

# Economists Incorporated Economists Ink

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## In This Issue

### ***New Applications for Consumer Research***

Carol K. Miu describes how consumer research tools can be applied to a number of issues in litigation and business consulting. Consumer research's comprehensive approach to data can be useful in addressing a wide variety of difficult questions. For example, consumer research tools can be used in investigating claims of false advertising, considering possible trademark and brand infringement, defining antitrust markets, and formulating strategies for launching new products.

### ***The Supreme Court Establishes a Standard for Predatory Bidding***

John H. Preston discusses the *Weyerhaeuser* decision, in which the Supreme Court decided that allegations of predatory bidding in input markets should be judged using the same Brooke Group standard that has been used for determining predatory pricing in output markets. This standard is superior to the vague standards that the lower courts used in this case.

### ***The PeaceHealth Standard for Bundled Predation and Recoupment***

David A. Argue discusses a Ninth Circuit decision that concerns alleged predatory bundled discounts. In its decision, the Ninth Circuit established a more rigorous standard for evaluating a theory of predatory bundled discounting than was used in the Third Circuit's *LePage's* decision. The Ninth Circuit's decision affirmed the price-cost test proposed by the Antitrust Modernization Commission (AMC). That test has a great deal of appeal, although its treatment of economies of scope is inadequate. Unfortunately, faulty logic led the Ninth Circuit to reject a recoupment standard, a critical second prong of the AMC's recommendation.

## New Applications for Consumer Research

By Carol K. Miu

The tools of consumer research, which were originally developed for use in marketing, have many other applications in litigation and business consulting. With proper design and execution, surveys and experiments can shed light on a wide variety of important questions. Among the areas in which these tools may be valuable are the investigation of claims of false advertising, the consideration of possible trademark and brand infringement, antitrust market definition, and new product launch strategy.

When investigating possible false advertising, consumer research methods can be valuable in addressing issues of deception and materiality. Surveys and experiments can be employed to identify deception through the analysis of advertising interpretation, and to determine the materiality of deceptive advertising through analysis of consumer behavioral intentions. For example, researchers could conduct an experiment involving the following steps: 1) measure the product category preferences of each individual consumer participating in the experiment, 2) show half of the subjects the original advertisement with the alleged deceptive content, 3) show the other half of the subjects a "corrected" advertisement that is identical to the original advertisement except that the alleged deceptive content has been removed, and 4) have the subjects answer questions that measure their understanding and perceptions of the advertisement and their behavioral intentions. Differences in the responses of the two groups of subjects could be attributed to the alleged deceptive content in the original advertisement.

Surveys and experiments can be useful when considering possible trademark or brand name infringement. Controlled experiments are useful in measuring brand confusion and estimating damages. Through recognition, recall, and elaboration exercises, researchers can evaluate the impact of trademark infringement and identify potential disproportionate effects on heterogeneous consumers. Assume that brand B is allegedly infringing on brand A's trademark. An experiment could confirm or reject the existence of brand confusion and determine whether certain customer characteristics make brand confusion more or less likely. For example, the experiment may find that heavy category users are less likely to be affected by the trademark infringement than light category users, or that high education consumers are less affected than low education consumers. Determining which users are most likely to be affected by infringement may have important implications for the estimation of damages.

Consumer research can also aid in market definition. Researchers can design experiments and surveys to help define the product market and the geographic market. Experiments, such as conjoint analysis, can determine the extent to which specific products are substitutes, and surveys can give consumers the opportunity to list products that they consider similar to the focal product. In conjoint analysis, consumers are shown a series of cards, each listing the attributes of a particular product. Certain products are very similar, differing along only one dimension. Through a ranking task or a repeated choice exercise, consumers reveal their preference for the different product attributes. Conjoint analysis has also been used to estimate consumers' reactions to changes in price. In that way, conjoint

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# The Supreme Court Establishes a Standard for Predatory Bidding

By John H. Preston

Earlier this year, the U.S. Supreme Court decided *Weyerhaeuser v. Ross-Simmons Hardwood Lumber* in favor of defendant Weyerhaeuser. Plaintiff Ross-Simmons had alleged, inter alia, that Weyerhaeuser had engaged in predatory bidding for alder sawlogs in the Pacific Northwest in violation of §2 of the Sherman Antitrust Act. Both Weyerhaeuser and Ross-Simmons purchased alder sawlogs to produce finished lumber at their saw mills. According to Ross-Simmons, Weyerhaeuser paid excessively high prices to raise log costs and thus drive Ross-Simmons out of business. Ross-Simmons closed its saw mill in 2001 following financial losses attributed to rising alder sawlog input prices and declining finished hardwood output prices.

The main legal issue concerned whether the Supreme Court's *Brooke Group* standard for determining predatory pricing in an output market should also apply to alleged predatory bidding in an input market. The *Brooke Group* standard is a two-part analysis. The first part requires that the plaintiff show that the defendant's alleged predatory prices were below "an appropriate measure" of its costs. The second part requires that the plaintiff show that there is a "dangerous probability" that the defendant will be able to recoup the losses from its below-cost pricing once the defendant's rivals have been eliminated.

As applied to input markets, the first part of the *Brooke Group* analysis would require that plaintiff show that the overbidding for inputs resulted in below-cost pricing in the relevant output market. In the *Weyerhaeuser* case, Ross-Simmons would have had to have shown that Weyerhaeuser's prices for finished lumber were below Weyerhaeuser's costs of producing finished lumber.

With respect to recoupment, the second part of the *Brooke Group* analysis, a monopsonist theoretically could recoup its losses from predatory overbidding in the input market or in the downstream output market. For recoupment to succeed in the downstream output market, the monopsonist must use its buying market power to foreclose essential inputs to its down-

stream competitors to drive them out of business. In *Weyerhaeuser*, however, the jury found that finished alder lumber was not a distinct product market and that the broader finished hardwood lumber market was competitive. Therefore, Weyerhaeuser, as an alleged predatory purchaser of alder sawlogs, would have had to recoup its lost profits entirely from the input market by forcing the purchase price of alder sawlogs below the competitive level once the competing buyers had been eliminated from the market.

The Supreme Court found that Ross-Simmons "conceded that it has not satisfied the *Brooke Group* standard" as applied to alleged predatory bidding by Weyerhaeuser. At trial, Weyerhaeuser provided evidence that it had sold finished lumber at a profit during the alleged predatory period. No evidence was provided that Weyerhaeuser could have recouped below-cost prices had they occurred. Nonetheless, the jury awarded Ross-Simmons over \$26 million, which was trebled to \$79 million.

Not surprisingly, Ross-Simmons' District Court victory in April 2003 spurred additional suits by other Pacific Northwest saw mill competitors of Weyerhaeuser. In 2004, Weyerhaeuser settled two cases with five saw mill plaintiffs for a total of \$49 million. In 2005, Weyerhaeuser settled a suit by five additional saw mill plaintiffs for \$13 million. In settling these suits, Weyerhaeuser paid \$62 million in total to ten saw mill competitors whose key liability theory was ultimately rejected by the Supreme Court.

In 2005, a jury awarded plaintiff Washington Alder trebled damages of \$16 million, a decision that Weyerhaeuser appealed to the Circuit Court. In addition, a class action suit was filed in 2004 on behalf of purchasers of finished alder lumber even though the jury in the Ross-Simmons case had found that the downstream output market was broader than finished alder lumber and that Weyerhaeuser had not monopolized or attempted to monopolize this broader hardwood lumber market. Both the Washington Alder and class action cases were stayed pending the U. S. Supreme Court decision.

In upholding the jury's decision against Weyerhaeuser, the Ninth Circuit Court of Appeals had decided that the *Brooke Group* standard for predatory pricing did not apply to alleged predatory bidding. The Circuit Court had reasoned that the *Brooke Group* standard applied only in circumstances where consumers might benefit from lower prices during the alleged predatory period. The Circuit Court dismissed the possibility that higher prices paid to suppliers of alder sawlogs might represent competition on the merits yielding beneficial economic effects by spurring an increase in the supply of alder sawlogs.

Instead of applying a rigorous predatory bidding standard in the *Weyerhaeuser* case, the Circuit Court approved the vague and subjective standards applied by the District Court in its jury instructions. The District Court had instructed the jury that it could find liability if it found that Weyerhaeuser "purchased more logs than it needed, or paid a higher price for logs than necessary in order to prevent [Ross-Simmons] from obtaining the logs they needed at a fair price." In relying on vague standards, such as "purchased more logs than it needed," "paid a higher price for logs than necessary," and "fair price," these jury instructions did not provide an analytical methodology to distinguish between competitive and anticompetitive conduct by Weyerhaeuser in its purchases of alder sawlogs.

The Supreme Court rejected these vague standards and ruled that the *Brooke Group* predatory pricing analysis applied equally to predatory pricing of outputs and predatory bidding for inputs. Thus, the Supreme Court reversed the Circuit Court and remanded the case to the lower courts for further consideration.



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# The *PeaceHealth* Standard for Bundled Predation and Recoupment

By David A. Argue

A recent Ninth Circuit decision addresses standards for determining if bundled discounts are predatory. Bundled discounting is a pricing strategy in which a multi-product firm sells its products at a lower price if they are purchased as a bundle than if they are purchased separately. Bundled discounting is a common practice in the U. S. economy, including in the health care sector. In *Cascade Health Solutions fka McKenzie-Willamette Hospital v. PeaceHealth*, however, the plaintiff alleged that PeaceHealth engaged in predatory discounting to gain market power in primary and secondary hospital services. In *PeaceHealth*, the Ninth Circuit established a more rigorous standard for evaluating a theory of predatory bundled discounting than the Third Circuit had in *LePage's v. 3M*. The Ninth Circuit's decision also affirmed the price-cost test proposed by the Antitrust Modernization Commission (AMC). Faulty logic, however, led the Ninth Circuit to reject a recoupment standard, a critical second prong of the AMC's recommendation.

Typically, bundled discounts enhance consumer welfare by lowering prices and increasing output. Bundled discounting may be predatory, however, if a firm has market power in at least one, but not all, of its products and attempts to leverage that market power over other products. The additional market power ostensibly is created by weakening or eliminating rivals producing competing products. A test is needed to distinguish between harmful predatory bundled discounting and beneficial competitive pricing. A key element of a test for predatory pricing is whether price is below incremental cost. In a single-product context, price is simply the price charged to consumers of the product, but in a multi-product context, the appropriate price to use in the comparison is less obvious.

The "discount attribution" approach to measuring price, which the AMC recommended and the Ninth Circuit adopted, assigns the discount of the entire bundle to the competitive product. The fully-discounted price of the competitive product is then compared to the incremental cost of producing that product. Logically, this approach reduces a multi-product bundled discount to a single-product pricing strategy. An argument for using the discount attribution approach is that a multi-product firm with market power in a product would not normally discount its price below the monopoly profit-maximizing levels. Thus, the argument continues, any discounts on those products when bundled with a competitive product must be disguised discounts on the competitive product.



A test is needed to distinguish between harmful predatory bundled discounting and beneficial competitive pricing.



The Ninth Circuit refers to the primary alternative to the discount attribution standard as the "aggregate discount" rule. That rule counts the discount as a price reduction for the bundle as a whole and uses the price of the entire bundle in the price-cost comparison. Advocates of the aggregate discount rule argue that bundled discounts often reflect the efficiencies of a multi-product firm exhibiting economies of scope. Economies of scope in producing or distributing the bundle of products may cause a multi-product firm to have lower costs than a single-product firm. The discount attribution approach ignores these economies. In hospital services, in particular, economies of scope are important production characteristics and should not be overlooked.

The second element of predatory pricing is whether a predator could recoup its investment in predation. Because below-cost pricing necessarily results in short-run forgone profits, a rational firm will engage in predation only if it can recoup those forgone profits. Nonetheless, the Ninth Circuit refused to include a recoupment requirement in its analysis of predatory bun-

## El News and Notes

### ***U.S. Steel Acquisition of Lone Star***

The Department of Justice Antitrust Division allowed U.S. Steel's acquisition of Lone Star Steel to proceed without a second request. The \$2.1 billion acquisition made U.S. steel the largest producer of steel pipe and tube in North America. Joseph W. McAnney presented the Division with a paper describing how the acquisition would lead to substantial cost savings and have no anticompetitive effects. Henry B. McFarland assisted in writing the paper. The law firm of Reed Smith was antitrust counsel to U.S. Steel.

### ***Clarke American Acquisition of Harland***

Clarke American, a wholly owned subsidiary of M&F Worldwide, recently acquired the John H. Harland Company for \$1.7 billion. William P. Hall worked with Jeff Spigel of King and Spalding in representing Harland during the Department of Justice Antitrust Division investigation of the acquisition. The Department of Justice decided not to challenge the acquisition, which reduced the number of national check printers in the United States from three to two.

### ***FCC Allocates Spectrum to TMI/TerreStar***

Bruce M. Owen and Kent W Mikkelsen assisted TMI/TerreStar in obtaining an increase in 2 GHz spectrum allocated by the FCC. Their analysis concluded that firms providing mobile satellite service (MSS) in the 2 GHz band compete with MSS providers in other frequency bands, so that the proposed allocation would not create a duopoly in the 2 GHz band. TMI/TerreStar was represented by Goldberg, Godles, Wiener & Wright, Vinson & Elkins, and Covington & Burling.

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analysis can be used to estimate the price elasticity of demand for a product, which can be used in market definition.

Surveys also may be useful in market definition. Surveys can collect demographic information on customers, such as zip code, and the resulting data on the geographic distribution of stores' customers can be used to define geographic markets. Such surveys may be particularly useful if stores do not collect individual customer data at the time of purchase. The importance of conducting statistically reliable surveys for the purpose of market definition is highlighted in *FTC v. Whole Foods*, in which the judge disregarded survey research due to potential biases from poor sampling methodology, questionnaire design, and response rate.

In formulating a new product launch strategy, the firm would like to gather information on consumers' perceptions of the new product versus its competitors. Focus groups can be assembled to compare test versions of the new product with competing products. In later stages of product development, focus groups can supply the firm with valuable information on optimal launch timing and promotion strategy. If the product is at the concept stage, however, and no prototype is available, conjoint analysis can be used to determine the importance of different product attributes to consumers.

Surveys and experiments of consumer research collect both quantitative and qualitative data, and its techniques enable researchers to combine both types of data. For example, content analysis allows the researcher to statistically analyze qualitative data by assigning quantitative scores to the language used in open-ended answers. Content analysis software can identify and categorize the emotions and opinions expressed in written passages. Well-designed surveys and experiments can provide researchers with high-quality data that can be used in econometric models for purposes such as calculating damages and forecasting demand. Consumer research's comprehensive approach to data can be useful in addressing a wide variety of difficult questions.



*Carol K. Miu is an Empirical Methods Consultant. She recently received her MS in Marketing from the University of Maryland, and she holds an SB in Economics from MIT.*

## The PeaceHealth Standard . . . . . Continued from Page 3

dled discounting, reasoning that bundled discounts may be predatory without actually causing the predator to incur a loss. The Ninth Circuit failed, however, to understand that while a predator may have positive profits, any below-profit-maximizing prices that are part of a bundled discounting strategy will cause the bundler to forgo some profits that it would have earned without bundling. Those forgone profits must be recouped for predation to be rational.

The Ninth Circuit's rejection of a recoupment standard is particularly curious because the need for recoupment is clear when profits are analyzed in a fashion parallel to the court's discount attribution rule. An example used in the opinion can illustrate this point. Suppose Firm A produces shampoo and conditioner at incremental costs of \$1.50 and \$2.50, respectively. Competitors produce shampoo but not conditioner. Firm A sells shampoo for \$3.00 and conditioner for \$5.00, but it sells them bundled for \$5.25, giving a \$2.75 discount. The Ninth Circuit standard allocates that discount to the competitive product, yielding a price for shampoo of \$0.25, well below incremental cost.

The recoupment question concerns whether Firm A's bundled pricing sacrifices profits. Firm A has a profit of \$4.00 when it sells shampoo and conditioner separately and a profit of \$1.25, or \$2.75 less, when it sells them as a bundle. A profit attribution analysis would attribute the entire profit reduction of \$2.75 to the shampoo. Firm A's profit on an unbundled sale of shampoo is \$1.50, but its profit on a bundled sale of shampoo is negative, a loss of \$1.25. Although the bundle as a whole is sold at a profit, the profit attribution test reveals the loss that must be recouped.

Much of the ongoing debate over how to distinguish between beneficial and harmful bundled discounts focuses on defining an appropriate measure of price to be used in a price-cost comparison. The Ninth Circuit's discount attribution approach has some logical appeal, although it inadequately accounts for economies of scope. The Ninth Circuit's failure to require a recoupment standard, in contrast, has no logical appeal and treats profits inconsistently with its treatment of discounts.

*David A. Argue has analyzed antitrust economics issues in numerous health care provider and payer sectors. He recently completed "Competition in Utah Health Care Markets," a study of market structures and contracting practices, including bundled discounting, in several health care services markets throughout Utah, on behalf of the Utah state legislature.*



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