HARVARD Kennedy School
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Faculty Research Working Papers Series

Prices and Profits in Dominant Firm Adjudication

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October 2008
RWP08-051

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August 2008 Revision

Abstract

Written for a conference at the University of Lisbon, this paper analyzes policies toward prices and profits in competition policy actions targeting dominant or monopolistic enterprises. Its motivation came from dilemmas posed by the European Commission's recent actions with respect to the Microsoft Corporation. The paper traces reasons why competition policy enforcers have been reluctant to assess the reasonableness of prices and profits and to prescribe changes in price levels. It identifies cases in which such oversight is essential for effective policy implementation. Drawing upon the Microsoft experience, it asks whether governmental intervention with respect to intellectual property licenses and the royalties they carry jeopardizes technological progress. An optimistic conclusion is reached.

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Let me begin by proclaiming that the Microsoft case was a European triumph.[1] It showed that the European competition authorities could deal with tough problems more effectively than their American counterparts. But from my participation during October 2004 as a witness before the Court of First Instance on behalf of Real Networks, I had two misgivings.

First, the Commission and the Court heard witnesses not only from the EC and Microsoft, but from competitors to Microsoft. I believe this is inappropriate. It gives the impression that the Commission is "protecting competitors rather than competition" -- a charge U.S. antitrusters have for decades avoided like the Plague. With a strong staff now, DG COMP should present <u>its own</u> witnesses and discourage third party intervention. To be sure, in complex cases it may need help from private parties, but that should be done informally, as it is in the United States.

Second, as I began my (awkward) consultation on behalf of Real Networks, I was shocked to learn that, although insisting that Microsoft offer a version of Windows with Windows Media Player unbundled, the Commission was requiring no price differential between the bundled and unbundled versions. It was clear from the outset that the remedy would be ineffective, and it has been. Almost no unbundled versions have been demanded.

The Problem of Controlling Prices

The second point raises a much more fundamental issue: to what extent the Commission should focus on <u>prices</u> in Article 86 abuse of dominance cases.

1 . For my own brief comparative analysis of the U.S. and E.C. cases, see F. M. Scherer, "Technological Innovation and Monopolization," forthcoming in W. D. Collins, ed., <u>Issues in Competition Law and Policy</u> (American Bar Association).

Article 86 of the original Treaty of Rome (1957) prohibits "any abuse ... of a dominant position within the Common Market," and in the first clarifying clause (a), it defines as abuses "directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions." This suggests three more pointed questions:

(1) Is it an illegal abuse for a dominant enterprise to charge high prices and realize commensurately high profits?

(2) Can high profits be used as contributory evidence of a dominant market position?

(3) Under what circumstances should price changes be ordered as a remedy to a finding of abuse by a dominant enterprise (or in the United States, as a remedy for proven monopolization)?

I believe I understand why the Commission did not try to specify prices for the unbundled version of Windows: Previous attempts by the Commission to infer abuse of dominance from high prices and to alter those prices were unsuccessful, having been rebuffed by higher Community courts.

In the <u>General Motors</u> case (1975 E.C.R. 1367), the European Court of Justice held that charging a price excessive relative to the economic value of the service could be abusive, but that the issue was moot because GM had refunded the allegedly excessive margins. The "excessive price" test articulated by the Court, I must note, is nonsensical to an economist, because <u>every</u> price along a monopolist's demand curve reflects the economic value of the relevant unit to a consumer on the margin between buying the service and not buying.

Similarly, in the <u>United Brands (Chiquita)</u> case (1978 E.C.R. 207), the Court of Justice concluded that the Commission had not charged prices that were unfair, and it set out difficult standards for proving unfairness, thereby nullifying the Commission's order for a 15 percent price reduction.

In parallel cases under German law, attempts by the Cartel Office to prove abuse of dominance through excessive pricing met with brusque rejection from higher courts, e.g., in the Valium tranquilizer case (1980) and a case alleging excessive markups of crude oil prices by leading petroleum

companies in 1974.[2]

A possible exception might be the cellular telephone roaming charge intervention that was concluded in 2006. COM(2006) 382 final (July 2006). Under it, cell phone operators were required to limit their roaming charges on calls made outside the telephone holder's EC home country to specified percentage amounts relative to the average charges levied for inter-network calls within the call-originating nation. But this action was rooted mainly in Article 95 of the EC treaty (on taxes that distorted trade within the Common Market), not in abuse of dominance under old Article 86 (now Article 82 following a treaty revision).

There are deep philosophical arguments for skepticism toward viewing excessively high prices as an actionable abuse of a dominant position.

For one, EC law was influenced significantly by developments in German law, whose passage was promoted by the Freiburg-Ordo School, of whom Franz Boehm was a contemporary leader and Ludwig Erhardt, later prime minister of Germany, was a powerful spokesman. Boehm is said to have exclaimed, "It is easier to hold a greased pig by the tail than to control a firm for abuse of a dominant position." Similarly, Ingo Schmidt, previously chief economist of the German Federal Cartel Commission, characterizes Freiburg school doctrine as perceiving competition to be "a process of discovery whose results are unknown." Therefore, he continues, "It is not possible to construct a hypothetical 'as if' price [i.e., one that would obtain under effective competition], as nobody knows this price. The von Hayek School, therefore, rejects <u>any</u> performance control as government intervention which is not consistent with a free society; it only agrees to conduct control."[3]

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2 . See e.g.Erich Kaufer, "The Control of the Abuse of Market Power by Market-Dominant Firms under the German Law Against Restraints of Competition," <u>Zeitschrift für die gesamte Staatswissenschaft</u>, vol. 136 (September 1980), pp. 510-532; Ingo Schmidt, "Different Approaches and Problems in Dealing with Control of Market Power: A Comparison of German, European, and U.S. Plicy Towards Market-Dominating Enterprises," <u>The Antitrust Bulletin</u>, vol. 128 (Summer 1983), pp. 417-460; and Eleanor Fox, "Monopolization and Dominance in the United States and the European Community: Efficiency, Opportunity, and Fairness," <u>Notre Dame Law Review</u>, vol. 61 (1986), pp. 981-1020.

3 . Schmidt, supra note 2, at p. 434.

Actually, it is inaccurate to attribute this hands-off stance to Friedrich von Hayek. In the 1976 edition of his classic, The Road to Serfdom[4], Hayek makes clear his antipathy to monopoly. And in one key passage (p. 198), Hayek concludes, "Even if [stringent price control] should have the effect ... that the services of the monopolistic industries would become less satisfactory than they might be, this would be a small price to pay for an effective check on the powers of monopoly. Personally, I should much prefer to have to put up with some such inefficiency than have organized monopoly control my way of life."

In the early development of U.S. antitrust law, the Supreme Court, confronted with a defense against collusive price-fixing arguing that the prices fixed were reasonable, observed inter alia that "The reasonable price fixed today may through economic and business changes become the unreasonable price of tomorrow ... [Holding price-fixing per se illegal avoids] ... "the burden of ascertaining from day to day whether it has become unreasonable through the mere variation of economic conditions."[5] Similarly, in the famous Alcoa case, appellate Judge Learned Hand chose not to consider claims that Alcoa's profits were reasonable, partly on accounting grounds -- "the profit on ingot was not necessarily the same as the profit of the business as a whole, and ... we have no means of allocating the proper share to ingot" -- and partly on more general grounds -- "the mere fact that a producer, having command of the domestic market, has not been able to make more than a 'fair' profit, is no evidence that a 'fair' profit could not have been made at lower prices."[6]

Dominant Firm Profitability

Despite the difficulties of having competition policy enforcers carry the burden of ascertaining whether prices are unreasonable and therefore abusive, there is a rationale for considering at least profitability in dominant firm cases. To pursue such a case, one must ascertain what the relevant market is. There are well-accepted tests for doing this -- i.e., the so-called SSNIP test, asking whether substitutes would flow into the market if prices were elevated significantly. But for dominant firms that have monopoly power, this test fails

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4 . The Road to Serfdom, revised with new preface (University of Chicago Press: 1976).

5 . U.S. v. Trenton Potteries Co. et al., 273 U.S. 392 (1927).

6 . U.S. v. Aluminum Co. of America et al., 148 F. 2nd 416, 430 (1945).

because of what is known as the Cellophane fallacy.[7] Specifically, a profit-maximizing monopolist will raise its price near to, but not at or beyond, the level at which substitutes become a significant threat.[8] Therefore, if one asks what will happen when an established monopolist should raise its price, one will usually find lurking substitute competition, which nullifies the valid finding of monopoly power. One way to avoid this is to examine the profitability of the alleged dominant firm. This was not done in the U.S. Microsoft case because the principal economic witness for the government had argued strenuously in the earlier IBM monopolization case (on behalf of IBM) that profit data are meaningless.[9] But in fact, correcting for accounting biases, my colleagues and I showed in an amicus curiae brief that Microsoft's return on investment was an astounding 88 percent -- a clear indication of monopoly power.[10]

The Relevance of Prices in Remedies

The remaining difficult issue is whether enforcement agencies and/or the courts should order changes in prices, or otherwise specify prices, when such intervention appears necessary in order to make the remedies for proven abuse of dominance, or monopolization, effective. From the Microsoft case, we can identify two sub-issues.

First, should the Commission have prescribed a percentage differential between the price of the bundled and unbundled versions of Windows? I would argue that such specification was necessary and appropriate to render the remedy effective. How could it be established? Given that the marginal costs of software are near zero, one way would be to reduce the price of the unbundled version by the ratio of proven R&D expenses developing Windows

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7 . An early indication of the difficulty was in my textbook, Industrial Market Structure and Economic Performance, second edition (Rand McNally, 1980), p. 60.

8 . A diagrammatic illustration of the problem is found in Scherer, "Technological Innovation and Monopolization," supra note 2, Figure 2.

9 . See Franklin Fisher et al., Folded, Spindled, and Mutilated: Economic Analysis and U.S. v. IBM (MIT Press: 1983), especially Chapter 7.

10 . Robert Litan, Roger Noll, William Nordhaus, and F. M. Scherer, amicus curiae brief on remedies submitted to Judge Thomas Penfield Jackson in U.S. v. Microsoft Corporation (April 2000), Appendix.

Media Player to the sum of those R&D costs plus R&D costs for the development of Windows XP. Or alternatively, if this is too difficult, an arbitrary 15 percent differential would have been appropriate.

After some delay, the European Commission eventually intervened in fixing the royalties Microsoft was to receive for interoperability technology its April 2004 decision required. I commend the Commission for its action. In October 2007, the Commission reduced the fee for provision of interoperability information to a flat 10,000 Euros, and, where Microsoft had originally demanded a 7.0 percent royalty for use of its patents, the Commission reduced the royalty rate to 0.4 percent. And no patent rights were to be asserted by Microsoft against non-commercial open source software projects. Here the intervention affected not product prices strictly speaking, but the price one must pay for access to proprietary technology and information.[11]

Does Intervention Jeopardize Technological Innovation?

On May 22, 2008, at a conference in St. Gallen, Switzerland, Judge Bo Vesterdorf, retired chief judge of the European Court of First Instance and presiding judge at the Microsoft appeal, expressed surprise at the magnitude of the non-compliance fines levied on Microsoft and, more directly to our concern here, he warned that "one should be careful" not to encroach too much on patent rights "by a too-zealous enforcement of competition law." He warned further that such encroachment could "create legal uncertainty for the holders of intellectual property rights, thereby perhaps diminishing the incentives to sometimes desirable but very expensive research and development."[12] His concern presumably turned on both the compulsory licensing of Microsoft's patents and Commission intervention in requiring royalty rates much lower than those sought by Microsoft. Compulsory licensing at royalty rates less than those companies could otherwise command is an important variant on the price intervention theme. Analogous actions have been taken by the EC authorities under an "essential facility" argument in

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11 . On government royalty-setting experience in compulsory licensing situations, see F. M. Scherer and Jayashree Watal, Post-TRIPS Options for Access to Patented Medicines in Developing Nations," Journal of International Economic Law, vol. 5 (December 2002), pp. 920-924.

12 . From a Reuters news dispatch May 22, 2008, by David Lawsky, read on the American Antitrust Institute web site.

the Magill (1989, 1995) and IMS Health (2004) cases.

I share Judge Vesterdorf's concern, but once upon a time I was much more worried about the problem than I am now. During the 1940s and 1950s, the U.S. antitrust authorities obtained orders requiring compulsory patent licensing in settlement of approximately one hundred antitrust cases involving an estimated 40 to 50 thousand patents. Concern reached a peak in January 1956, when both IBM and AT&T consented to compulsory patent licensing decrees involving more than 10,000 patents, most to be licensed at zero royalties. My colleagues and I at the Harvard Business School were so concerned about the threat to technological progress posed by these decrees that we launched a joint research effort, interviewing 22 companies, most targets of the compulsory licensing decrees, and receiving written questionnaires from 69 companies. We learned to our great surprise that the compulsory licensing decrees had little to no perceptible adverse impact on companies' research and development investments and that, more generally, patents were simply not a very important consideration in R&D support decisions.[13] More important, we found, were the advantages companies obtained by being "first movers" in new product or process technology areas. This finding has been validated in numerous additional studies, by C. T. Taylor and Z. Aubrey Silberston in the United Kingdom, by Edwin Mansfield from the University of Pennsylvania, by Richard Levin and associates at Yale University, by Wesley Cohen and associates at Carnegie-Mellon University, and in a statistical study by me.[14] There are, to be sure, exceptions, e.g., patent protection is very important in pharmaceutical development decisions. But for most fields of technology -- and the software work done by Microsoft is

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13 . F. M. Scherer and eight others, Patents and the Corporation (second edition, privately published: Boston, 1959).

14 . C. T. Taylor and Z. Aubrey Silberston, The Economic Impact of the Patent System (Cambridge University Press: 1973); Edwin Mansfield, "Imitation Costs and Patents: An Empirical Study," Economic Journal, vol. 91 (December 1981), pp. 907-918; Mansfield, "Patents and Innovation: An Empirical Study," Management Science, vol. 32 (February 1986), pp. 173-181; Richard Levin et al., "Appropriating the Returns from Industrial Research and Development," Brookings Papers on Economic Activity, 1987: Microeconomics, pp. 783-831; Wesley M. Cohen et al., "Protecting Their Intellectual Assets: Appropriability Conditions and Why U.S. Manufacturing Firms Patent (or Not)," National Bureau of Economic Research working paper no. 7552 (May 2004 revision); and F. M. Scherer, The Economic Effects of Compulsory Patent Licensing, New York University Monograph Series in Finance and Economics (1977), pp. 66-78.

included here -- compulsory licensing decrees pose at most mild risks. This evidence -- and I urge skeptics to examine it carefully -- will, I hope, assuage the fears of Judge Vesterdorf and others.

Conclusion

To sum up, much remains to be done within the European Community in establishing the correct tradeoff between control of monopolistic abuses and intervention of a price-regulating character. The Microsoft case was a key milestone in that development, and it is fair to say, the Commission's success was considerable but not complete. The Commission competition authorities and their reviewing courts need to recognize that there are times when intervention in the price-setting mechanism is an appropriate, and perhaps the only feasible, way to remedy monopolistic abuses.[15] Reticence, to be sure, is warranted. They need also to study the extensive literature, mostly originating in the United States, about the effects of compulsory patent licensing and other impairments on intellectual property rights. The result will be an even more effective enforcement program.

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15 . When California electricity prices were soaring to unprecedented levels, my students were astonished to learn that, through the application of appropriate price controls, a monopolist could be induced to increase its output. An early demonstration was in Joan Robinson, The Economics of Imperfect Competition (Macmillan: 1933), pp. 160-163. A more extended discussion with historical references is in F. M. Scherer, Industrial Market Structure and Economic Performance, first edition (Rand McNally: 1970), pp. 413-416.