



Price-cost tests for loyalty discounts and exclusive dealing: Comments on Fumagalli and Motta (2017)

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Disclaimer: These are not necessarily the views of any organisation with which I am associated.

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Paper aims to debunk 3 key myths

1. Theories of Harm arising from predation are fundamentally different from those arising from exclusive dealing:
 - with the latter (but not the former) involving ‘raising rivals costs’.
 2. Exclusive dealing theories do not require profit sacrifice, but predation theories do.
 3. Some forms of loyalty discounts so closely resemble exclusive dealing that they should be treated in the same way.
- Approach of paper is to consider relevant theory, extending it in places, to draw general conclusions, which can inform policy.

Plus ‘clarifications’ arising from paper

- a) Even if losses ($P < MC$) are required for exclusion, this doesn’t necessarily require $P < MC$ *on average across all sales*.
 - Rather an incumbent can exclude by targeting low prices on specific customers or on the specific part of customers’ demand.

- b) Even if profit sacrifice is required for exclusion, this can occur *at the same time* as recoupment, rather than sequentially.

- c) There is an important difference between an exclusive dealing contract and a discount that is contingent on a buyer purchasing 100% (or most) of its needs from a specific supplier.
 - In the former, the buyer is bound by the contract, over its duration. The buyer may need to be incentivised to commit to such a contract.
 - In the latter, the buyer can switch freely, albeit at the cost of losing discount.

Plus ‘clarifications’ arising from paper

- d) There does need to be some sort of *asymmetry* between the incumbent and the rival which explains why the rival is vulnerable to the loss of key customers/sales, while the incumbent is not susceptible to the same tactics. This can, eg, arise from:
- The entrant not yet having sunk its full entry cost (NB This lies at the core of many of the models presented)
 - The incumbent having access to certain non-contestable customers/sales, which allows it exploit scale economies or network externalities
 - The incumbent having lower sensitivity to financial constraints, perhaps because endowed with its own liquidity (or because of its established track record in the market)
 - The incumbent being able to act first in offering eg an exclusive dealing arrangement. (NB This first mover advantage is relevant only if long-term and non-reversible)

Key findings from theory

	Necessary for exclusion?		
	$P < MC$	Profit sacrifice	No profit sacrifice
Predation	If scale economies, entry cost and sequential offers to customer. Involves losses on some (early or contestable) customers. Can be done through quantity discounts, which induce self-selection.	<p>‘Deep pocket’ theory of predation</p> <p>Predation of less efficient competitor</p>	If scale economies, entry cost, uncoordinated buyers and simultaneous offers across buyers (FM08)
Loyalty rebates	As above, but involve losses on contestable sales only. Can make exclusion cheaper.		If buyer’s demand or rival’s costs/quality are private information (CD13/CL15)
Exclusive dealing	‘Divide and conquer’ strategy needed if some buyers can facilitate entry alone, or can coordinate or if entrant can make counter-offer. Involves losses (or at least profit sacrifice) on some - but not all - customers. Need not involve long-term contracts (BW98). (Still needs scale economies and entry cost).		If scale economies, entry cost, uncoordinated buyers, and ability to offer long-term ED contract before entrant can counter-offer (RRW91/SW00). Staggered contracts can lengthen impact (C13).

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Key findings from theory

	Necessary for exclusion?		
	P < MC	Profit sacrifice	No profit sacrifice
Predation	If scale economies, entry cost and sequential offers to customers (involves losses on some - but not all - customers (contestable) can be done through offers which induce	‘Deep pocket’ theory of predation Predation of less efficient competitor	If scale economies, entry cost, uncoordinated buyers and simultaneous offers across buyers (FM08)
Loyalty rebates	As scale economies involve losses on competitors only. Can make competitors cheaper.		If buyer’s demand or rival’s costs/quality are private information (CD13/CL15)
Exclusive dealing	‘Deep pocket’ strategy needed if some competitors can enter alone, or can coordinate to make counter-offer. Involves losses (or a profit sacrifice) on some - but not all - customers. Need not involve long-term contracts (BW98). (Still needs scale economies and entry cost).		If scale economies, entry cost, uncoordinated buyers, and ability to offer long-term ED contract before entrant can counter-offer (RRW91/SW00). Staggered contracts can lengthen impact (C13).

Findings and mechanisms similar

Key findings from theory

	Necessary for exclusion?		
	P < MC	Profit sacrifice	No profit sacrifice
Predation	<p>If scale economies, entry cost and sequential offers to customers involve losses on some (contestable) customers can be done through quality cuts, which induce sequential entry.</p>	<p>‘Deep pocket’ theory of predation</p> <p>Predation of less efficient competitor</p>	<p>If scale economies, entry cost, uncoordinated buyers and simultaneous offers across buyers (FM08)</p>
Loyalty rebates	<p>Asymmetries involve losses on competitors only. Can make market cheaper.</p>		<p>If buyer’s demand or rival’s costs/quality are private information (CD13/CL15)</p>
Exclusive dealing	<p>‘Deep pocket’ strategy needed if some entry alone, or can coordinate to make counter-offer. Involves losses (or profit sacrifice) on some - but not all - customers. Need not involve long-term contracts (BW98). (Still needs scale economies and entry cost).</p>		<p>If scale economies, entry cost, uncoordinated buyers, and ability to offer long-term ED contract before entrant can counter-offer (RRW91/SW00). Staggered contracts can lengthen impact (C13).</p>

More serious anti-competitive concerns

Key policy finding

- ❖ $P < MC$ should not be the only distinguishing factor in assessing any of these behaviours, as it is not necessary for exclusion, and indeed also not sufficient.
 - It is a relevant piece of evidence, but only as part of an overall ToH.
- ❖ Other potentially relevant evidence includes:
 - Were exclusive dealing contracts signed before entrant was in a position to make a counter-offer? How long do they last? Are they staggered?
 - Are there scale economies (Including learning effects or network effects), such that an entrant has to reach critical scale to be viable?
 - Are there entry or expansion costs, which have been sunk by the incumbent, but not the entrant?
 - Does the incumbent have the benefit of some less contestable (more loyal) customers or portions of their demand?
 - How fragmented/uncoordinated are buyers?
 - Does the incumbent have better access to finance than the entrant?

Some comments - Positive

- ❖ Nice paper, brings together lots of models and thoughts in a constructive and clear way. Today's slides perhaps even better.
 - [Although NB it was hard to put together my key findings table!]
- ❖ Agree with many of key findings, and in particular the point that $P < MC$ is neither necessary nor sufficient for exclusion.
- ❖ Also agree that $P < MC$ (and even profit sacrifice if it can be demonstrated) can be an important relevant piece of evidence as part of a ToH.
- ❖ But I do have some concerns:
 1. About how complete we can consider the set of models presented: The paper could do more to highlight that there are more stories than this that can be told, even where these have not so far been modelled.
 2. About the policy implications drawn

Some comments – 1. About completeness

- ❖ In general, stories link to a new entrant, not a smaller existing competitor. But we observe the latter far more often in real cases. (They are the complainants).
 - Covered briefly in paper, as extension of the general models, with scale economies including learning and network effects.
 - But this is a bit ‘handwave-y’.
 - Arguably more is work needed on this, perhaps more specifically linked to expansion (as opposed to entry) costs.

Some comments – 1. About completeness

- ❖ Linked to this, in most of the models, the entrant is assumed to be at least as efficient as the incumbent, if it can gain the same scale.
 - (Indeed, several of the models essentially assume a market which is a natural monopoly, albeit recognise that this is a simplification)
 - Isn't this too strong a test?
 - Can argue that even inefficient competitors can enhance competition and consumer surplus, even in a static homogeneous goods market.
 - Isn't the argument stronger if they also enhance differentiation or innovation?
 - In general, paper shows that foreclosure will tend to be easier where entrants are less efficient (albeit no innovation/ differentiated models!).

Some comments – 1. About completeness

- ❖ There are a variety of other possible theories (not so far modelled, I think):
 - If a new entrant lacks credibility, it may need access to higher end retailers that can offer a ‘quality certification role’. Deals which tie in these specific retailers to existing suppliers can thus exclude.
 - If a new entrant needs consumers to be able to ‘try out’ their product in person, then tying in B&M retailers to existing suppliers could exclude.
 - Potential for exclusion by incumbent oligopoly (eg if tie up key retailers)
 - Behavioural evidence that the ‘suction effect’ of loyalty rebates can exceed what is fully rational. (Morell, Glöckner and Towfigh, 2009)
 - And there may be more.....

Some comments – 1. About completeness

- ❖ I agree with point that more discriminatory behaviour is more anti-competitive, but it is again a bit ‘handwave-y’.
 - But is the point that exclusion is cheaper? Or more effective?
 - Do the models show selective predation (which can also involve simultaneous recoupment) is really so different to loyalty rebates?

- ❖ Finally, while it doesn’t claim to do so, it is noteworthy that the paper does not look at pro-competitive/ efficiency arguments for these behaviours.

Some comments – 2. About policy

- ❖ P < MC over contestable sales was proposed for improved administrability:
 - Intended to create a rebuttable presumption, to provide guidance for business and authorities about when discounts/rebates were most likely to be found anti-competitive.
 - Not intended (I think) to be necessary, or sufficient, for infringement.
 - I am not entirely clear why this is not in line with the models in this paper (although I do recognise that even this test is not *that* easy to apply).

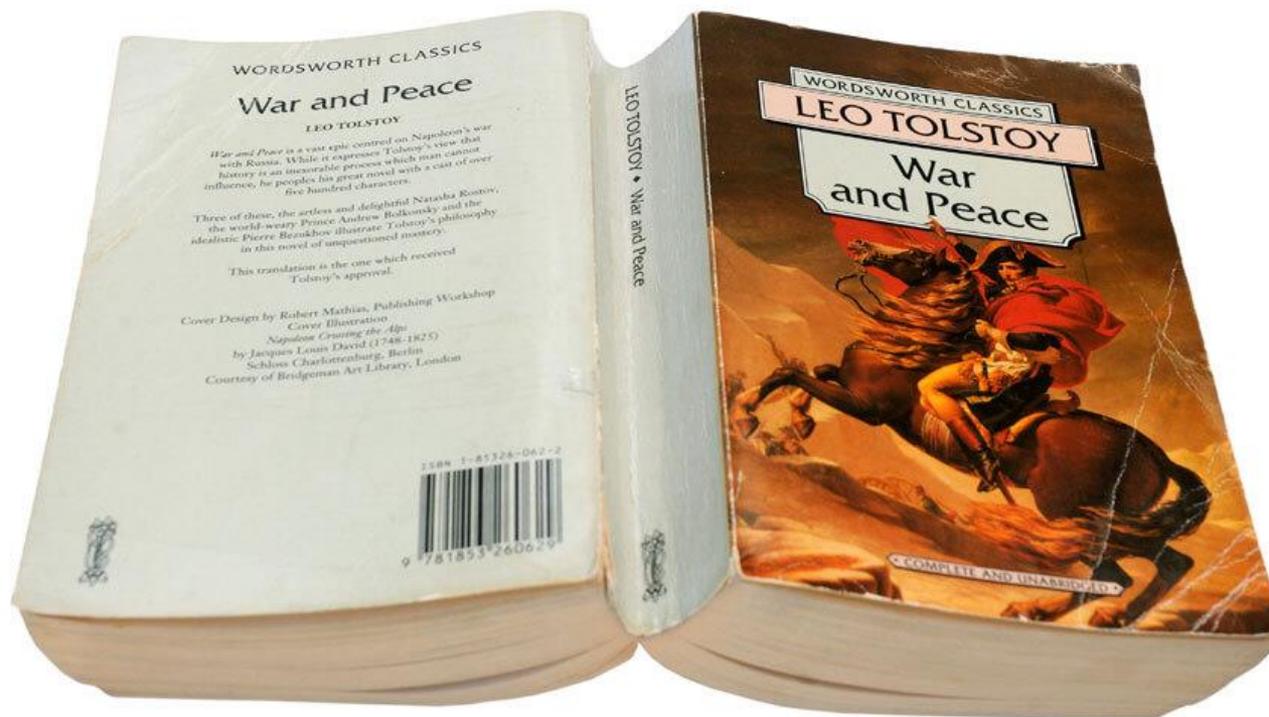
Some comments – 2. About policy

- ❖ Key point: Administrability is not the same for a competition authority as it is for a firm when self-assessing.
 - Hence the push for clearer ‘screens’.
 - Raises question: What is the counterfactual in terms of enforcement approach? Full ToH or a system of screens?
 - $P < MC$ test was intended to replace the simple ban on all loyalty rebates, taking as given the need for screens.

- ❖ Proposition: In developing screens, it is important not only to look at potential anti-competitive effects, but also pro-competitive/efficiency benefits.
 - Exemplified by proposal to make $P > MC$ a safe harbour for predation, but not for ED/loyalty rebates.
 - Fine but why not go further, and consider this more explicitly? (NB Efficiency rationales for ED may be stronger than for rebates).

Overall then...

- ❖ This is a nice paper, which takes the debate forward and should be read by us all.
- ❖ But (sadly) I don't think we have yet reached the final chapter in this ongoing saga!





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