., assuming that rivals do not change their prices or outputs) for an inability to exercise market power by conduct that affects rivals' output and price responses.[19]

These traps are best understood by beginning with the definition of market power. Market power is the power profitably to charge a price above the competitive level. In order to evaluate market power correctly in an antitrust case, it is necessary to identify the proper competitive benchmark. If the competitive benchmark is defective, then the market power evaluation may be irrelevant or erroneous.

In microeconomics texts, the standard competitive benchmark for gauging market power is the defendant's marginal cost. Even aside from the knotty issues involved in measuring marginal cost, however, the usefulness of this test for antitrust is limited for a number of reasons. Most important, using this test in antitrust can lead to false positives and false negatives in evaluating the competitive impact of specific conduct.

On the false positive side, the test leads to a conclusion that virtually every firm in the economy will have some market power according to the test. It is clear, however, that possession of market power measured in this way does not by itself violate the antitrust laws. Moreover, the fact that a firm can profitably price above marginal cost does not mean that the firm can maintain or enhance its power by engaging in specific conduct alleged to be anticompetitive.[20]

The test also leads to misleading conclusions on the false negative side. There, the fact that a firm prices at marginal cost does not ensure that there can be no anticompetitive conduct. A firm that prices at marginal cost could still have incentives to attempt to achieve market power by acquiring competitors or by raising its rivals' costs. Even if it must always price at marginal cost, a firm might be able to expand its

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[19] The *Unilateral SSNIP Trap* is closely related to the *Threshold Test Trap.* The two traps are distinguished because the errors to which they refer occur in different contexts. For example, the *Unilateral SSNIP Trap* could arise in a horizontal agreement case as well as in an exclusion case. In addition, the *Unilateral SSNIP Trap* focuses on the market definition methodology whereas the *Threshold Test Trap* focuses on an erroneous finding of market power.

[20] The greater the difference between price and marginal cost, the larger is the effect on the deadweight loss in economic surplus (consumer plus producer surplus) that results from changing output, when other factors are held constant. This suggests the need for greater antitrust concerns in those markets where the difference between price and marginal cost is greater. *See* Raymond Jackson, *The Consideration of Economics in Merger Cases,* 43 U. CHI. J. BUS. 439 (1970).

output and obtain a higher market price once its excluded competitors shrink their own output. Thus, improperly relying on a measure of market power based on marginal cost in isolation from the alleged anticompetitive conduct can lead to the error of the *Marginal Cost Trap.*

As explained above, one of the key implications of the first principles approach is the identification of the proper competitive benchmark. *The proper competitive benchmark for evaluating alleged anticompetitive restraints in antitrust is the price that would prevail in the absence of the alleged anticompetitive restraints or conduct.*[21] This benchmark focuses the analysis on whether the conduct at issue has an effect on price. Stated in market power terms, this price benchmark focuses the analysis on the impact of the conduct on the defendant's degree of market power.[22]

This definition also provides the proper benchmark for assessing the relevant firm's market power in the market in which the anticompetitive effects are alleged to take place.[23] The precise benchmark, however, depends on the type of antitrust allegation being made. For example, if the claim is that certain conduct will permit a firm to raise its price above the current price level in the future, as in a typical merger analysis, then the proper benchmark is the pre-restraint, current price.[24] The current price, however, is not necessarily the proper benchmark for

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[21] This benchmark is similar to the standard set forth in the draft of the Competitor Collaboration Guidelines. U.S. Federal Trade Commission, Draft Antitrust Guidelines for Collaborations Among Competitors (Oct. 1, 1999) § 1.2, *reprinted in* 64 Fed. Reg. 54,484 (Oct. 6, 1999).

[22] Benjamin Klein prefers a market power test based on whether a firm's prices have any significant effect on market quantities. Klein, *supra* note 1, at 76. If one broadens the test, going beyond price to include the alleged anticompetitive conduct and to take into account the effect of the conduct on rivals' prices and outputs, then Klein's test moves closer to the first principles approach set out here. The analysis in this article may indeed be what Klein means when he discusses *changes* in market power. However, Klein's focus on market quantities raises the question of whether the two approaches are consistent; the question is complicated because Klein does not set out a market definition methodology. *Id.* at 85.

[23] This article's analysis focuses on the market in which the alleged anticompetitive effects occur. Tying and other leverage theories also involve the evaluation of market power in a second market, the tying/leveraging product market. The resulting analysis may still involve a comparison to the perfectly competitive price, particularly in the case of per se offenses. However, it also may involve the power to exclude competitors profitably. This is because the fundamental issue is whether a firm has the power to profitably carry out the alleged anticompetitive leveraging conduct that causes harm in the tied product market. In contrast, in the case of leveraging used to maintain (i.e., defend) market power in the tying/leveraging market, the issue does not arise in the same way. *See* Robin C. Feldman, *Defensive Leveraging in Antitrust,* 87 GEO. L.J. 2079 (1999).

[24] U.S. Department of Justice & Federal Trade Commission, Horizontal Merger Guidelines (1992, as amended 1997), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,104.

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other kinds of anticompetitive allegations, and ignoring this distinction can lead to the other traps identified above.

Suppose, for example, that the antitrust allegation is that certain conduct has already permitted a firm to raise its price. In these circumstances, the proper competitive benchmark is not the current price. Instead, it is the lower price that would have prevailed absent the alleged restraint. If the current price is used as the competitive benchmark, the result will be an erroneous finding of no market power. This is the error that occurred in the *Du Pont* case, which now is explained under the rubric of the *Cellophane Trap,* or *Cellophane Fallacy.*[25] There, Du Pont engaged in a variety of conduct that eliminated competition, permitting Du Pont to raise its price. The Court, however, evaluated market definition as a threshold filter that focused on the profitability of price increases above the already achieved monopolized price. That hypothetical price increase was found to be unprofitable, leading the Court to affirm the finding of a broad market and a lack of market power by Du Pont. The Court's conclusions regarding lack of market power also led it to forgo a detailed analysis of competitive effects. In contrast, in *Kodak* the Court's analytic approach allowed it to avoid the *Cellophane Trap.*[26]

As another variant, suppose that a plaintiff's antitrust allegation is that a restraint prevented a price reduction that otherwise would have occurred. For example, suppose the alleged anticompetitive conduct deterred the entry of a new efficient competitor. For this *price-down* allegation, the proper competitive benchmark should be the price that would prevail after the price reduction caused by the entry, that is, the post-entry price. If instead the *current* price is used as the competitive benchmark, the result might be an erroneous finding of no market power. This is the *Price-Up Trap.*

Using the lower price that would prevail in the absence of the alleged anticompetitive conduct as the competitive benchmark is appropriate whenever it is alleged that a restraint will prevent price from falling to a lower level. For example, this lower price benchmark would apply to cases that present exclusionary conduct directed against new or growing competitors, like the facts presented in *Lorain Journal*[27] or *Radiant Burners.*[28] This benchmark also would apply to actual potential entry merger

[25] United States v. E.I. du Pont de Nemours & Co., 351 U.S 377 (1956). For the classic statement of the Supreme Court's error, see Donald Turner, *Antitrust Policy and the Cellophane Case,* 70 HARV. L. REV. 281 (1956). *See also* Krattenmaker et al., *supra* note 11.

[26] *See* 504 U.S. at 471.

[27] Lorain Journal Co. v. United States, 342 U.S. 143 (1951).

[28] Radiant Burners, Inc. v. Peoples Gas Light & Coke Co., 364 U.S. 656 (1961).

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cases, where it is alleged that the merger will prevent entry that would have led to lower prices. Similarly, it would apply to joint ventures, horizontal mergers (like *Staples*), or other agreements where the parties would be passing future cost savings along to consumers in the form of lower prices absent the agreement, and where the agreement reduces or eliminates the parties' incentives to pass on future cost savings to consumers by reducing competition.[29]

Traps can occur, however, even when the current price is the proper competitive benchmark. Suppose that competitive constraints created by certain actual and potential rivals (including the producers of substitute products) currently prevent a firm from profitably raising its price above the current level.[30] In those circumstances, conduct that eliminates or reduces the rivals' competitive constraints would allow the firm to raise its price profitably. For example, the firm might gain power to raise price by acquiring some of the rival firms or by raising their costs by foreclosing their efficient access to key inputs.[31] In either case, the proper competitive benchmark would be the current price. However, a court using market power as a threshold test might conclude that the firm lacks market power, given the current existence of these rival firms as efficient independent competitors. As a result, the court would allow the firm to engage in conduct that eliminates or reduces the competitive constraints provided by these very rivals. This clearly erroneous result, the *Threshold Test Trap*, can easily occur if market power is used as a threshold filter, divorced from the conduct and effect allegations.

A court would not fall victim to the *Threshold Test Trap* in a horizontal merger case, where the focus of the analysis has always been placed on post-merger competition. The risk posed by this trap, however, is higher in an exclusion case. *Klors* can be used to illustrate this risk.[32] In the summary judgment motion reviewed by the Supreme Court, the defendant Broadway-Hale argued that it lacked the market power necessary to create an anticompetitive effect because of the "hundreds of retailers" with which it competed for the sale of appliances.[33] The Court's language

[29] FTC v. Staples, Inc., 970 F. Supp. 1066 (D.D.C. 1997). The 1992 Horizontal Merger Guidelines contain a sentence that could cover this scenario. 1992 Merger Guidelines, *supra* note 24, § 1.11; *see also* Draft Competitor Collaboration Guidelines, *supra note* 21, at § 3.32.

[30] That is, even a monopolist faces competitive constraints from substitute products, which place a ceiling on its price. For example, see Judge Hand's discussion of foreign imports in *United States v. Aluminum Co. of America*, 148 F.2d 416, 426–27 (2d Cir. 1945).

[31] For one example applied to distribution inputs, see ROBERT BORK, THE ANTITRUST PARADOX 156 (1979).

[32] Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207 (1959).

[33] *Id.* at 209–10.

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rejecting Broadway's contention is consistent with a concern for the pitfalls of the *Threshold Test Trap.* The Court states that "[m]onopoly can surely thrive by the elimination of such small businessmen, one at a time, as it can by driving them out in large groups."[34]

Erroneous measurement of market power, furthermore, can occur even when the competitive benchmark is properly identified. Consider first a case in which the proper competitive benchmark in a single firm monopolization case is the current price. One analytic approach might be to try to gauge the defendant's market power by applying a variant of the *SSNIP* market definition test set out in the Horizontal Merger Guidelines and evaluating the profitability of a small unilateral price increase by the defendant.[35] Microeconomics, however, is premised on the assumption that an unregulated firm will set the price that maximizes its profits, a principle that means that a unilateral price increase above the profit-maximizing level necessarily would reduce profits. As a result, if the current price is used as the competitive benchmark, and market power is gauged by examining the profitability of a unilateral price increase above that benchmark, then no unregulated firm, even a monopolist, would ever be found to have market power.[36] Thus, applying the standard *SSNIP* test to a single firm's conduct would be erroneous, or what might be called the *Unilateral SSNIP Trap.*

The Guidelines' *SSNIP* test, however, can be better used to identify a group of firms that could profitably raise price above the current level. In those circumstances, the defendant's market share could be used as a rough gauge of its market power, along with an analysis of ease of entry and other competitive factors. To carry out this share calculation appropriately, however, the shares of the firms affected by the restraint (e.g., the parties to an alleged agreement plus the parties alleged to be disadvantaged by the restraint) must be combined with the defendant's current market share. For example, in horizontal merger cases the share of the acquired firm is assigned to the acquiring firm. Of course, in

[34] *Id.* at 213.

[35] A SSNIP is a "small but significant and non-transitory increase in price." 1992 Merger Guidelines, *supra* note 24, § 1.0. A unilateral price increase is one that is not followed by rivals.

[36] Another aspect of this error arises out of a focus on *unilateral* price increases. The unilateral SSNIP test assumes that rivals would respond to the firm's price increase by expanding their output to meet additional demand as consumers substitute. However, it may be more profitable for competitors instead to raise their own prices in response to the firm's price increase, and it would be erroneous to ignore this potential price response. Market power is the ability to profitably raise price, *taking rivals' expected responses into account.* Thus, the expected response must be examined; one cannot simply assume that rivals will maintain their prices at the initial level.

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order to carry out this market share adjustment, it is necessary to begin to evaluate the plaintiff's anticompetitive allegations. In addition, the effect of the alleged restraint on the ease and likelihood of entry must be evaluated.

The need to evaluate a plaintiff's allegations in order to set an appropriate benchmark is especially acute in cases of completed conduct or price-down cases where the conduct allegedly prevents prices from falling as they would in a competitive world. In those circumstances, the competitive benchmark is a price level below the current price, which also makes the appropriate market share-based test more complicated to apply. For example, the SSNIP market definition test would have to be based on the hypothetical lower price that would have existed in the absence of the restraint. An alternative market power test might be to assess the likelihood that an agreement between the defendant and the firms affected by the restraint would lead to an increase in price above the benchmark price level.[37] This test would also need to take into account the effect of the restraint on entry.

If the determination of the lower price competitive benchmark is supported by evidence that the restraint has maintained or already achieved a higher price, then the key analysis of anticompetitive effect already has been completed. If there is direct evidence of anticompetitive effect, then a separate test of market power, let alone a *threshold* test of market power, is redundant. In essence, the evidence of anticompetitive effect also proves market power in the affected market.

Recent Supreme Court decisions have recognized this issue and have permitted direct evidence of the effects of market power to replace the indirect evidence provided by the market definition/market power approach.[38] As stated in *Kodak*, "It is clearly reasonable to infer that Kodak has market power to raise prices and drive out competition in the aftermarkets, since respondents offer direct evidence that Kodak did

[37] For an example of a test of market power based on collective market share in the context of exclusionary conduct in joint ventures, see Dennis W. Carlton & Steven C. Salop, *You Keep on Knocking But You Can't Come In: Evaluating Restrictions on Access to Input Joint Ventures*, 9 HARV. J.L. & TECH. 319 (1996).

[38] As evidence that this point is indeed a matter of first principles, Fred Kahn pointed out to me that it was recognized as far back as *United States v. Addyston Pipe & Steel*, 85 F. 271, 292 (6th Cir. 1898), by Judge Taft: "Much evidence is adduced upon affidavit to prove that defendants had no power arbitrarily to fix price, and that they were always obliged to meet competition. . . . The most cogent evidence that they had this power is the fact, everywhere apparent in this record, that they exercised it."

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so."[39] The *Indiana Federation of Dentists* decision explains the rationale in more detail:[40]

> Since the purpose of the inquiries into market definition and market power is to determine whether an arrangement has the potential for genuine adverse effects on competition, 'proof of actual detrimental effects, such as a reduction of output,' can obviate the need for an inquiry into market power, which is but a "surrogate for detrimental effects."[41]

A willingness to accept such direct proof of market power is clearly consistent with the first principles approach.[42] It incorporates the analysis of market power into the analysis of anticompetitive conduct and effects, rather than treating market power as a disconnected threshold test. It also acts as a first line of defense against the various traps discussed above. Of course, it does not eliminate the need to specify the competitive benchmark, which ensures that the direct evidence offered is probative.

IV. CONCLUSION

This short review indicates that antitrust is alive and well at the turn of the millennium. The *Kodak* opinion indicates that antitrust law is indeed able to grapple with new economic ideas and to incorporate them into antitrust analysis. Antitrust is not facing intellectual stagnation. Nor is it a victim of rigid economic orthodoxy. The nimbleness of recent antitrust analysis will help to ensure that antitrust does not become an anachronism that must be replaced by an alternative means of constraining market power.

If the first principles approach is followed, courts will be able to analyze a diverse variety of antitrust allegations in a single coherent framework. The analysis of market power will be incorporated into the analysis of

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[39] 504 U.S. at 477.

[40] This approach also has been followed by a number of lower courts. Re/Max Int'l, Inc. v. Realty One, Inc., 173 F.3d 995, 1016–19 (6th Cir. 1999); *see* Coastal Fuels of Puerto Rico, Inc. v. Caribbean Petroleum Corp., 79 F.3d 182, 196–97 (1st Cir. 1996); Rebel Oil Co. v. Atlantic Richfield Co., 51 F.3d 1421, 1434 (9th Cir. 1995); Flegel v. Christian Hosp., 4 F.3d 682, 688 (8th Cir. 1993); Reazin v. Blue Cross & Blue Shield of Kan., Inc., 899 F.2d 951, 966–67 (10th Cir. 1990); Byars v. Bluff City News Co., 609 F. 2d. 843, 850 (6th Cir. 1979).

[41] FTC v. Indiana Fed'n of Dentists, 476 U.S. 447, 460–61 (1986) (quoting 7 PHILLIP AREEDA, ANTITRUST LAW ¶ 1511, at 429 (1986)); *see also* NCAA v. Board of Regents, 468 U.S. 85, 109–11 n.42 (1984).

[42] For a similar commentary in the context of merger analysis, see Franklin M. Fisher, *Horizontal Mergers: Triage and Treatment*, 1 J. ECON. PERSP. 23, 30 (1987); Jonathan Baker, *Product Differentiation Issues Through Space and Time: Some Antitrust Policy Issues*, 42 ANTITRUST BULL. 177, 185 (1997).

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anticompetitive effects, rather than being divorced from the conduct. It will, therefore, be easier to evaluate evidence of market power and the conditions necessary to establish anticompetitive effect. Antitrust will, therefore, be able to focus on the real issue of the actual benefits and harms of alleged anticompetitive conduct, rather than becoming entangled in imperfect, threshold tests that provide only indirect evidence of effects. In addition, antitrust will be able to avoid complicated and often useless disagreements over the identification of the proper market definition and focus instead on the actual factual disputes regarding the likely effect of the alleged anticompetitive practices. In short, antitrust analysis will be less confusing and more accurate.

By maintaining the focus on anticompetitive effects, the first principles approach can also streamline antitrust analysis. The threshold analysis of market definition and market power is sometimes used by plaintiffs as a diversion to cover up a claim's lack of plausibility. By focusing on effects, this implausibility can be revealed more directly and quickly. Plaintiffs also sometimes equate claims that a firm has pre-existing market power with a conclusion that the firm has engaged in anticompetitive conduct that has anticompetitive effects. By applying the first principles approach, this error also can be avoided.

In this regard, antitrust law seems to be moving closer to the first principles approach, which will ensure that the analysis of market power is not only consistent with, but also furthers, a correct evaluation of the effects of alleged anticompetitive conduct. It will be clear that the first principles approach has become firmly established when the first analytic question antitrust practitioners ask themselves is no longer *"what is the relevant market,"* but instead *"what is the alleged anticompetitive effect?"*

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