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Proposed Legal Rule for Unilateral Refusals to Deal

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The following is the practical legal rule that flows out of the normative analysis in my 9/21/05 Statement to the AMC.

Basic Requirements

It will be a violation of Section 2 of the Sherman Act for a vertically integrated firm with monopoly power to refuse a valid offer by an unintegrated competitor (in the output market) to purchase a product that the defendant manufactures and uses as an input for its output, if the court finds the following facts:

- A1. The potential purchaser has offered a price above the *non-exclusion benchmark price* level defined below.
- A2. The defendant has monopoly power in the sale of the product that the purchaser desires to buy.
- A3. The defendant has or will achieve monopoly power in the market in which the purchaser will compete.
- A4. The refusal to deal likely would cause prices to be raised or maintained at a supra-competitive level in a relevant market affected by the refusal to deal. (These relevant markets potentially include the product being purchased, the market(s) in which the potential purchaser would compete, and market(s) in which the purchaser's customers or producers of complementary products would compete with the defendant.)

Basic Defenses

- B1. This standard applies to all refusals to deal, even (in the rare case) where the defendant has previously sold the product. However, under no circumstances would this rule require the defendant to supply its product at a price below its incremental cost of supplying the purchaser.
- B2. The integrated firm may refuse to deal if selling the product to the purchaser would be technologically infeasible or raise the defendant's own costs to a prohibitive level (e.g., would make the defendant unable to supply its own needs or would subject the defendant to prohibitive reputational or other free rider problems). However, it is not a valid justification to claim that selling to the purchaser would increase competition and thereby reduce the defendant's investment or innovation incentives. This is because the benchmark price provision ensures adequate incentives by compensating the defendant for incremental profit-margin lost on output sales taken by the purchaser.

Non-Exclusion Benchmark Price

- C1. The non-exclusion benchmark price W compensates the defendant for profits lost on output sales taken by the purchaser. This price is presumed to be measured as follows:

$$W = Cu + D \times (P - Cu - Cd),$$

where P is the defendant's price of output in the market in which the potential purchaser would compete; Cu is the defendant's incremental unit cost of producing the product that the purchaser wishes to acquire; Cd is the defendant's incremental unit costs of producing the output (other than the cost of the product supplied to the purchaser) in the market in which the purchaser would compete; $(P - Cu - Cd)$ is the defendant's price-cost margin; D is the fraction of output sales of the purchaser that entail a reduction in the output sales of the integrated firm.

The non-exclusion benchmark may be calculated differently under certain circumstances:

- C2. Where the defendant and the potential purchaser have a prior course of dealing for the product at some other price and that relationship has been terminated by the defendant, or where the defendant sells the product to other purchasers, the non-exclusion benchmark price would presumptively be equal one of these alternative prices, subject to evidence by either party that these alternative benchmarks are not appropriate.
- C3. Where the defendant shows that selling to the purchaser would raise the defendant's own costs, but not prohibitively (e.g., by the defendant's limited capacity or by a valid concern regarding reputational free riding, etc.), the court will apply a higher benchmark price to take these costs into account.
- C4. Where the court finds that the defendant has not responded in good faith to valid offers from the potential purchaser and has made no valid offers or counteroffers of its own ("non-negotiable" or "flat" refusals to deal), the burden of overcoming the purchaser's claim that its price offer was valid and exceeds the benchmark price will be placed on the defendant.
- C5. Where the defendant's monopoly power in the product (i.e., input) market has not been acquired or maintained legitimately, owing to some conduct other than the refusal to deal, such that that the court would have less concern about providing the firm with an adequate return on input sales, the court may apply a lower benchmark price. However, under no circumstances would the benchmark price be set below the defendant's incremental cost of supplying the purchaser.