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Considering Welfare In ITC Exclusion Order Cases

Law360, New York (May 02, 2011, 2:18 PM ET) -- The primary remedy available to a complainant in an International Trade Commission Section 337 investigation is an "exclusion order," which enjoins the importation of infringing articles into the U.S. A "limited exclusion order," or LEO, applies only to the infringing articles imported by respondents.

A "general exclusion order," or GEO, applies more widely to infringing articles imported by any party. One of the factors that the ITC considers in evaluating whether to issue an exclusion order is the effect of the exclusion order on the "public interest."

Recently, the ITC has shown an increasing focus on this issue. For example, in October 2010, the ITC sought public comment on proposed amendments to its Rules of Adjudication and Enforcement that would instruct complainants and respondents to evaluate the effect of exclusion orders on the public interest (see here).

Central to determining the impact on the public interest is the economic concept of "welfare." We discuss the economic factors that determine how an exclusion order would affect welfare.

The ITC's Proposed Amendments and "the Public Interest"

Our reading of the proposed amendments is that the ITC intends to define "public interest" to include both consumer welfare and producer welfare. An economic calculation of consumer welfare can be measured as the value consumers receive from products above and beyond the price they pay for those products. Producer welfare is defined as the profits that firms make on the products that they sell.

The ITC's proposed amendment to §210.12 asks a complainant to "address how an issuance of an exclusion order and/or a cease and desist order in this investigation could affect … competitive conditions in the U.S. economy …or U.S. consumers." Consumers are explicitly mentioned, and "competitive conditions" can be interpreted to mean economic welfare, which encompasses both consumers and producers.

Specifically, the proposed amended §210.12(a)(12) goes on to ask the omplainant to:

"iii) Indicate the extent to which like or directly competitive articles are produced in the U.S. or are otherwise available in the U.S. with respect to the articles potentially subject to the orders; iv) indicate whether complainant, complainant's licensees, and/or third-party suppliers have the capacity to replace the volume of articles potentially subject to an exclusion order and a cease and desist order within a

commercially reasonable time frame."

The first of these points appears to be asking whether noninfringing substitute products are available for consumers to purchase in place of the products that would be subject to the orders. The second point appears to be asking whether there are firms that could replace the supply of products subject to the orders.

Although these two points are important, especially for determining the magnitude of the effect of an exclusion order on consumer welfare, they do not exhaust the questions that must be asked to assess the effect of an exclusion order on either consumer welfare or total welfare.

Since an exclusion order effectively eliminates one or more products from the market, it can result in a reduction in consumer welfare if it leads to reduced product variety, increased prices or the need for consumers to incur costs to switch products.

The elimination of products from the market is also likely to harm some firms while benefiting others. The net effect on producer welfare depends on the circumstances. Additional factors, therefore, may need to be considered in order to evaluate the effect of an exclusion order on total welfare.

Additional Economic Factors Affecting Welfare

A nonexhaustive list of additional factors that might be considered in evaluating welfare includes the following:

1) Consideration of the costs and time it would take a customer to switch to substitute products.

Customers (or a subset of customers) who buy the excluded product may face costs in switching to substitute products. The term "customer" may include final consumers as well as firms that are downstream from the excluded product. Switching costs may be direct out-of-pocket expenses or indirect costs (such as loss of sales, e.g., for a downstream manufacturer) associated with the time it takes to switch to alternative products.

The impact of such switching costs should be weighed in the consideration of the availability of substitute products. For example, an infringing product may be a component of a system. Customers may purchase separate accessories or components that are related to the infringing product but these separate products may not themselves infringe. An exclusion order against the infringing product may require customers to switch out the whole system and purchase different accessories or components that are compatible with the noninfringing product.

2) Consideration of loss in consumer welfare due to reduction in product variety in differentiated product industries.

In industries in which product differentiation is important, an exclusion order may cause a loss in consumer welfare from a reduction in product variety.

How close a substitute the "directly competitive articles" are to the infringing product will determine the extent of the loss in consumer welfare. The consumer welfare associated with one given product in differentiated product industries can be large even when there are a number of articles that may be defined as "directly competitive." In this case, the effect of the exclusion order on consumer welfare

might be substantial.

Empirically, the economics literature has demonstrated that a single product in a differentiated products industry may have large value even if there are substitute products. This literature has also addressed how to measure the loss in consumer welfare arising from the loss of one product from consumers' choice set.

The potential loss in consumer welfare due to the reduction in product variety is particularly relevant in the context of a GEO that would bar imports of final goods ultimately sold to final consumers, since final goods are often differentiated products.

For example, suppose the patent-in-suit reads on a particular type of semiconductor chips used in cellphones. Even if the chips of different suppliers may be relatively homogenous (as in the case of dynamic random access memory), the final product — cellphones—may be much more differentiated.

A general exclusion order would result in withdrawal from the market of all cellphone models containing the infringing chips. Even if there are other cellphone models available in the market, and consumers could quickly switch to those cellphone models without incurring any cost, there could still be a substantial loss in consumer welfare. Some consumers would no longer be able to purchase the specific cellphone model they most preferred (i.e., one of the excluded cellphone models). This effect will be smaller the "closer" the available substitutes are.

3) Consideration of the potential for a price increase from the reduction in competition.

An exclusion order eliminates a firm from the market. This can have an adverse impact on competition, leading to effects on the prices of products in the market in question. These price increases in turn harm consumers. Economic models of competition show that eliminating a supplier can lead to price increases, even if the remaining firms have capacity to replace supply and offer a substitute for the excluded product.

As an extreme, but instructive example, consider two suppliers of a perfectly homogenous product, each with substantial excess capacity. If one supplier was blocked by an exclusion order, the remaining supplier would be a monopolist, and accordingly it would have the incentive to increase its price. This price increase would occur despite the fact that the remaining supplier offers a perfect substitute for the excluded product and has substantial excess capacity.

Outside of this example, the magnitude of the price increase and its impact on consumer welfare will depend on the specific context of the industry. The price increases by remaining suppliers after a supplier has been excluded depend on, among other things, the extent to which the remaining products are substitutes for the excluded product, the excess capacity of remaining suppliers and the nature of competition between the remaining suppliers.

The impact of a price increase on consumers may also be different in cases where the exclusion order blocks the final good than when it blocks an intermediate good. The price effect on consumers is direct, or nearly so, for an exclusion order that blocks a final good.

When the exclusion order blocks an intermediate good, the price effect is indirect and will depend on whether and how much the downstream firms pass through the price increase to final consumers. The amount that a company passes through a price increase depends on cost, demand and competitive

conditions in the industry, as well how quickly such intermediary producers respond to changes to input costs.

4) Consideration of the ability of noninfringing firms to offer close substitutes and the time required to do so.

As previously mentioned, the impact on prices will depend on the availability of close substitutes to the infringing product. This consideration should include products that are already on the market, but should also account for the ability of noninfringing firms with capacity to expand production to offer close substitutes to the excluded products.

The impact of an exclusion order will be greater if there is a mismatch between firms with lots of capacity and the type of product that needs to be replaced, or if it takes a long time to expand capacity or switch production.

5) Consideration of potential entrants. The economic theory of competition suggests that, even if there are currently no firms with capacity, a new entrant (or entrants) could enter the market and lead to lower prices.

Evaluating the impact of potential entrants on price outcomes requires assessing barriers to entry, the amount of time it would take for new firms to enter the market, and the competitiveness of potential entrants. The impact of an exclusion order may be greater in industries with significant barriers to entry. On the other hand, in some industries just the threat of quick and easy entry may be sufficient to deter significant price increases

6) Balancing the potential profit lost by vertically-related firms against the potential profit gained by competitors and competitors' vertically-related firms.

An exclusion order may cause firms that are vertically related to the excluded firm to lose profits. This consideration, however, needs to be balanced against the increased profits of nonexcluded competitive firms, and firms that are vertically related to the nonexcluded firms in order to calculate the total net effect on producer welfare.

Going back to the cellphone chip example, a general exclusion order that barred cellphones containing the infringing chip would potentially harm the chip manufacturer and the cellphone manufacturers that had been using the infringing chip, while potentially benefiting noninfringing chip manufacturers and the cellphone makers that use those noninfringing chips.

But the general exclusion order would also potentially harm the cellphone service providers who sold the cellphones at issue, while benefiting other cellphone service providers.

Addressing Questions of Equities

As a final but separate matter, another economic consideration that the ITC might take into account when considering the impact of an exclusion order is the question of equities. For example, in some situations, the infringing article may be a small value component of the imported product that would be subject to the exclusion order. In such a case, the exclusion order would stop the importation not only of the infringing article, but also of noninfringing components of the product.

In addition, it may be difficult for the manufacturer of the imported product to switch to a noninfringing component. These considerations could play a role in the ITC's decision when choosing a remedy.

Conclusion

Our discussion provides a list of significant factors that may affect consumer and total welfare from an exclusion order arising from a Section 337 ITC investigation. Because different issues will arise in each case brought before the ITC, companies should consider "public interest" as defined by general economic principles related to consumer welfare and producer welfare, rather than any one set of specific factors.

By adopting a general but structured economic framework, complainants and respondents can address public interest issues that are likely to be relevant to the ITC in Section 337 cases while maintaining the flexibility to handle the specific circumstances of each individual case.

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