The American Antitrust Institute

Written Statement of Samuel R. Simon

on Behalf of the American Antitrust Institute

for the House Committee on Transportation and Infrastructure

Regarding the Strategic Alliance Between UPS and DHL

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I am Samuel R. Simon, a private attorney from Philadelphia, Pennsylvania, speaking for the American Antitrust Institute ("AAI"), an independent research, education, and advocacy organization founded in 1998 that frequently comments on developments relating to the antitrust laws and competition policy.[1]

I. Overview of the Proposed Transaction

There are three principal competitors in the U.S. market for air express package delivery, FedEx and UPS being the largest and DHL being a much smaller third player.[2] DHL is a substantially larger player in Asia and Europe and though it is lagging in its North American market share, it is not alleged to be a failing company here or elsewhere. Indeed, according to its website, "DHL is the global market leader of the international express and logistics industry."[3] DHL, owned by Deutsche Post, had entered the U.S. market by purchasing Airborne.[4] Changing the name to DHL, the company became a trucking entity (therefore not subject to foreign ownership limitations that apply to air carriers) by ending its integrated air operations and outsourcing to two independent air carriers, ABX Air and ASTAR, as the providers of the air linkage in the DHL delivery system. In the proposed transaction, DHL would switch the sourcing of its critical air linkage input from ABX Air and ASTAR to UPS.

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[1] For further information on the AAI, please visit www.antitrustinstitute.org.

[2] There is also a fringe of very small competitors. The U.S. Postal Service is not considered a competitor in this market for just-in-time deliveries, although it offers second-day delivery. In fact, it has an alliance with FedEx for express deliveries.

[3] See http://www.dhl-usa.com/Company/CompanyInfo.asp?nav=companyInfo.

[4] For background, see Albert A. Foer, "Airborne and DHL, Some Policy Considerations, 5-12-2003" at http://www.antitrustinstitute.org/Archives/245.ashx.

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II. Antitrust Concerns

Consumers of air express delivery services are likely to be benefited the most by prices, service quality, and choice that are determined by more--rather than fewer--independently controlled suppliers in the market. The principal concern of consumers should therefore be whether DHL will remain a viable and independent competitor if it replaces air linkage service provided by independent air carriers with one of its two major rivals, UPS.

From our perspective, the deal appears on its face to set DHL up to be squeezed on prices and services by a principal competitor. We believe that by becoming entirely reliant on one of its two major competitors for one of its most crucial in-puts (air delivery of its parcels), DHL will at best lose its independence as a competitor, and at worst will ultimately deteriorate to the point that it is no longer a factor in a market that will have gone from three to two competitors.

As a result of this proposed transaction, it would appear that a large part of DHL's costs will be controlled by a competitor, reducing DHL's ability to price its overall services competitively by reducing the pricing on the air linkage services component. Moreover, in an industry in which timely delivery is of the very essence, DHL will be in a position where its competitor can give itself an advantage by discriminating in small and perhaps hard-to-detect ways against DHL.

Even if UPS refrains from actually squeezing DHL, the clear potential of this will overhang the relationship as a form of discipline that should be considered as effectively neutering DHL. The transaction should be viewed by the public as if it were a three-to-two merger; and even though a third company will be left on the ground (quite literally), its ability to influence its two primary competitors will have disappeared. Two of three competitors would essentially be agreeing to cease competing.

If DHL does not intend to depart the U.S. market, then perhaps its objective is to facilitate horizontal collusion, whereby it would benefit from higher prices within a less competitive market in which only two players need to make pricing decisions. It is usually easier for two similar rivals than for three more diverse rivals to tacitly collude.

III. Legal Implications

Express air parcel delivery requires a closely coordinated linkage of air and ground transportation systems. These can be vertically integrated within the same company or can be integrated through outsourcing contracts. UPS and FedEx are vertically integrated. DHL purchases the air transport element in the marketplace and handles the coordination function internally. There is normally no competition problem with either method of organizing a firm's functions, but a problem can arise when DHL becomes locked into purchasing a critical input from a vertically integrated competitor.

The competitive problem can arise either if UPS internally charges itself a lower price for its own air services than it charges to DHL, so that it can set a retail price that cannot practically be equaled by DHL, or if UPS provides a more efficient, higher quality service to its own retail customers than it does to DHL's customers. In other words, the vertical integration sets up the possibility of discrimination in a way that can undermine DHL's appeal to customers who must choose between DHL and UPS. In theory, this can lead to a reduction in DHL's profit margin as it reduces its retail prices in order to offset the wholesale cost disadvantage, to the crippling of DHL as a competitor, as it recognizes UPS's ability to take retributive actions if DHL reduces its prices to customers below UPS's prices or fails to follow a UPS price increase, and to the ultimate departure of DHL from the U.S. market.

Let us ask whether the law of contract or the law of antitrust would be likely to save DHL in the face of a price or service squeeze by UPS.

A. Contract

Presumably DHL is fully aware of the competitive risks imposed by the proposed agreement with UPS. Perhaps DHL can adequately protect itself from these negative possibilities by an iron-clad and highly detailed contract or the threat of an antitrust case. Generally, we wouldn't care if a company makes an independent but unwise decision. But if DHL enters a contract that fails to protect it against a price squeeze or a service squeeze (or both), or otherwise fails to protect its competitive independence, the result will be to reduce what is already a highly concentrated market to an effective duopoly, a matter that would be of public concern.

However, can a contract really be iron-clad when so much of the information about whether it is being followed is likely to be ambiguous and difficult to prove in a court? Keep in mind that whether there is price discrimination against DHL will depend on what part of its multitudinous accounting lines UPS allocates to the wholesale price and that intentional degradation of services can occur without a paper trail or other evidence that is more than merely circumstantial. What disadvantage would DHL be at during the pendency of disagreements over whether a price squeeze or service squeeze, or both, were occurring? Negotiations could drag out, while DHL's business diminishes. An actual breach of contract suit could drag on for years longer.

B. Antitrust

1. Section 2 of the Sherman Act

An antitrust case would likely take even longer than a breach of contract case. It is, in any event, doubtful that DHL could depend on a private antitrust action to bail it out after a price squeeze under Section 2 of the Sherman Act, which protects against monopolization and attempted monopolization. Putting aside the possibility of a Supreme Court decision in *linkLine* (described in the Appendix) that undermines any antitrust liability for price squeeze conduct, there is a question of whether UPS would be considered a monopolist (or attempted monopolist) within the tradition of

the price squeeze literature. It would still have at least one competitor, FedEx, and control less than half of the overall market.

Suppose DHL became convinced that its dependence on UPS was misplaced. Aside from the fact that by this time its customer base and credibility would have been eroded, what switching choices would it realistically have several years from now? Presumably, FedEx would not be an alternative, because its vertically integrated structure would present the very same structural problems as UPS. Would both ABX Air and ASTAR (or either) likely be available to pick up DHL's air transport requirements? Will they survive being cut off from DHL? Are there any other alternatives to which DHL could smoothly switch? Congress and the DOJ should be asking these questions.

2. Section 1 of the Sherman Act

While the foregoing considerations make it unlikely that a successful Section 2 case could be prosecuted by DHL in the future, the overhang of disciplinary discrimination by UPS makes it appropriate to examine whether the transaction should be blocked today as a Section 1 agreement that is likely unreasonably to restrain competition.

The argument here is straightforward. DHL and UPS, direct competitors in a highly concentrated market, are agreeing to eliminate one of the principal dimensions of competition that currently exists between them, in a context that makes it unlikely that DHL will be able to compete aggressively. DHL will no longer control the air component of its service and it will know that its much larger competitor and supplier of this component will be able to impose discipline if it competes in ways that UPS dislikes. This will leave UPS and FedEx, both of which strongly opposed DHL's acquisition of Airborne five years ago, in a position where they need not worry about an independent third competitor, but can key off of each other much more predictably in setting prices and other terms of trade.

The agreement might therefore be considered a "facilitating practice" that makes it easier for firms in an oligopoly to coordinate their pricing.[5] Such a practice can be enjoined.

3. Section 7 of the Clayton Act

Section 7 of the Clayton Act, which declares unlawful mergers or acquisitions where the effect "may be substantially to lessen competition," applies to acquisitions of assets, but here there is no acquisition by UPS, merely an agreement with DHL.

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[5] See Hay, "Oligopoly, Shared Monopoly, and Antitrust Law, 67 Cornell L. Rev. 439 (1982). According to Sullivan & Grimes, The Law of Antitrust: An Integrated Handbook (2d ed., 2006), "Use by oligopolists of a facilitating practice that enables the participants to coordinate prices should be vulnerable under Section 1 even if they are using it interdependently, rather than by explicit agreement…And, where oligopolists do not avoid but interdependently embrace such conduct, there is an available judicial remedy: their conduct can be enjoined." (198-99.)

Nonetheless, the analogy is useful in demonstrating the general intent of the antitrust law to stop anticompetitive agreements in their incipiency.

4. Section 5 of the Federal Trade Commission Act

If the Department of Justice (DOJ) is uncomfortable bringing an injunctive action against the DHL/UPS transaction as a violation of Section 1, it should, rather than close its investigation, refer the matter to the Federal Trade Commission (FTC) for investigation under the standard of Section 5 of the Federal Trade Commission Act, which outlaws "unfair methods of competition." On its face the proposed transaction would appear to qualify, even if not technically violating the other antitrust statutes, because of its likely negative impact on the competitive process.

APPENDIX

History and Background on Price Squeeze

I. Price Squeeze in Fully Unregulated Industries

Many companies simultaneously sell the same product at the retail and wholesale levels; that is, they sell directly to customers while simultaneously selling to their non-integrated competitors, who in turn sell the product to their own customers. The economic phenomenon known as a "price squeeze" (sometimes known as a "price-cost squeeze") occurs when such a vertically integrated company, having monopoly power, sets its prices at the first level (often called the "upstream" or "wholesale" level) so high that its wholesale customers cannot compete with it in the second-level ("downstream" or "retail") market because their profit margin is non-existent. The integrated company has imposed a "squeeze" between the wholesale and the retail price that disables the non-integrated company, which is both a competitor -- and by happenstance a customer -- from selling the product. If the competitor goes out of business, the integrated company is free to take over the departed company's customers as its own. In any event, the squeeze can reduce the competitor's appeal to customers, thereby leading to less market share and profitability and subjecting the competitor to discipline for what the integrated company sees as undesirable aggressiveness.

The courts have long condemned the concept of price squeeze as violative of the monopolization clause of Section 2 of the Sherman Act and, where joint action has been proven, under Section 1. As early as 1910, a federal court of appeals upheld the validity of a Sherman Act complaint by a New York anthracite coal dealer against a railroad that had conspired with other railroad companies who controlled large tracks of Pennsylvania coal lands to increase the price of anthracite coal at the mines to 65% of the New York retail price, and then to charge an additional 40% of that price for transportation to New York, thus inflicting a ruinous price squeeze on the plaintiff and forcing it from the New York market, which was defendants' goal. *Meeker v. Lehigh Valley R.R.*, 183 F. 548 (2d Cir. 1910). Six years later, Judge Learned Hand, confronting a government antitrust suit against an integrated manufacturer of raw glucose and glucose syrup, determined that the defendant had engaged in unlawful "maintenance of substantial equality of price between glucose and syrup," thereby destroying the profit margins of the non-integrated syrup mixers in violation of the Sherman Act. *United States v. Corn Products Refining Co.*, 234 F. 964 (S.D.N.Y. 1916).

Although neither *Meeker* nor *Corn Product Refining* used the term "price squeeze," those decisions accurately described -- and condemned -- the "pincer" phenomenon (high wholesale price; low retail price) as violative of the antitrust laws. Thus, by the time the court of appeals had occasion to revisit the question in 1945 in the famous *Alcoa* case (*United States v. Aluminum Co. of America*, 148 F.2d 416 (2d Cir. 1945)), the price squeeze by a company with monopoly power was a well-known and universally condemned method of inflicting antitrust injury because it made it

impossible for competitors of a vertically integrated manufacturer with monopoly power to remain in the marketplace by the mere happenstance that the competitors' monopolistic commercial rival happened to be their source of an indispensable raw ingredient.[6]

Numerous decisions since *Alcoa* have found a price squeeze in violation of the Sherman Act in situations where the vertically integrated defendant (a) enjoyed monopoly power in the relevant product at the first level, (b) sold the product to its competitors-customers at a high, monopoly price, and (c) priced the product it directly sold to customers at the retail level in a way that made it impossible for its retail competitors to remain in business, thus engaging in unlawful monopolization of, or attempt to monopolize the downstream market in violation of Section 2. One court of appeals put the proposition as follows:

> If a competitor is also a customer his relationship to the monopolist is not only a competitive one. The monopoly supplier who retaliates against customers who have the temerity to compete with him, by cutting such customers off, is severing a collateral relationship in order to discourage competition.

Olympia Equipment Leasing Co. v. Western Union Telegraph Co., 797 F.2d 370, 376-77 (7th Cir. 1986).

The DHL/UPS transaction takes place in an unregulated environment, but to provide a full background of the antitrust potential, we must go on to discuss regulated and partially regulated industries.

II. Price Squeeze in Regulated Industries

Regulated industries are those where a company's prices are imposed or approved by the government. They include electric utilities, natural gas companies, and telephone companies -- i.e., regulated utilities. Such companies not infrequently sell their product at two levels of distribution, i.e., the retail level (sales directly to consumers), and the wholesale level (sales to the company's competitors, who seek to sell to the same consumers). An example would be a large publicly regulated electric utility company that (a) sells electric power directly to retail customers; and (b) simultaneously sells the same electric power to municipal utilities, who in turn sell it to their own retail customers within their more limited geographic area.

Government control over such utilities' wholesale and retail prices introduces new

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[6] Alcoa possessed monopoly power in the production of aluminum ingot. The company sold its ingot to independent fabricators, who turned the ingot into sheet aluminum. Alcoa also fabricated sheet aluminum itself. It was thus in direct competition with its wholesale customers for sales of aluminum sheet. Alcoa set its ingot price higher than a "fair price," and simultaneously set its price for sheet so low that its competitors, who had no other place to buy the ingot they needed to make sheet, could not match Alcoa's price and still make a "living profit." On these facts the court of appeals held that Alcoa had violated Section 2 of the Sherman Act. 148 F.2d 416, 437-38 (2d Cir. 1945).

elements into the courts' analysis of the price squeeze theory, and has led to rulings that a price squeeze in a *fully regulated* industry does *not* violate the antitrust laws because the prices were imposed from without. For example, in *Town of Concord v. Boston Edison, Co.*, 915 F.2d 17(1st Cir. 1990), the court of appeals held that where a monopolist (there, an electric utility company) sells at two levels, and its wholesale price to municipal utility companies is too high while its retail price to individual rate paying customers is too low, so that its municipal utility competitors could not compete with it at the retail level, that "pincer" does not constitute an unlawful price squeeze because both prices were regulated by the government. *Concord*, 915 F.2d at 22. Accord, *City of Anaheim v. Southern Cal. Edison Co.* 955 F.2d 1373 (9th Cir. 1992); *City of Mishawaka v. American Electric Power Co., Inc.*, 616 F.2d 976 (7th Cir. 1980).

Under these circumstances, the courts of appeals have generally required that an antitrust plaintiff show a "specific intent to monopolize" (an element of an attempted monopolization claim), which generally cannot be proven because (a) regulators "try to set prices that reflect costs" (*Concord*, 915 F.2d at 25), and (b) regulated prices are designed to provide the utility's investors with a reasonable rate of return. See, e.g., *Anaheim*, 955 F.2d at 1378-79; *Mishawaka,* 616 F.2d at 985; *City of Groton v. Connecticut Light & Power Co.*, 662 F.2d 921, 931-32 (2d Cir. 1981).

III. Price Squeeze in Partially Regulated Industries

Concord, an opinion that carries much weight because it was written by then-Judge (now Justice) Breyer, is pellucid that its reasoning and conclusions are confined to fully regulated industries. The decision has no application to industries where prices are regulated at only a single level (typically the wholesale or upstream level):

> [O]ur reasoning applies with full force only when the monopolist who engages in the squeeze is regulated at both industry levels. . . .We recognize that a special problem is posed by a monopolist, regulated at only one level, who seeks to dominate a second, unregulated level, in order to earn at that second level the very profits that regulation forbids at the first.

Concord, 915 F.2d at 29. Where, as in *Olympia*, supra, 797 F.2d at 376-77, a competitor has no choice but to buy its output (or, as in *Alcoa*, an indispensable ingredient of its output, which is the same thing) from a monopolist whose upstream rates happen to be regulated while its downstream rates are not, the antitrust law's century-long prohibition against price squeeze remains the only way to protect the competitor from being caught in the pincers and eliminated from the industry as a competitive force.

A price squeeze by a company with monopoly power in an industry that is less than completely regulated, i.e., a industry where one level of prices is not set by the

government, may be unlawful under an unbroken line of precedents extending back to 1910.

IV. The linkLine Case: A Preview

The Supreme Court has itself never directly spoken on the price squeeze theory, although it has been part of the nation's jurisprudence since 1910. (*Alcoa*, the 1945 court of appeals decision, is often treated as equivalent to a Supreme Court precedent because it was the court of last resort.) This Term the U.S. Supreme Court will decide an antitrust case that presents it with an opportunity to decide the scope, contours, and continued viability of the price squeeze doctrine. In *Pacific Bell Telephone Co. v. linkLine Communications, Inc.*, No. 07-512 (*linkLine*), the Court confronts a challenge to the concept of price squeeze in the partially regulated telecommunications industry, in which some rates are set by government regulation while others are set by the companies themselves.

The case presents a situation in which a dominant regional telephone company (Pacific Bell) also provides digital subscriber line (DSL) Internet service to retail consumers over its infrastructure and facilities. Pursuant to the pro-competitive duties and obligations that Federal Communications Commission (FCC) regulations imposed on such dominant telephone companies as the quid pro quo for permitting them to enter the long distance telephone market previously reserved for AT&T, Pacific Bell, when providing DSL internet service to own retail customers, was required to supply new entrants such as linkLine with DSL access to its network and facilities so that the entrants can connect to Pacific Bell's facilities (the only ones available) and sell DSL internet service to their own retail customers, thus "jump-starting" competition in the DSL internet access market. Thus, as in the normal price squeeze case, linkLine is simultaneously a competitor and a customer of Pacific Bell; moreover, as in the ordinary price squeeze case, linkLine is compelled to be Pacific Bell's customer because Pacific Bell's monopoly position in the relevant market leaves linkLine with nowhere else to turn.

LinkLine sued Pacific Bell, claiming that it was the victim of a price squeeze and other antitrust violations because the juxtaposition of Pacific Bell's high (and regulated) wholesale rates governing the provision of DSL transport, on the one hand, and its low (and unregulated) retail rates in providing DSL internet access, on the other, made it impossible for linkLine to compete in the provision of DSL Internet services to its customers. The district court and the court of appeals sustained the price squeeze allegations against Pacific Bell's contention that two intervening Supreme Court decisions had effectively abolished or severely limited the price squeeze doctrine. Pacific Bell, joined by the dissenting opinion in the court of appeals, argued that the Supreme Court's decision in the *Trinko* case, 540 U.S. 398 (2004), established the proposition that except for peculiar circumstances not present here a competitor has no antitrust duty to assist its rivals, and that the Court's earlier decision in the *Brooke* case, 509 U.S. 209 (1993), held that only a "predatory" price (i.e, a price below some measure of defendant's costs, which the

linkLine complaint does not allege) is subject to antitrust scrutiny lest vigorous but above-cost price-cutting be deemed unlawful.

The DOJ, but not the FTC, urged that the Supreme Court reverse the court of appeals lest companies such as Pacific Bell, which must offer wholesale services to its competitors by statute, cease to offer low retail prices to its own retail customers. The DOJ thus took the position of a "vertical integration apologist," echoing the Chicago School of Economics approach that there should be no antitrust barriers preventing a vertically integrated monopolist that supplies its competitors with an essential raw ingredient obtainable nowhere else from compelling them to leave the market by imposing a price-cost squeeze on them.

At stake in *linkLine* is whether the venerable concept of price squeeze will, at least as currently understood, continue to be part of the fabric of antitrust jurisprudence to protect from extinction or, at least anticompetitive discipline, companies who are compelled to purchase an indispensable ingredient of their end product from a monopolistic commercial rival. While a decision against the plaintiff could be limited to situations in which there is regulation, thereby making it easy to distinguish from the DHL/UPS transaction, the tenor of the opinion could conceivably end the antitrust life of the price squeeze. This possibility demands a watchful Congress.