SHOULD “PRICE SQUEEZE” BE A RECOGNIZED FORM OF ANTICOMPETITIVE CONDUCT?

Dennis W. Carlton*

ABSTRACT
Should a “price squeeze” constitute anticompetitive conduct requiring investigation under the antitrust laws? A price squeeze occurs when a vertically integrated firm supplies an input to its downstream competitors at a price that generates a profit margin so low that the competitors exit the downstream market. I ask whether it is sensible to try to use antitrust laws to prevent such conduct or whether such an attempt would create more harm than benefit. The current case, *linkLine Communications, Inc. v. SBC California, Inc.*, raises this exact question.

*I* frame the problem as follows. Assume that Product *A* is a necessary input in the production of Product *B* and that Product *B* is produced in a fixed proportion to the quantity of Product *A* used as an input. Although it has no effect on the results, assume for exposition that one unit of Product *A* is required to produce one unit of Product *B*. Assume that Firm 1 is a vertically integrated producer of Product *A* and Product *B*. Assume that Firm 2 purchases Product *A* from Firm 1 at price *P*-*A* and sells Product *B* at price *P*-*B* in competition with Firm 1. Furthermore, assume that Firm 1 is a monopolist seller of Product *A*.2 Suppose Firm 2’s profit margin (*P*-*B* – *P*-*A*)

---

1 503 F.3d 876 (9th Cir. 2007).
2 As I explain below, if there is competition in the sale of Product *A* and Firm 1 is a price taker in that market, then the price squeeze would occur only if Firm 1 depressed the price of Product *B* because Firm 1 could not raise the price of Product *A*. In that situation, the
declines to a level so low that Firm 2 exits the market. Should Firm 1’s actions be subject to condemnation under the antitrust laws because it leads to some harm that is not actionable under other antitrust causes of action and, if so, under what circumstances?

To answer this question, one must first carefully identify the likely harm. Initially, I examine the claim that elimination of competing sellers of Product B causes consumer harm. This seems to be the standard price squeeze claim; however, I will show that it has no merit. Next, I also consider a more complicated scenario that might involve consumer harm.

The remainder of this paper is organized as follows. In Section II, I explain the general difficulty of regulating single-firm exclusionary conduct under the antitrust laws, using predatory pricing as an example of how a policy prohibiting certain conduct that is often procompetitive can lead to a social loss. In Section III, I first show that, even in the absence of liability under a price squeeze theory, firms have no incentive to engage in a price squeeze when Product A is used in fixed proportions with Product B. I then show how, in more complicated models, the price squeeze theory can have merit; but even in those cases there generally are offsetting procompetitive effects. Therefore, no general conclusions about harm from a price squeeze can be drawn. I then analyze the implications of price squeeze liability under two sets of circumstances: (1) no duty to deal; and (2) duty to deal. Under the assumption that there is no duty to deal, I show that a price squeeze theory will create incentives not to deal, even though absent the potential liability from a price squeeze theory there would be dealing to the benefit of consumers. This suggests that there may be high social costs to giving recognition to a price squeeze theory when there is no duty to deal. I then assume that the law imposes a duty to deal on Firm 1. That is, Firm 1 does not have the option to refuse to sell Product A to Firm 2. I show that, in this situation, inefficiencies will be created as a firm either raises its price of Product B or withdraws from production of Product B in an effort to reduce its liability.

II. DIFFICULTIES IN EVALUATING EXCLUSIONARY CONDUCT

A price squeeze can be viewed as one form of exclusionary conduct in which Firm 1 may use its position as seller of a critical input to Firm 2 to exclude Firm 2 from the downstream market and thereby increase or maintain Firm 1’s market power in some market. Before analyzing the price squeeze problem, I address the general difficulty in regulating exclusionary

---

analysis would be identical to the analysis of predatory pricing in Product B and there is no need for a separate “price squeeze” theory of antitrust liability.
conduct with the antitrust laws. To do this, I use the example of predatory pricing.

As a general matter, conduct that leads to the exit of rivals from a market may benefit consumers—that is, it may be procompetitive. Examples of such conduct include lowering price and improving quality, actions that harm rivals (and may even drive them from the market), but benefit consumers. It may be possible to show, however, that certain types of conduct could reduce social welfare if certain assumptions about market conditions and firms’ interactions are satisfied. However, the particular circumstances under which conduct also harms consumers may be so narrow or uncommon that a rule of antitrust law that subjects a whole class of conduct to antitrust scrutiny on the grounds that it may sometimes be anticompetitive will cause a substantial social loss if the policy also prohibits or discourages procompetitive conduct. For this reason, there is a risk that antitrust enforcement against potentially anticompetitive exclusionary conduct will cause economic harm by discouraging procompetitive conduct. Because of this risk, the fact that a particular economic model demonstrates the possibility of harm to competition is not a sufficient basis for subjecting conduct to antitrust scrutiny, particularly when the results of that model may not apply under different, and more realistic, circumstances.

To illustrate, consider the classic case of predatory pricing. In the simplest story, one firm sets a low price, drives out its rivals, and then raises price. The profits when price is high (the recoupment period) more than offset the loss when price is low. Although the low price is usually assumed to be below the firm’s costs, it is possible to construct economic models in which one very efficient firm lowers price below its rivals’ costs but above its own costs, drives rivals out of business, and then recoups. There are very few empirical examples of successful predation. At the same time, price reductions generally benefit consumers, and consumers would suffer if firms were fearful of competing by lowering price (as the Supreme Court has recognized). Hence, courts require that the low price must be below some measure of the firm’s cost and that recoupment is a “dangerous probability.” Although above-cost predation is theoretically possible, and a categorical rule that above-cost pricing is lawful may declare conduct lawful despite the possibility of harm to consumers, I agree with the reasoning that leads courts to impose the more stringent requirement that price be below some measure of the firm’s cost when assessing whether there is antitrust

---


5 See id. at 224.
liability. Such a rule is necessary to avoid chilling valid competitive behavior on the small chance of deterring a remote predatory scenario.6

To summarize: courts treat above-cost pricing as categorically lawful not because above-cost pricing can never lead to consumer harm. Rather, courts have (wisely in my view) determined that a legal rule that would purport to penalize only predatory above-cost pricing would (1) be difficult to administer; (2) be unpredictable in application and therefore difficult for businesses to follow; and (3) discourage proconsumer price cutting.7 Furthermore, courts have (again, correctly in my view) recognized that the possibility of above-cost predation that actually harms consumers is remote. It is precisely these types of concerns that should arise when one contemplates whether there should be a “price squeeze” doctrine, a question that I now turn to.

III. PRICE SQUEEZE ANALYSIS

I first evaluate whether Firm 1 has an incentive to engage in a price squeeze even if there is no potential liability under a price squeeze theory. I then conduct the analysis of a price squeeze first under the assumption that there is no duty for Firm 1 to deal with Firm 2. That is, Firm 1 is not required to sell Product A to Firm 2, but if it chooses to do so, it faces potential liability under a price squeeze theory. I then analyze the same issues under the assumption that there is a duty to deal. That is, Firm 1 is required to sell Product A at some price $P_A$ to Firm 2 and faces potential liability under a price squeeze theory.

A. The Incentive to Engage in a Price Squeeze

The price squeeze doctrine holds that Firm 1 sets the price of A so high that the margin between the output price, $P_B$, and the input price, $P_A$, is too low to allow Firm 2 to compete in the market for Product B, resulting in Firm 2’s exit. The first question that one should ask is whether this loss of Firm 2 creates a competitive harm, that is, is there some price, presumably $P_B$, that rises as a result of Firm 2’s demise?

If not, then it is improper to condemn the behavior. Moreover, even if it is possible to think of circumstances under which a competitive harm can occur, as we saw in the case of predatory pricing, the real policy question is whether the gains from condemning such behavior offset any losses that might arise from chilling competition. Before addressing this issue, though, I return to the basic question of whether the price squeeze causes antitrust harm by leading to higher prices.

The mere fact that Firm 2 exits the market for B, by itself, does not imply that consumers suffer any harm. For example, Firm 2 may exit because it is inefficient and it would surely lead to large-scale inefficiency if Firm 1 had an antitrust obligation to price \( P_B \) and \( P_A \) so that Firm 2 could survive regardless of Firm 2’s cost. Imposing such an obligation would result in \( P_B \) being set higher than necessary and would in essence impose a tax on consumers of Product B. Therefore, just as in the case of predatory pricing, any sensible price squeeze theory must use the costs of an efficient firm in applying the financial viability test.

But if one assumes that Firm 1 is efficient, then under the stated assumption of fixed proportions,8 Firm 1 cannot gain by driving Firm 2 out of the market for B. The reason is that Firm 1 already has all the power it needs, by assumption, to extract the profit from Firm 2 by raising \( P_A \) to just enable Firm 2 to earn a normal rate or return without driving Firm 2 out of business. Firm 1 gains nothing further by destroying Firm 2, even though any sales that Firm 2 would have made would instead be made by Firm 1. Because the increased profits that Firm 1 would earn by so doing would be the same as Firm 2 (assuming that both firms are efficient), and because that profit on Product B is “normal,” there is no extra (above normal) profit to be earned. This example is just an illustration of the “one monopoly profit theory” associated with the Chicago School.

Of course, economic theory can be used to show that in more complicated situations than the standard one, there could be an incentive to engage in a price squeeze that does harm consumers. For example, suppose that Firm 2 produces not Product B but some differentiated substitute to Product B, say Product \( B' \). Firm 2’s Product \( B' \) competes with Firm 1’s Product B in the eyes of consumers. Because each product is different from the other, it is possible that Firm 2 earns a profit above the normal level for some given prices of Products \( A \) and B. Firm 1 would like to extract this profit from Firm 2 but may not be able to if it can only charge a price \( P_A \) per unit (as distinct from other contractual arrangements; for example, purchase of Product B or nonlinear prices). If it cannot extract all of Firm 2’s excess profit, it may prefer to cause Firm 2’s exit and either eliminate Product \( B' \) (in which case it may sell more Product B) or try to produce and price Product \( B' \) itself. If it produces Product \( B' \) itself, it likely would not do so as efficiently as Firm 2 (if it is as efficient, then we are back to the case of “one monopoly profit”). Therefore, there would be an inefficiency and consumers of Product \( B' \) could be harmed by Firm 2’s exit, because they will either be unable to consume Product \( B' \) at all or perhaps face higher prices for Product \( B' \) than before, because Firm 1 is not as efficient a producer of Product \( B' \) as Firm 2.

8 If Firm 1 was not as efficient as Firm 2 in the production of Product B, then Firm 1 would willingly deal with Firm 2 at prices under which Firm 2 makes profits.
But even here, matters are not so simple. If Firm 1 drives out Firm 2, but chooses to produce Product $B'$ itself, then even though it may be less efficient than Firm 2 (which will tend to cause price to rise), it may actually lower the price of Product $B'$. The reason has to do with the elimination of double marginalization. When Firm 2 buys Product $A$ at $P_A$, it faces a price that is above the marginal cost of Product $A$, yet $P_A$ is the marginal cost to Firm 2 of an additional unit of Product $A$. In contrast, when Firm 1 produces an additional unit of Product $B'$, it recognizes that, because it produces Product $A$, the additional cost of Product $A$ is not $P_A$, but the lower marginal cost of $A$. Therefore, Firm 1 will have an incentive to produce more Product $B'$ and price lower than Firm 2. This effect could offset the inefficiency of Firm 1 and lead to lower prices and greater output for Product $B'$.

The point of this complicated example of a price squeeze is that, although it is possible to produce situations where a price squeeze leads to competitive harm, even in these cases it is possible that the results could go the other way and there would be no competitive harm. Figuring out which way the results go is hard, because necessary data are almost always unavailable or uncertain. Moreover, the inquiry as to whether a price squeeze leads to competitive harm necessarily must be conducted ex post, which therefore makes it impossible for a firm to know in advance whether its pricing practices will be anticompetitive.

Furthermore, figuring out what $P_A$ should be may be very complicated for a court. The price can be determined only where price observations pursuant to dealing with other firms, similarly situated to Firm 2, can be observed. Any other procedure for determining $P_A$ will likely lead to arbitrariness. But if prices charged to other firms are used to set $P_A$, then the incentive to deal with those other firms, as well as the prices charged to them, will be affected.

B. No Duty to Deal

In the absence of a duty to deal, Firm 1 would have no duty to provide Product $A$ as an input to Firm 2, but if it did so, it would be subject to potential liability if the prices that it charged for Product $A$ and Product $B$ excluded Firm 2 from the market for Product $B$. By hypotheses, Firm 1 can exclude Firm 2 from the market for Product $B$ simply by refusing to provide Product $A$ at all. Therefore, the only interesting question arises when Firm 2 also produces Product $C$. In such a case, a price squeeze rule could create substantial consumer harm. A rule of law that imposes a risk of liability if Firm 1 *voluntarily* provides Product $A$, despite the absence of any duty to do so, will tend to discourage Firm 1 from selling Product $A$ at all. As a result, consumers of products *other than* Product $B$ could be harmed, as I now illustrate.
Consider the following example. Suppose that Firm 2 uses Product A to produce, in addition to Product B, some Product C that Firm 1 cannot produce. Firm 2 buys Product A, uses it to produce Product C as well as Product B and this benefits consumers who otherwise would be forced to do without Product C. Suppose now that Firm 2 can profitably produce Product C but not Product B at the current price for Product A. A price squeeze doctrine would permit Firm 2 to complain that it is subject to a price squeeze on Product B. Firm 1 could respond to this liability threat by increasing the price of Product B. This would be bad for consumers, at least in the short run, as I discuss further below. Furthermore, Firm 1 could also avoid the liability simply by refusing to deal with Firm 2. If it did so, it would deprive consumers of Product C, creating consumer harm at the same time that it avoids antitrust liability. Thus, there is the increased risk of significant harm created by the incentive to avoid antitrust liability if there is a price squeeze doctrine.

C. Duty to Deal

Let us now consider the consequences of a price squeeze doctrine in the case where Firm 1 has a duty under the antitrust laws to sell Product A to Firm 2; that is, that there is a duty to deal.9 Recall that in the standard example of a price squeeze that I described earlier, there is nothing to be gained by Firm 1. This important observation informs the analyst that the motivating situation where the price squeeze theory is thought to apply is one where there is no competitive harm. If there were a recognized price squeeze theory and the courts subjected firms to it, then Firm 1 might charge a higher price than necessary for \( P_B \) to avoid any possible litigation (this can also happen when there is no duty to deal but the firm chooses to deal). Put differently, the threat of antitrust liability from a price squeeze could lead to consumer harm through a price umbrella for Product B. In such a case there would be no benefit and only harm from a price squeeze theory of antitrust liability.

Alternatively, Firm 1, facing potential liability from a price squeeze when there is a duty to deal, may opt to exit the production of Product B. In this way, it can earn monopoly profit from the sale of Product A to Firm 2.

---

9 I assume that the duty to deal is imposed under the antitrust laws. In *Verizon Communications, Inc. v. Law Offices of Curtis V. Trinko, LLP*, the Supreme Court spoke about the reluctance that courts have in imposing an antitrust duty to deal on a firm such as Firm 1. 540 U.S. 398 (2004). The reluctance stems from the weighing of the costs and benefits of such a duty. *See* id. at 414. Although one can think of instances where a duty to deal may benefit consumers, a duty to deal reduces property rights and as such reduces the fundamental incentives of a capitalist system to reward those who create products that consumers want. Any reduction in this incentive will generally harm consumers, especially when one realizes how important new products have been in raising living standards. *See* Carlton, *supra* note 2. I note that regulatory duties to deal are not relevant to this inquiry. If a regulator imposes a duty to deal, the regulator should also establish the terms of dealing. *See* *Trinko*, 540 U.S. at 411–12.
without generating liability from a price squeeze litigation. If Firm 2 is as efficient as Firm 1 in the production of Product B and there are many firms like Firm 2, then there is no consumer harm resulting from Firm 1’s exit from the market for Product B. However, if Firm 2 is less efficient than Firm 1 in the production of Product B, then there will be consumer harm.

To summarize, in the most straightforward case, and perhaps the one most applicable to the facts of the linkLine case, the price squeeze theory leads to no competitive harm. In more complicated cases, there may or may not be competitive harm, though that could be difficult to determine. Creating antitrust liability for a price squeeze could induce Firm 1 either to set a price for \( P_B \) that is higher than necessary or to exit production of Product B, causing consumer injury. Accordingly, because the gains from deterring an anticompetitive price squeeze seem quite modest but the costs are likely to be high, a sensible weighing of the gains and losses from adopting a price squeeze theory could lead one to reject that theory.

IV. CONCLUSION

Using a general theory of price squeeze to create antitrust liability is likely to chill competition and harm consumers. Where there is a duty to deal under the antitrust laws, application of the theory is likely to create incentives for inefficiency as firms either raise price or cease production to avoid liability. Where there is no duty to deal under the antitrust laws, application of the theory is likely to lead to withdrawal of goods from the market to the detriment of consumers as firms stop dealing with each other so as not to trigger liability.