Conditional Pricing Practices and the Two Anticompetitive Exclusion Paradigms

Steven C. Salop
Professor of Economics and Law, Georgetown University Law Center
Senior Consultant, Charles River Associates

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Disclaimers

My opinions are my own and are not necessarily shared by my colleagues at Georgetown or CRA, or by any clients with whom I have provided economic consulting. This short deck and the associated brief presentation are designed to stimulate discussion and so cannot reflect my full analysis of these issues.
Issues to Discuss

• 2 exclusionary conduct paradigms
  • Predatory pricing
  • Raising rivals’ costs

• Application to conditional pricing practices (CPPs)
• How can any “discount” harm consumers
• Limits of entrants’ counterstrategies as self-protection
• Flaws in price/cost standards for RRC/CPP allegations
The Issue: Should the Same Legal Standard Apply to All of this Conduct?

A monopolist facing entry announces to its distributors:

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2. *Or,* “I am not changing my basic wholesale prices. I know you were thinking of stocking the entrant’s products for about 10% of your sales. If you remain exclusive with me, I will give you a 15% discount on that “extra” ~10% of your purchases, which averages to a little less than 2% off on all your purchases.”

3. *Or,* “I am not changing my basic wholesale prices. But, if you remain exclusive with me and his entry fails, I will pay you $50,000, which is about 8% of your purchases from last year.”

4. *Or,* “I am not changing my wholesale prices for my exclusive distributors. But, if you distribute for the entrant, I will add a 15% surcharge to your price.”

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Two Separate Paradigms

**Predatory Pricing**
- Paradigmatic scenario
  - War of attrition

- Reduce price as an investment
  - Cause rival to exit
  - Recoup investment by raising price up to monopoly level

- Consumer harm on balance

**Raising Rivals’ Costs**
- Paradigmatic scenario:
  - Raise competitors’ costs, which leads them to reduce output and raise price, which permits firm to raise or maintain its price and harm consumers

- Two variants
  - *Input foreclosure*: raise rivals’ input costs
  - *Customer foreclosure*: limit rivals’ output; reduce rivals’ revenues

- Variants interact
  - Harm to competition does not require total foreclosure
  - Higher costs can lead to customer losses
  - Customer losses can lead to higher costs
  - Price increases could involve coordination and/or unilateral effects
Distinguishing the Paradigms: *Ross Simmons v Weyerhaeuser*

- Two types of anticompetitive overbuying
  - *Predatory overbuying*: Overbidding for timber to gain monopsony power in the (upstream) *purchase of timber*
  - *RRC overbuying*: Overbidding for timber to gain market/monopoly power in the (downstream) *sale of lumber*
  - *E.g.*, see Salop, 72 Antitrust L.J. 669 (2005)
- Plaintiff alleged only predatory overbuying
Comparing the Paradigms for Antitrust Policy

- Conventional view of predatory pricing
  - “Rarely attempted and even more rarely successful”
  - Success requires victim to exit
  - Short-term profit-sacrifice as investment in recoupment
  - Speculative future consumer harm
  - Inherent short-term consumer benefit from lower prices

- Compare raising rivals’ costs conduct
  - “More credible and dangerous strategy”
  - No exit requirement – higher costs lead to higher prices
  - No short-term profit-sacrifice (“simultaneous recoupment”)
  - Immediate consumer harm from higher prices
  - Short-term cognizable consumer benefits may not occur

Conclusion: RRC raises greater antitrust policy concerns
Applying the Predatory Pricing Paradigm to CPPs

Basic *Brooke Group* analysis and similar conclusions

- Discounts benefit consumers in the short-run

- Recoupment unlikely
  - Only if the discounts cause exit
  - Only cause exit (by equally effic. entrant) if “below-cost” CPPs (i.e., IR<IC)
  - Discounts more costly to monopolist than to the entrant
  - Entrant can compete for exclusive or non-exclusive distribution

- Thus, consumer harm unlikely
Applying the RRC Paradigm to CPPs

• Distributors provide an input – distribution services

• CPPs can reduce entrant’s ability to compete effectively
  • Higher distribution costs from loss of distributors and/or lower scale
  • Output/revenue loss may cause exit or marginalize entrant.
  • Lower scale reduces ability to threaten monopoly sales

• Monopolist thus may maintain monopoly power
  • Maintain prices or cushion any necessary price reductions
  • Weakened entrant has potential incentives for pricing coordination

• Counterstrategy of bidding for non-exclusive distribution often fails
RRC Paradigm Suggests Greater Concerns

- Exit not required for consumer harm
  - If CPP neuters a viable rival, higher prices nonetheless can occur

- Short-term profit-sacrifice not required
  - Simultaneous recoupment; or greater bang per buck of cost
  - Higher cost rivals raise prices immediately
  - Output constrained rivals permit higher market prices

- Payments for exclusivity may not benefit consumers even in short-run
  - *Penalties* for non-exclusivity, *not discounts* for exclusivity
  - *Lump sum payments* to distributors (weaken or eliminate incentives to pass-on to consumers)
  - Discounted price still may exceed price in but-for world without CPPs

- Price-cost tests do not accurately predict consumer impact
  - Below-incremental cost pricing not required for success
  - Also, may not even accurately predict anticompetitive purpose
Discounts vs Penalties: The But-For World

• How can a “discount” possibly harm consumers?

  • “Discount” may really disguise a price “penalty”
    • Suppose non-exclusive price exceeds monopoly price
    • Extreme example: Non-exclusive price is infinite (as in coerced exclusive dealing)

    • Less extreme scenario: Lack of CPPs would lead to successful entry, which would cause prices to fall -- even lower and across-the-board
      • E.g., Suppose price in but-for world would have fallen to (say) $80

• Just because a CPP is “framed” as a “discount” does not make it procompetitive.
Often Limited Self-Protection From Counterstrategies

- Preemptive long-term exclusivity contracts *before* entrant arrives to counterbid
- Paying to avoid exclusion raises entrant’s costs
- Monopolist’s “exclusion value” provides incentive to bid higher than equally efficient entrant
  - Monopolist may be *purchasing market power*, not just distribution
- Entrant’s need for wide (non-exclusive) distribution creates “coordination problem”
  - *But*, if very limited distribution is sufficient, then bargaining advantage shifts
Monopolist’s Bidding Incentive and Advantage from Anticompetitive “Exclusion Value” of Maintaining Market Power

<table>
<thead>
<tr>
<th></th>
<th>Monopolist Wins</th>
<th>Entrant Wins</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Exclusive (No Entry)</td>
<td>Non-Exclusive (Successful Entry)</td>
</tr>
<tr>
<td>Monopolist</td>
<td>$220</td>
<td>$70</td>
</tr>
<tr>
<td>Entrant</td>
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<td>$70</td>
</tr>
<tr>
<td>Total Profits</td>
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<td>$140</td>
</tr>
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Incumbent monopolist has higher maximum bid; Wins exclusivity by outbidding entrant with a bid of $71

*Bidding advantage also shows flaws in price/cost tests*  
*(No need for monopolist to bid IR<IC since get monopoly price)*
Non-level Playing Field: Entrant’s Coordination Problem

• Suppose that entrant can only succeed if it gains wide non-exclusive distribution from multiple distributors
  • Entrant cannot compete for exclusives with limited product offering

• Entrant is a risky bet for each distributor
  • Entry fails unless many distributors forgo the incumbent’s exclusivity offer
  • Each distributor’s expectations matter
  • Creates a coordination problem for entrant
  • Less likely for entrant to succeed, even if equally/more efficient
Coordination Problems Eliminate Rational Incentive to Counterbid

• Suppose 3 distributors and entrant needs to obtain non-exclusive distribution *at all 3* for viability
  • Viability ➔ $70 duopoly profits

• Rationally foresighted entrant would not bid
  • Why? Incumbent surely would outbid entrant at third distributor with bid of $71 and entry would fail.
  • So, it makes no sense for entrant to pay to win earlier bids

• Result same if entrant needs 2 non-exclusive distributors
  • Entrant’s max bids = 2 x $70=$140
  • Monopolist’s incremental monopoly profits = max bids = $150
  • Monopolist has greater incentive to win and bidding advantage!
But, Bidding Disadvantages Do Not Doom All Entrants

• Much more efficient entrant can succeed.
  • Each distributor may have a strong preference for maintaining competition

• Or, if significant product differentiation
  • Entrant preferred by “enough” consumers

• Or, if very limited distribution is sufficient
  • Example: Entrant needs only one non-exclusive distributor
  • Monopolist would need to bid $71 \times 3 = $213 to prevent entry
  • But, monopolist incremental monopoly profit = $150
  • So, monopolist lacks incentive to outbid (i.e., $213 >$150).
  • Entry thus would succeed
Flaws in a Below-Cost Pricing Standard
Applying *Brooke Group* to Conditional Pricing: A Flawed Transfer

- Standard “war of attrition” predatory pricing reasoning does not apply, if RRC scenario
  - CPPs provide more exclusion benefits per dollar of the monopolist’s exclusion cost, relative to predatory pricing ("cheaper exclusion")
  - CPPs provide less consumer benefits per dollar of the monopolist’s exclusion cost, relative to predatory pricing
- These properties together suggest a more intrusive legal standard for CPPs, relative to predatory pricing
- *IR < IC* pricing test does not present a bright-line standard in practice
  - More difficult to measure and evaluate *IR < IC*, relative to *price < cost*
  - *IR* varies for different output levels
  - Determining “contestable volume” is contentious and imperfect
- *IR < IC* standard leads to false negatives, false positives, and under-deterrence (*discussed next*)
False Negatives, False Positives, and Under-Deterrence

- Errors lead to improper deterrence, as well as false acquittals/false convictions
  - False negatives cause under-deterrence
  - False positives also can cause under-deterrence
    - Reduce incremental gains from complying with the standard
    - "If you might well get a ticket at 50mph when the speed limit is 55mph, then you have less to lose by going 75mph"

- Errors are not surprising:
  - IR<IC test gauges “intent,” not “effect,” and is even an imperfect intent test
  - IR<IC test is difficult to administer because “contestable volume” differs by customer and often is difficult/impossible to know in advance
IR>IC: Examples of False Negatives

- “Coerced” exclusive dealing always satisfies IR>IC
  - Requirement → infinite price charged to non-exclusive distributors
  - Always satisfies IR>IC since zero revenue at infinite price/zero purchases alternative

- “Simultaneous recoupment” always satisfies IR>IC
  - E.g., price penalty example:
    Non-exclusive Price = $110; Exclusive Price = Monop. Price = $100

- Single distributor example (“exclusion value”)
  - Monopolist “purchases market power,” not just distribution

- Coordination examples with multiple distributors
  - Examples where entrant needs 2-3 non-exclusive distributors
  - Entrant lacks incentive to counterbid high (if at all); since always lose in the end
IR<IC: Examples of False Positives

• **Example where single distributor sufficient**
  - Monopolist lacks incentive to outbid for every potential distributor, even if it “overbids” (IR<IC) for some distributors

• **Long-term benefits from a lead customer/sponsor**
  - A “lead customer” certifies quality, leading to sales to other customers over product lifetime
  - Entrant and monopolist have similar incentives to offer below-cost price to sponsor (long term investment in certification)
  - Equilibrium of head-to-head competition between equally-matched competitors could involve payments below single-period cost (IR<IC).
Should the Same Legal Standard Apply to All of this Conduct? *My Answer is “No.”*

A monopolist facing entry announces to its distributors:

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Should CPPs Be Treated Like Predatory Pricing?

• CPPs provide more exclusion benefits per dollar of the monopolist’s exclusion cost, relative to predatory pricing
  • *This “cheaper exclusion” property increases the monopolist’s incentives to use CPPs to exclude*

• CPPs provide less consumer benefits per dollar of the monopolist’s exclusion cost, relative to predatory pricing
  • *This property reduces consumers’ collective incentives to permit CPPs*

• IR<IC test leads to substantial false negatives, some false positives, and under-deterrence
  • *Even more error-prone to administer than standard predatory pricing P<C test*

• These properties together suggest a more intrusive legal standard for CPPs, relative to predatory pricing
Choice of Legal Standards

- Price/Cost Test (IR<IC)
- Harm to Competition Evidence
Legal Standard: Applying the RRC Paradigm

- Basic 4-Prong Analysis
  - Harm to competitors (RRC/RRR)
  - Harm to competition (POP)
  - Efficiencies
  - Overall (net) effect on consumers
  - Focus primarily on harm to competition, not merely harm to competitors

- Investigation of reasonable counterstrategies
  - If not, why not? If so, why failed?

- Limited role for price/cost standard
  - IR<IC may suggest anticompetitive intent; but not a per se rule
  - IR>IC helps defendant (*i.e.*, better than IR<IC), but not per se legal
    - But not so helpful since IR>IC is consistent with anticompetitive purpose and effects
  - Standard should focus on evidence of harm to competition, not imperfect proxy for inferring anticompetitive purpose
Variety of Possible Evidence for Harm Finding

• Injury to competitors step (RRC/RRR)
  • Magnitude of cost increases from loss of distribution?
  • Magnitude of foreclosure? How many distributors? Representing what share?
  • Magnitude of lost sales?
  • Constraints on entrant’s output level/output expansion?
  • Long run effects of lost window of opportunity to enter or grow quickly?
  • Magnitude of marginal cost increases from lower scale?

• Harm to competition step (POP)
  • Overall increase in rivals’ costs and/or sales constraints?
  • Likely impact on market prices?
  • Evidence regarding likely exit or failure to invest?
  • Likelihood that competition will be softened or coordination occur?
  • Market power of excluding firm(s)?
  • Sufficiency of non-excluded, non-coordinating competitors?
  • Evidence suggesting/rejecting anticompetitive purpose?

• Facts vary and not every piece of evidence is relevant for each case
What if Excluding Firm(s) Lack Market Power?

• Exclusionary conduct can allow firm(s) to achieve market power
• Parallel exclusion by multiple firms can lead to anticompetitive coordination
• But, competition from non-excluded firms may prevent consumer harm (power over price)
  • Competition includes other substitute products
• Pro-competitive efficiency benefits carry more weight if excluding firm(s) not dominant
Some Potential Efficiencies

- True conditional discounts may achieve some cognizable competitive benefits
  - Allow “standardized” volume discounts that induce retailer promotion and sales
  - Account for differential retailer sizes and uncertain aggregate demand
  - Issue: Is standardization claim non-pretextual and reasonably necessary?
- Lower “marginal” prices might lead to lower retail prices
  - If marginal price does not reflect penalty, and
  - If lower marginal price is anticipated at time of retail pricing decision, and
  - If marginal price is lower than would be price in but-for world without CPPs

If so, need to balance procompetitive harms and benefits to predict likely net effects on consumers and competitive process
Buyer-Driven Conditional Pricing as an Over-reaching Presumption

- Buyers may try to use exclusives or conditional pricing to extract lower prices from competing firms
- But, ....
  - Some buyers might cooperate with monopolist to extract bribes for deterring entry (e.g., JTC Petroleum)
  - Monopolist can use penalties to eliminate any real compensation
  - Buyers might request compensation relative to the monopoly outcome, not relative to the but-for more competitive world absent the CPPs
  - Entrant’s coordination problems reduce the necessity of monopolist offering significant compensation