Public Comments to Department of Justice and Federal Trade Commission

Conditional Pricing[1]

Joseph Farrell[2]

A firm with market power can profit by limiting its trades with customers, but this exercise of market power is typically limited by customers' ability to trade instead, or also, with the firm's rivals. Anticompetitive conduct involves somehow limiting *others'* trades—in particular limiting trade between the firm's rivals and their mutual customers—thus weakening the competitive constraint on the firm's market power. Conditional pricing encompasses a range of possible techniques for such limiting.[3] As the Invitation to Comment noted, those techniques can include denying rivals the scale or scope that they need for competitive vigor; but my central point in these comments is that the danger is by no means limited to that mechanism. On the contrary, some of the dangers apply even if rivals operate under constant returns.

As discussed at the Workshop, there are a variety of ways in which agreements between a dominant firm and its distributors—or, sometimes, unilateral practices by the dominant firm—can tax or limit purchases by those distributors from the dominant firm's rivals. For example, the dominant firm might make clear that it will raise its prices to distributors who also buy from its rivals, as in certain forms of "loyalty pricing." Or it might negotiate agreements that limit distributors' ability to steer customers to rivals' products (e.g. by setting lower retail prices) in response to better wholesale terms offered by those rivals. Or it might negotiate "partial exclusive dealing" agreements that limit (not necessarily to zero or even to a very low level) a distributor's quantity or share of purchases from those rivals.[4]

Such agreements or practices raise a distributor's incremental cost of buying more from the dominant firm's rivals.[5] In the presence of flexible pricing, such a tax on the buying side can be expected to affect trade between those rivals and this distributor in much the same way as would raising those rivals' costs on the selling side. One difference is in the scope of the tax: it covers this distributor's purchases, rather than all of a rival's sales. Another important factor, as to agreements with distributors, is that the distributors had to be convinced to agree.

Having to convince buyers to agree is sometimes a substantial protection against harmful practices, as Chicago School commentators have stressed. One celebrated exception involves the "divide-and-conquer" mechanism. That mechanism does hinge on denying rivals efficient scale, and it is possible that

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[1] This summarizes what I tried to say at the Workshop, and what I am exploring in more depth in ongoing work that unfortunately is not yet ready for public posting.

[2] Professor of Economics, University of California, Berkeley, and Partner, Bates White LLC: affiliations for identification purposes only. That is, these are my views and don't purport to represent others'.

[3] Here I follow the Invitation to Comment in interpreting "conditional pricing" to mean conditioning prices to distributors on such things as the distributors' trades with one's rivals. More broadly, it is illuminating to note that both classic horizontal collusion and classic predatory pricing involve conditional pricing. In the former, each of a group of rivals makes clear that it will price high as long as others do (or have done) so. In the latter, a firm makes clear that it will price low if competition is present, and high otherwise.

[4] Those examples involve vertical restraints that "reference rivals" (explicitly so in these contractual examples), and I believe that usually those that do not reference rivals are less apt to cause this kind of competitive harm.

[5] Or, analogously, limit the extent to which it can do so.

the elegant economic theory of this mechanism has encouraged commentators to focus on this case. But another major weakness in the protection of having to convince buyers to agree arises when those are not final buyers, but rather distributors who compete downstream. In that case, manufacturers and distributors collectively may well gain from anticompetitive agreements, at the expense of downstream consumers. No divide-and-conquer is thus needed in order to induce distributors' assent.

Analytically, that is not the end of the story, because even when manufacturers and distributors collectively gain from agreements that soften competition, a "holdout problem" can obstruct the process of negotiating enough such bilateral agreements to create a substantial anticompetitive effect rather than merely expose a soft underbelly to remaining unsoftened competitive forces. The holdout problem is that each distributor would gain if enough other distributors agreed to soften competition; and each might therefore hold out for a large share of the potential joint gains, since it will be well off if its own negotiation breaks down but others' deals go through. This effect—which is the reverse of the "negative contracting externality" among buyers that drives the divide-and-conquer mechanism—can indeed make it hard to negotiate mutually profitable webs of competition-softening restraints. But economic theory indicates reasons why "hard" here need not mean "impossible;" and empirically the vertical-restraint context should not stop us from recognizing that analogous negotiation and holdout problems are sometimes successfully addressed by horizontal cartels.

Thus in my view economic theory points to substantial scope for competitive harm from such vertical restraints, and this concern is by no means limited to cases where rivals are denied efficient scale. Nor am I aware of anything in the economic logic suggesting that above-cost prices somehow avoid these concerns. On the contrary, the core concern is about practices (including conditional pricing) that *insulate high prices against competition*. Antitrust does well to focus on the insulating against competition, more than on the highness of prices, but the idea that antitrust must limit itself to practices surrounding low prices seems perverse.