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

Chiara Fumagalli (Bocconi University)

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Relevant questions

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- 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?

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- This approach does not undermine administrability.

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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.
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- **BELOW COST** pricing to early buyers.

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

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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).
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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.

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- Price-cost test not applied mechanically but complementary to the theory of harm.

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  - 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).
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- See also Choné & Linnemer (2015).

Exclusive dealing contracts

Exclusive dealing contracts $\neq$ 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)

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- 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;
  - when buyers are asymmetric and large ones alone make entry profitable.

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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.

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- Extent to which their enforcement is credible must be assessed (Dentsply: evidence of such threats carried out in the past)

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- Where do we draw the line?

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- No safe harbor does **NOT MEAN** that the price-cost test is **IRRELEVANT**.
- Finding that prices are above/below costs anyway informative because it is a piece of evidence that **MUST GO** hand-in-hand with the theory of harm.
- 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 are 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?
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  - Is there buyer power?
- 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).

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- Heavy-duty truck transmission market; Eaton long-time dominant, Meritor smaller rival (with an incomplete product range), stepping up its offer.

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- Judge Greenberg disagreed there was enough evidence for credible enforcement of such threat.

US case-law: ZF Meritor v. Eaton

- 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'.