On the use of price-cost tests in loyalty discounts and exclusive dealing arrangements

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Much discussion both in the US (ZF Meritor v. Eaton Corp. – Eisai v. Sanofi Aventis) and in Europe (Intel Corp. v. Commission – Post Denmark) on the application of price-cost tests to loyalty rebates (or exclusivity rebates).
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Some of the issues that have been raised are:

- Should economic considerations and an EFFECTS-BASED APPROACH be taken into account in rebates cases?
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- Is it true that exclusive dealing contracts (and loyalty rebates because closely resemble ED) follow **DIFFERENT PARADIGMS** of exclusion as opposed to predation and quantity rebates?
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- Should economic considerations and an **EFFECTS-BASED APPROACH** be taken into account in rebates cases?
- Is an effects-based approach **ADMINISTRABLE**?
- Is is true that exclusive dealing contracts (and loyalty rebates because closely resemble ED) follow **DIFFERENT PARADIGMS** of exclusion as opposed to predation and quantity rebates?
- As a consequence of such fundamental difference, should price-cost tests be **USED ONLY FOR PREDATION**, but not for exclusive dealing and for loyalty rebates cases?
Incumbent’s losses NOT NECESSARILY THE FEATURE that distinguishes an abusive practice from a practice that it not abusive.
Key points of the presentation

- Incumbent’s losses **NOT NECESSARILY THE FEATURE** that distinguishes an abusive practice from a practice that it not abusive.

- Predation, ED, loyalty rebates do not follow different exclusionary paradigms (indeed a **COMMON MECHANISM** may rationalize their exclusionary effect).


▶ Price-cost tests **JUST A PIECE OF EVIDENCE**, a useful piece of evidence, that must be consistent with the theory of harm.

- Reasonable to treat ED (and loyalty discounts) **DIFFERENTLY** from predation.

▶ Prices above costs **SAFE HARBOR** for predation but not for ED (and loyalty discounts).

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This approach does not undermine administrability.
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- Crucial role given to the spelling out of a **COHERENT THEORY OF HARM**: clear mechanism explaining why exclusion is profitable; facts of the case consistent with that mechanism.
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- **Predation based on scale economies**: predatory prices below costs when the prey is more efficient than the incumbent (over total production).
  - Ingredients and underlying mechanism.
Predation based on scale-economies

Crucial ingredients:

- If rival denied access to critical number of buyers, sales, profits, it is poorly competitive.
- Instead, if rival achieves critical scale, it will be viable and more efficient than the incumbent.
  - Demand-side and supply-side scale economies, learning effects.
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- **Below cost** pricing to early buyers.
Price-cost tests for predatory pricing

Economic theory does **NOT PREDICT** that below-cost pricing **NECESSARY** for exclusion.

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  - Moreover, above-cost predation if the rival is **LESS EFFICIENT** than the incumbent (and product differentiation).
Price-cost tests for predatory pricing

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- To this purpose, **SAFE HARBOR** when prices are above some measures of costs.
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The price-cost test **JUST** a piece of evidence that **COMPLEMENTS THE THEORY OF HARM**:  
- provision of a convincing mechanism explaining why predation is profitable;  
- facts of the case are consistent with that mechanism;  
- mechanism corroborated by the price-cost test.
Contracts that allow to discriminate

Pricing schemes that allow to target **SPECIFIC BUYERS** facilitate exclusion:

- **Selective price cuts** allow to implement a divide-and-conquer strategy.
- **Quantity discounts** induce asymmetric buyers to self-select into the different pricing schemes (Karlinger and Motta, 2012).
- The **FINER** the discriminatory pricing policy the **STRONGER** the exclusionary effect.
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Pricing schemes that allow to target **SPECIFIC PORTIONS** of buyers’ demand facilitate exclusion:

- **Quantity discounts** or **market share discounts** allow to target the discount on the contestable demand of early buyers.
Contracts that allow to discriminate

- Price-cost test **NOT** necessarily applies across **ALL CUSTOMERS** or across **ALL THE UNITS** purchased by a given customer.
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- Price-cost test not applied mechanically but complementary to the theory of harm.
Exclusivity Rebates

Discounts conditional on exclusivity raise more severe anti-competitive concern:
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- In the scale-economies setting, they allow the incumbent to secure the crucial buyers while LIMITING THE DISTORTIONS on sales to those buyers (Bernheim and Whinston, 1998).

Calzolari and Denicoló (2013, 2015) propose other reasons.

- Dominant firm more efficient (or higher quality product) than the rival.
- Imperfect rents extraction from customers, for instance for private information.
- Exclusivity requirement facilitates the dominant firm in separating low-demand buyers from high-demand buyers (buyers that demand a lot harmed by exclusivity because of love for variety).
- Distortion reduces rival’s (not own) sales.
- When asymmetry between the dominant firm and the rival large enough, exclusivity requirements benefit the dominant firm but harm total welfare.

See also Choné & Linnemer (2015).
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  - Buyers approached sequentially; suppliers use two-part tariffs.
  - Exclusionary equilibrium: incumbent offers to early buyers linear price equal to own marginal cost and **negative fee + exclusivity requirement**.
  - Without exclusivity, below-cost linear prices which entail allocative inefficiency.
  - Exclusion less profitable for the incumbent.

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Exclusive dealing contracts

Exclusive dealing contracts ≠ exclusivity rebates:

- ED bilateral contracts that involve a **commitment** by the buyer not to purchase from alternative suppliers during a given reference period.
- Exclusivity rebates are unilateral offers in which the supplier commits to offer different terms of trade depending on how much the buyer purchases.
- This difference matters for the exclusionary effect (Ide, Montero, Figueroa, 2016)
Exclusive dealing contracts

Ex-ante commitment on the side of the buyer allows the incumbent to exploit FIRST-MOVER ADVANTAGE and use LONG-TERM ED contracts to exclude a more efficient rival (Rasmusen et al. 1991; Segal and Whinston 2000). Underlying mechanism based again on SCALE ECONOMIES and crucial number of buyers for profitable entry. The incumbent can use long-term ED to deny the rival access to such crucial buyers. When buyers approached sequentially NO PROFIT SACRIFICE (as well as when buyers are approached simultaneously and suffer from coordination failures). Sequentiality allows the incumbent to exploit in the most profitable way the NEGATIVE EXTERNALITY that a buyer exerts on the others by entering into an ED contract. However, the incumbent must rely on a DIVIDE-AND-CONQUER STRATEGY, compensating richly SOME buyers (and suffering losses on them):

▶ when buyers communicate and coordinate their decision;
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- Same mechanism based on scale economies and rents extraction from later buyer favorable to the incumbent.
- The incumbent suffers losses on the contracts offered to early buyers when the rival more efficient at full scale.
All-or-nothing clauses

Exclusionary effect stronger when ‘ALL-OR-NOTHING’ clauses: the dominant firm threatens buyers not to supply them at all if they reject an ED, or a rebate offer.
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- Extent to which their enforcement is credible must be assessed (Dentsply: evidence of such threats carried out in the past)
Implications

- A COMMON mechanism may rationalize predation, rebates, ED.

It is not the presence of incumbent’s losses that makes predation different from ED or loyalty rebates. It is not the presence of incumbent’s losses that necessarily distinguishes between abusive and non-abusive practices. Richer contracts allow the incumbent to exploit this mechanism in a more profitable way: the anti-competitive potential of ED (and loyalty rebates) is stronger than that of predation.

Prices above costs safe harbor for predation but NOT FOR ED and for loyalty rebates (?).

Where do we draw the line?
Implications

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- It is not the presence of incumbent’s losses that makes **PREDATION** different from **ED OR LOYALTY REBATES**.
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- A **COMMON** mechanism may rationalize predation, rebates, ED.
- It is not the presence of incumbent’s losses that makes **PREDATION** different from **ED or LOYALTY REBATES**.
- It is not the presence of incumbent’s losses that necessarily distinguish between **ABUSIVE** and **NON-ABUSIVE** practices.
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- It is not the presence of incumbent’s losses that makes **PREDATION** different from **ED OR LOYALTY REBATES**.

- It is not the presence of incumbent’s losses that necessarily distinguish between **ABUSIVE** and **NON-ABUSIVE** practices.

- Richer contracts allow the incumbent to exploit this mechanism in a more profitable way: the anti-competitive potential of ED (and loyalty rebates) is stronger than that of predation.
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- Where do we draw the line?
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- If incumbent suffers no loss (or profit sacrifice) on any ED contract: why did the incumbent manage to secure all buyers into ED? Why couldn’t the rival outbid the incumbent’s offer?
  - Strategic asymmetry?
  - Buyers’ fragmentation?
  - Buyers’ coordination failures?
  - Non-contestable part of the demand? Credible threat not to supply that part if exclusivity rejected?
Implications

If the incumbent suffers losses on the ED contracts offered to SOME buyers:

- What is the mechanism that makes exclusion profitable?
- Are those buyers particularly important for the rival’s success?
- What is the asymmetry between the incumbent and the rival that allows the incumbent to make offers that cannot be matched?
- Is there competition for exclusivity?
- Is there buyer power?
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- The ingredients for spelling out a coherent theory of harm can easily be dealt with by competition lawyers and judges (and no more complex than what is routinely done in merger control).
Heavy-duty truck transmission market; Eaton long-time dominant, Meritor smaller rival (with an incomplete product range), stepping up its offer.
US case-law: ZF Meritor v. Eaton

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- Eaton used Long-Term Agreements (LTAs): discounts to OEMs (only 4) if buying at least (from 68

3rd Circ: LTAs foreclosed a substantial part of market, harming competition. Prices above average avoidable costs; but the Court DID NOT APPLY THE PRICE-COST TEST: it considered pricing not predominant mechanism of exclusion.

Non-price mechanism: failure to meet the targets would have led to cancellation of contracts with Eaton and shortage of supply.

Meritor did not sell all range of transmission. Eaton unavoidable trading partner. Judge Greenberg disagreed there was enough evidence for credible enforcement of such threat.
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- The judges considered economic arguments, and assessed height of entry barriers, extent of Eaton’s market power, duration of the agreements, their coverage, evolution of Meritor’s market shares, potential pro-competitive justifications.
- Perhaps the theory of harm may be spelled out better, evidence of ‘coercion’ better discussed, but ...
- ... contrast with the General Court decision in Intel according to which ‘establishing a violation in loyalty rebates cases requires no economic analysis’.