Conditional Pricing Practices and the Two Anticompetitive Exclusion Paradigms

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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)s
- 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:

1. "In order to better compete, I am reducing my wholesale prices by 15% across-the-board."
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."
5. *Or,* "I am not changing my wholesale prices to my exclusive distributors. But, if you distribute the entrant's products, I will not deal with you, now or forever."

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

	Monopolist Wins Exclusive (No Entry)	Entrant Wins Non-Exclusive (Successful Entry)	Max Bid
Monopolist	**$220**	**$70**	**$150**
Entrant	**0**	**$70**	**$70**
Total Profits	**$220**	**$140**	

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 x 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