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CAN A PRODUCT PRE-ANNOUNCEMENT BE A PREDATORY ACT?

Announcements that products will be available in the future are often alleged to be predatory acts in high technology industries. Such allegations date back at least to 1969 and the government's original complaint in *U.S. v. IBM*. In *U.S. v. Microsoft*, however, the Department of Justice seems to have adopted the position that product pre-announcements can only violate the antitrust laws if "those pre-announcements are knowingly false and contribute to the acquisition, maintenance, or exercise of market power." This view of pre-announcements is challenged in a *Microsoft* opinion handed down by Judge Sporkin and by some antitrust economists, particularly in the context of network industries. A careful analysis reveals, however, that pre-announcements will not necessarily harm competition and may benefit consumers, even if the pre-announcements are intended to thwart the development of a competitor's product.

The economic case against pre-announcements stems principally from economic research that finds that even truthful pre-announcements may lead to an economically inefficient decision to adopt a new technology. These results notwithstanding, however, it is hard to justify treating good-faith pre-announcements as predatory, in the sense of being harmful to consumers. When adoption of the new technology is efficient, pre-announcement may prevent consumers from making wasteful investments in a technology that will soon become obsolete. Whether pre-announcement is harmful or beneficial in any specific case will depend on a number of factors that cannot be measured. Thus, a rule against pre-announcements cannot be limited to cases where they are harmful.

Limiting a rule against pre-announcements to those cases where the firm intended to frustrate competitors (which would address Judge Sporkin's concerns regarding Microsoft), would not avoid condemning efficient pre-announcements. In fact, such a limitation would be meaningless. If a market for a network good will eventually support only one provider, firms may compete for this monopoly position. That competition may significantly benefit consumers by leading firms to offer low initial prices, to improve products, and to speed the introduction of products. When firms compete for a monopoly, however, everything they do will be designed to frustrate their competitors and to ensure that their product, not their competitor's, prevails. Such efforts are the essence of competition, and the antitrust laws should not be employed to prevent these efforts. Not only would a rule against good faith pre-announcements have no beneficial results, it could reduce competition. Firms compete in part by offering attractive product characteristics, one of which is rapid availability. To forbid firms from advising consumers when their product is likely to be available would hamper their ability to compete in this way.

A more difficult question is whether pre-announcements that are deliberately false can be predatory. Deliberately false pre-announcements cannot be defended on the grounds that they improve consumer information. Furthermore, such pre-announcements may have significant anticompetitive effects. Often technologies will experience a window of opportunity. If they are not adopted by a certain time, continued technical progress will leave them behind. A false

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pre-announcement that a product will soon be available may prevent adoption of the first product forever, even though that adoption would be efficient. Suppose consumers are willing to wait 18 months, but not two years, for the second product. The product's supplier falsely announces that it will be available in one year, so the consumers wait. Then in one year, the firm announces a one-year delay. Consumers may still wait, eventually adopting the second product even though they would have preferred immediately adopting the first. Thus, a false pre-announcement can enable a firm to succeed while harming consumers. (Of course, consumers might decide that since the first announcement was false, the second one is too, and adopt the first product. In that case, false pre-announcement does not benefit the supplier, but it still harms consumers, who needlessly postponed adopting the first product for a year.) Thus, situations may exist when deliberately misleading pre-announcements are predatory acts.

Caution should be exercised in applying antitrust sanctions to even deliberately misleading pre-announcements, however, because such sanctions will often be unnecessary and have the potential for abuse. The loss of credibility a firm employing this tactic would suffer may be deterrent enough; antitrust action against it would not be necessary. Furthermore, the skepticism with which consumers in the computer industry treat "vaporware" suggests that they know how to protect themselves from questionable pre-announcements. Moreover, it will often be hard to determine whether a pre-announcement was made in bad faith. Product development is often a lengthy and uncertain process, particularly with a complex product using an emerging technology. Announcements of future product availability made in good faith may turn out to have been far too optimistic.

Thus, product pre-announcements made in good faith should not be considered predatory acts, even if their purpose is to prevent adoption of a competitor's product. Deliberately misleading pre-announcements may be predatory acts, but caution should be exercised in sanctioning such acts.

Senior Economist Henry B. McFarland has worked on antitrust issues involving a number of high technology industries. This article is adapted from a more detailed piece forthcoming in Computer Industry.

EXCESS CAPACITY AND ANTICOMPETITIVE AGREEMENTS

Excess capacity is sometimes perceived as a sign of an anticompetitive agreement that reduces output below normal levels. In fact, excess capacity may arise from many different causes. Moreover, it is a generally accepted principle in the economics literature that excess capacity makes it easier for members of an industry to cheat profitably on an anticompetitive agreement or to expand output in response to a unilateral decision by one firm to reduce output. Unless there is strong ancillary evidence of an anticompetitive agreement, little basis exists for viewing excess capacity as an outcome of collusion.

Excess capacity, which appears periodically in different industries, may have disparate causes. One possible cause of excess capacity is a collusive agreement to reduce output. Under an output-restricting agreement, some of the capacity that had been chosen based on the larger, pre-collusive level of output becomes excess. Alternatively, excess capacity may have its origins in short-run demand instability and "lumpy" fixed investment. Firms with high fixed costs may not be able to reduce capacity quickly in response to rapid reductions in demand. As a consequence, some of the capacity remains idle. Another cause may be regulatory schemes that induce firms to compete on factors others than price. The trucking and airlines industries, for example, had very low load factors during regulation, but load factors increased substantially during deregulation as capacity and utilization were adjusted. Mistakes in planning may also be the root cause of excess capacity. Thus, the outward evidence of excess capacity may reflect a collusive agreement or it may result from normal business decisions, either in the context of regulation or in an industry with high fixed costs and fluctuating demand.

In circumstances in which demand fluctuations create excess capacity, firms have an incentive to cooperate to mitigate its influence on industry pricing. Historical evidence exists of collusion in industries with very substantial excess capacity. Collusive agreements in these industries are often attempts not

to increase prices, but to avoid the downward price spiral that occurs in the face of cyclical demand declines and excess capacity. The well-known collusive scheme among electrical equipment suppliers in the 1950s is a case in point.

There are some arguments that excess capacity can be used strategically by firms in the industry to erect barriers to expansion or entry by other firms. Much of the economic research on the topic, however, is couched in terms of the limited conditions under which a monopolist might strategically maintain excess capacity. In an oligopolistic industry setting, by contrast, allocating the cost of the excess capacity across firms would likely be an insurmountable problem. Thus, excess capacity is unlikely to be adopted by a cartel as a means of limiting entry.

Excess capacity tends to undermine anticompetitive actions whatever the cause of the excess capacity may be. This is evident in industries with significant fixed costs that cannot easily be shed. When demand falls short of that necessary to fully occupy the capacity of firms in an industry, the firms can either reduce costs or reduce prices in order to generate business to fill the excess capacity. Those firms with high fixed costs for which reducing costs is difficult have a strong incentive to reduce prices. In the electrical equipment suppliers collusion, for example, significant excess capacity caused widespread cheating on the agreement, which subsequently broke down. This is likely to be the case generally with collusive agreements when facing substantial excess capacity.

The Merger Guidelines specifically recognize the role of excess capacity in undermining both cooperative and unilateral anticompetitive effects of mergers. With respect to cooperative effects, the Guidelines note that "maverick" firms with excess capacity and the ability to expand output easily can destabilize a cartel. The Guidelines further state that only if all the excess capacity is in the hands of the core collusive group could it be an instrument to punish deviations from a cooperative outcome. In a unilateral effects context, the Guidelines state that a unilateral price increase from a merger is unlikely when a large number of the merged firm's customers can find economical alternative sources of supply that are neither capacity-constrained nor significantly higher cost.

In sum, it is clear that unless excess capacity in an industry is persistent, arises suddenly and cannot be explained by normal cyclical forces, the existence of excess capacity by itself is not useful evidence of cartel behavior. Rather, the existence of cyclical excess capacity in an industry is strong evidence that firms will have a heightened incentive to cheat on an anticompetitive agreement or otherwise increase their sales in order to make additional contributions to fixed costs.

Vice President Robert D. Stoner has researched issues related to excess capacity in connection with several recent merger cases.

THE ECONOMICS OF THE DUBUQUE HOSPITAL DECISION

In its October 1995 opinion on the Dubuque hospital merger, a U.S. District Court employed a strict Merger Guidelines approach to market definition by assessing the profitability of a post-merger price increase. In doing so, the court turned aside the government's analysis. The U.S. Department of Justice had filed a complaint seeking injunctive relief against a merger of Mercy Health Center and Finley Hospital, the only two hospitals in Dubuque, Iowa. The Court's denial resulted in large part from its rejection of the narrow geographic market alleged by the government.

Using the Elzinga-Hogarty test, the government alleged a geographic market that included Dubuque County, Iowa and a 15-mile arc encompassing parts of Illinois and Wisconsin. This area includes both Mercy and Finley, as well as a small third hospital, Galena-Stauss. The government's expert economist testified that 88 percent of the patients residing within the alleged market use one of these three hospitals and approximately 76 percent of the patients using the three hospitals reside within the alleged market. Thus the claimed market passed the weak Elzinga-Hogarty test.

The same migration patterns relied upon by the government, however, actually reveal why the government's market was too narrow, a bias associated with the Elzinga-Hogarty test. Approximately 24 percent of the patients using the three hospitals in the government's market reside outside that market, which implies that at least these patients have realistic alternatives to the hospitals in the alleged market. A

detailed examination of patient migration from individual zip codes confirmed the availability of alternate hospitals. Approximately 24 percent of Mercy and Finley's patients reside in zip codes in which at least one-third of the residents already use an alternate hospital.

The Court incorporated the profitability analysis in the Merger Guidelines in noting that the loss of only a fraction of those patients residing outside the government's market would be sufficient to defeat an attempted price increase by the Dubuque hospitals. For a 5 percent price increase to be unprofitable, the Dubuque hospitals would need to lose only 8 percent of their current patients. Even if none of the patients inside the government's market would switch hospitals, only one-third of the patients residing outside the government's market would need to switch to alternate hospitals to defeat a 5 percent price increase. This finding was based on a cost study of the Dubuque hospitals, which revealed a contribution margin of approximately 56 percent. When contribution margins are high, relatively small losses of patients cause price increases to be unprofitable.

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While only a small portion of patients would need to switch to an alternate hospital to defeat a price increase, the merging hospitals still needed to show that such a switch would occur. The actual use of alternate hospitals fell into two broad categories. Many residents of zip codes located near one of several rural hospitals surrounding Dubuque were served by both the Dubuque hospitals and the rural hospital. The services provided by the smaller hospitals were the same services received by approximately two-thirds of the patients using the Dubuque hospitals. The remaining third tended to use the larger but more distant hospitals that offered a wider range of services, though generally for services also offered in Dubuque. While not every alternate hospital could provide all of the services offered by the Dubuque hospitals, collectively they made it impossible for the Dubuque hospitals to raise rates. Consequently, a properly defined geographic market needed to include these alternate hospitals.

The government argued that even in zip codes where many patients already used other hospitals, additional switching would not occur due to strong patient-doctor loyalty and an unwillingness by physicians to practice at the alternate hospitals. The Court disagreed, explaining that competition among managed care plans and among large physician clinics often entailed patients switching doctors. A telephone survey of Dubuque area residents confirmed that approximately one-third of the population indicated a willingness to switch physicians to avoid a rate increase and that an additional one-third of the population did not need to switch doctors because they did not have a primary care physician.

Testimony from a large Dubuque-based physician clinic strengthened further the case for patients' willingness to use other hospitals. The physician clinic indicated that it competed through outreach clinics with other multi-specialty physician clinics, including those based some distance away in Wisconsin. This testimony also indicated that hospital use was determined by which physician clinic a patient chose. The Court's opinion cites two towns that are 40 miles closer to Dubuque than to the hospital associated with a Wisconsin physician clinic, yet the Dubuque physician clinic testified that in these two towns it faced strong competition from the Wisconsin physician clinic.

Overall, the Court's opinion employed a strict Guidelines analysis, asking whether a sufficient number of patients would switch hospitals to make a price increase unprofitable. Answering this question required consideration of the Dubuque hospitals' cost structure and the preferences of patients in the Dubuque hospitals' service area. The evidence in Dubuque was that enough people would switch from the Dubuque hospitals to require inclusion of numerous other hospitals in the market.

Principal Barry C. Harris testified on behalf of the Dubuque hospitals.