

FTC-DOJ Conditional Pricing Practices Workshop  
June 23, 2014  
Segment 7  
The Law of Conditional Pricing Practices (continued)  
Transcript

ANDREA E. ZACH: Good afternoon and welcome back. My name is [INAUDIBLE] Zach. I'm an attorney here at the Bureau of Competition here at the Federal Trade Commission. I'm here with my co-moderator Sam Weinstein, an attorney with the legal policy section, anti-trust division, US Department of Justice. And we're very delighted for this second panel on the law of conditional pricing practices.

We have a very distinguished group with us today. I'll just go ahead and quickly introduce. We have John Jacobson from Wilson Sonsini.

We have Sean Gates from Morrison and Foerster, Leah Brannon from Cleary Gottlieb, and Professor Fiona Scott Morton from Yale University School of Management. We'll also have our two commentators or discussants. That will be Professor Steve Salop, Georgetown University Law Center, and Professor Abe Wickelgren from the University of Texas Law School. And with that, I'll turn it over to John.

JOHN JACOBSON: Thanks, Andrea, and thanks for inviting all of us here today. It's a great experience and very exciting. It's wonderful to be on the 3:45 panel and try to figure out something that hasn't been said a lot better. But what I'm going to try to do is propose a general equally efficient rival paradigm with no math. So let's see if we can do that.

So starting out on what I hope is common ground, the conditional discounts are not per se illegal. They're assessed under the rule of reason at least here where we don't have 283 page numbered decisions. Conditional discounts can be a means of competing.

And the important point that I want to focus on is the plaintiffs who lose out just because they're lazy or incompetent or just don't want to meet the competition that the defendant is providing are not the sort of plaintiffs that we should be allowing to sue. And that's something really was not discussed a lot earlier in the day, although Dan Crane articulated that point in a way that I very much agree with. So how do we get from that common ground to actual rules?

Well, I think we can generally agree that practices that impair rivals to the extent that they can no longer constrain the defendant's market power, raising rivals cost to achieve power over price is, while Tom reminded us, may warrant prohibition. I think we also agree that competition for the contract should be encouraged and that attaching conditions to a discount may make that competition more effective.

So a rule that allows inefficient rivals to prevent competitive discounts can be a use of antitrust to subvert competition. And we don't like that. So the rules need to provide some basis to distinguish legitimate conditional pricing practices from those that harm consumers. And that's

particularly important in a litigation context and particularly important-- and it occurs daily-- in a counseling context.

So the way I would articulate the equal efficient rival test is that conditional discounts that a hypothetical rival facing the same incremental cost as the defendant can meet or beat profitably and that these should not be deemed exclusionary. Discounts that cannot be met on that basis may be exclusionary and unlawful if the effect of the condition-- this is the achieved power over price part-- is to increase, protect, or maintain the defendant's market power. The point of this test is to ensure that the defendant is able to compete for the contract. In this analysis, I suggest-- and from what I've heard today seems to confirm it-- that given current knowledge, which is still in infinite infancy even in Europe 40 years later, that that is the best mode we have for distinguishing the plaintiff who should be allowed to sue from the plaintiff who should be barred at the motion to dismiss or summary judgment doors.

Now, in terms of the two practices that we're focusing on most today-- bundling and loyalty discounts-- the concerns are a bit different. And there will therefore be some differences in applying the equally efficient rival test. So the underlying concern about bundling is similar and analogous-- I'm anticipating Sean's remarks-- to tying the underlying concern about loyalty discounts is similar to exclusive dealing. I agree with those who say this is not about predatory pricing. Because the harm, if any, flows from the conditions, not from the price level.

So your full Brooke group paradigm is really inapt when applied to conditional pricing practices. Now, critics on what I'll call the right say we should apply a full Brooke group approach to everything because discounting is so important. But the concern here is not price levels.

It's tying or exclusive dealing. It's exclusion irrespective of the price level. And both tying exclusive dealing and similar conditional discounts can be profitable even if the total price is above full Brooke group levels. Critics on the left-- and we heard this today-- make the point that even less efficient rivals can compete in a manner that lowers prices to consumers.

And that is absolutely true. The problem is that we need some leeway for granting conditional discounts. And we do not want to discourage competition for the contract. Because if we do, the long run effect on competition will be negative in a material and possibly significant way.

So that's what I suggest the EER approach. Now, application to bundling is relatively straightforward, may involve some math-- so I was fibbing a little bit earlier-- under the discount attribution test that the PeaceHealth court applied, that the Ortho case applied, and that the AMC recommended. Incidentally, Yanish [? Ortover ?] tells me that he invented this test during a lunch break during his deposition in the Ortho case.

I've heard others claim to invent it. But that was the most interesting story that I've heard on it. And I have no way to disprove it.

So under this approach in the bundling context, you take all the discounts from all the products. You apply them to the competitive product. And there's a safe harbor.

It's not a test of illegality. There's a safe harbor if the pricing on that basis is above incremental cost. The reason for this is that if a rival cannot compete profitably on that basis, the problem is the rival's higher cost structure or incompetence, not the conduct of the defendant which could be described as exclusionary in that context. So care must be taken.

Einer and others made this point today that the defendant has not artificially raised the unbundled prices and that the discounts are really discounts and not disguised penalties. But this is not nearly as hard as critics made out. I've actually never seen it in my case. The case that Einer described seemed fairly easy to discern that those were penalties rather than discounts. So I don't think that's a big problem or reason not to use this test.

So loyalty discounts are more challenging. I do not advocate-- in fact, I advocate against trying to isolate the contestable and incontestable volume. I think it's a fruitless exercise.

I've never seen it worked. I've seen it argued. I've seen it modeled beautifully in economics papers. But in the real world, it's just not practical.

So the question ought to be asked more directly. In a loyalty discount case, can the smaller rival, assuming it had the same incremental cost as the defendant, meet or profitably beat these discounts either with a straight discount strategy or some other reasonable and reasonably available competitive counter strategy? And in both of these cases, the touchstone should be the same.

In applying the rule of reason, the key question should be whether the plaintiff, or in a government case an equally efficient rival, can meet or beat the discounts on sufficient value that the rival can continue to constrain the defendant's market power. It's not enough that the rival can meet it on 5% of the volume. If you need to reach minimum efficient scale, 25%-- the volume that you have to be able to meet or beat effectively has to be enough to enable you to prevent the defendant from raising prices. This means that absent the unusual case where a plaintiff is more efficient than the defendant, if it's clear that the plaintiff can compete effectively for the business in question-- and often, you can tell that from the complaint-- but that the plaintiff simply has not done so, dismissal or summary judgment should be granted.

And That should be a way to more economically dispose of unmeritorious cases. Now, the Eisai case which got past a motion to dismiss but was sent off on summary judgment provides a useful analysis. If the court had the facts right, the plaintiff Eisai's profit margins were 85%, which is very high. I question whether that number is accurate. But that's what's in the reported decision.

And in any event, it was clear, at least based on the facts that the judge Cooper found to be beyond genuine dispute, that Eisai could profitably have reduced that profit margin significantly, gained significant volume, and constrained Sanofi's market power. So Eisai is a case where I thought the reasoning at least-- whether she got the facts right or not is another question-- but that the reasoning is consistent with what I'm arguing today. And contrast the Eden case, the Eden case actually talks about an equally efficient rival analysis.

The court doesn't adopt that as a test, but it is integral to the analysis that the Eden court talked about. Now, I think the search for whether something is predominantly price or predominantly not is rather an elusive one and that the focus should instead be, you know, is this a loyalty discount? In which event, let's see if an equally efficient rival can compete.

Basically, convert it into exclusive dealing analysis or a bundling case apply to the PeaceHealth case. I have a final slide on Europe. And it's simply to reflect my shock and awe at the decision of the general court. Thank you.

SPEAKER 1: Thanks, John. Now we'll hear from Sean Gates.

SEAN GATES: All right. What I'd like to talk to you about today is how do we develop legal rules in the face of uncertainty. Typically, when you look at the development of antitrust rules in the US system, at least, you have courts following consensus economic view. You've got scholarly consensus.

You've got a long line of cases. But in the case of bundle rebates and loyalty discounts, you don't have that. So what is the court, what is an agency to do?

Now, the courts have been dealing with this for quite some time. It's not a new phenomenon. I saw some cases that were put up by Einer going back to, I don't know, 1870 or something like that.

But if you look back in 1976, there was a SmithKline versus Eli Lilly decision clearly dealing with these issues in 1976. We've had district court decisions out of New Jersey, several out of California, Ohio, Pennsylvania, Massachusetts, Missouri, and New York. We've had decisions out of the Second Circuit, the Third Circuit, the Eighth Circuit, the Ninth Circuit.

These are not new things. So what are these courts doing? Well, what they're doing in the face of a lack of economic consensus, is they're turning to analogies. And you've heard them today numerous times-- predatory pricing, exclusive dealing, and tying.

So the question then becomes, well, OK. Is this really about just putting this behavior in a box that we're all familiar with? Or is there something else to it?

Well, my contention is that analogical reasoning, which is what the courts use and it's a common law tradition, is actually fundamental to the way we think about things and the way we discover things. We see it in science. For example, there's a molecule for benzene-- was a mystery for years and years until a certain scientist actually had a dream about a snake eating its tail. Use that as analogy and he came up for the structure of benzene.

The idea that an atom, the structure of an atom, is similar to the solar system is an analogy that's been used. There's entire fields of design by analogy where people and engineers will come up with products based on analogies to things that we see in nature. Analogy is endemic.

It's what will we use and it's what the courts use. And you've heard this morning lots of economists use it. So it's not foreign and it's not some kind of sub-par type of reasoning.

So how do we know, however-- how do we know whether we have a good analogy or a valid analogy? Some say, you know, predatory pricing. Some say it's like exclusive dealing. Some say it's like tying.

How do we test that? How do we know what's good, what's bad? Is it some say to-may-to, some say to-mah-to? Some people say that picture on the screen is a rabbit. Some people say it's a bird.

How do we know? Is it vote? Is it who said it?

Well, it turns out that actually there are some ways that we can test analogies to see whether or not they're really good. There's actually an entire field examining the psychology and cognitive science of analogies. Analogies are simply a way to map something that we're familiar with on to something that we want to learn about.

And the idea is that you take those similarities and you map them to the target. And in the process, what you're trying to do is to maintain the relational structure. So it's not enough to just have physical similarities. You have to maintain the relational structures.

So gaining consensus among antitrust lawyers is like herding cats, OK? We all understand that because you can't herd cats. They don't follow the rules.

And just as we saw this morning, antitrust lawyers and economists don't agree on a lot of things. You can't herd them. An electrical circuit is like a plumbing system. Not because electricity is like water, but because pressure in a plumbing system is similar to voltage in an electrical system.

There's a relational similarity. High pressure leads to flow. High voltage leads to flow of electricity.

So a good analogy is one that maps the elements onto the analog while maintaining these relational structures. Similarities in physical structures aren't enough, you know? So HCL-- hydrochloric acid-- and water are similar in that they both have hydrogen atoms and both of them are liquid at room temperature. But the effect on your skin is a little bit different from one to the other.

You wouldn't want to take a shower in hydrochloric acid because the relational structure between hydrochloric acid and your skin condition is different from that of water. That's an example of a bad analogy. So how does this turn out?

How do the courts-- how are the courts doing when they're applying analogies for conditional pricing practices when they're using the predatory pricing, when they're using exclusive dealing? How are they doing it? Well, for the most part, the problem is that the courts are just looking at the similarities in the contact, OK?

Rebates are like price discounts. Therefore, predatory pricing involves price discounts. Reply that rule.

Bundled discounts are, you know. They involve conditional sales of multiple products. Tying involves multiple products and conditional sale. So we use those rules.

And what the courts do is based on these kind of, I will call them surface similarities or conduct similarities, they infer that the same economic effects apply and therefore the same legal rules should apply. But antitrust rules, legal rules, are more than just similarities in conduct, right? We actually blend both the economics, the policy, and the prudential concerns.

Now, what we need to do, and the courts have failed to do for the most part, is to evaluate how those policy concerns and those prudential concerns map onto the target. So let me give you an example. The example is the predatory pricing analogy.

Since everybody's been, as I understand, throwing dirt on the price cost test, I'll throw a little bit more dirt on it. All right, so the price cost test, the Brooke group test, right? That was not driven purely by economics, right?

The court in Brooke group even said that above cost, pricing may reduce economic welfare. So the test, the price cost test, is not about economics per se. It was more about other types of concerns.

Well, we've heard about it this morning. One of the concerns was a skepticism that predatory pricing is a viable strategy. You've heard it this morning-- rarely tried and even more rarely successful. Why?

Because you have all these conditions, one of which the courts focused on is that you have to recoup your losses. So there's a deep skepticism towards predatory pricing. And of course, the price cost test was driven by prudential concerns, right? The fear of chilling pro-competitive price cutting.

So the question is, well, how do these concerns map? If we're going to use predatory pricing as the analog, how do those map onto the target of, say, conditional discounts? Well, let's start out.

What about the skepticism? This idea that you-- and there's a problem there because there has to be a recruitment. Well, at least on something conditional pricing practices, you don't have a recruitment problem. So that doesn't map at all.

It doesn't apply at all. And, you know, the skepticism that predatory pricing is rarely tried and less often successful, does that really apply to conditional pricing practices? What about the prudential concerns?

Well, if you look at Brooke group and you look at the Supreme Court cases, what they're really saying is that, look, we don't want to chill pricing-- unconditional price. Because that's kind of the core conduct-- competitive conduct. I mean, what's the alternative to that?

What do I do? If I can't lower my price, what else can I do? I don't know. You can improve your product, maybe.

But that takes a lot of time and a lot of effort. Pricing itself is at the core of the competitive process. So there's a lot of concern about chilling that.

Well, does that same concern applied to a conditional pricing practice? Do we think that conditional pricing practice is a kind of irreducible element of competition? I'd say probably not.

So the problem here, and what we're seeing, is that the courts are applying these analogies. But they're not really doing a full blown analysis. And they're not really meticulously looking at whether the analog maps onto the target.

You could do this with exclusionary conduct-- or excuse me, exclusive dealing. You can do this with tying and see whether the analogies are really apt. So this is just an example where I would say that the predatory pricing analogy isn't really apt because it doesn't map from the analog to the target.

So one of the things that has driven a lot of the argument about what analog to apply is kind of the decision theoretic argument. All right, well, if we don't apply predatory pricing, we're going to get too many false positives. We're going to get inefficient competitors and allow them to come into market, oh dear, and allow them to sue.

Well, I would say that if you really look at that from an analogical reasoning perspective, the problem with that methodology is that it really gives you a false sense of rigor. I mean, let's face it. We have no idea whether or not we can measure the pro-competitive versus the anti-competitive benefits. And when we say, well gee, there's this risk of false positives, maybe there's a risk.

But how much of a risk? So that's number one. Number two, really, that decision theoretic framework was developed for binary decisions. I test Leah for cancer.

She either has it or not. If she doesn't have it and I test positive, that's a false positive. But what this framework doesn't do a good job of looking at things in a continuum. So when we develop antitrust rules, what we're looking at is we want to say, well, OK. Is this really bad conduct, or is it maybe a small chance of a risk here?

Where is it along the continuum? That decision theoretic framework doesn't allow you to do that. And then lastly, you heard it this morning quite a bit.

What are the alternatives? So if we have a false positive, then what? What will firms do?

And is that less or more competitive? So in conclusion, let me end with just a quote and an analogy. The quote is from Samuel Butler. The analogy is often misleading. It's the least misleading thing we have.

So in other words, he look. In the absence of an economic consensus, this is best we can do. And it's actually a very powerful tool.

An analogy is the platypus, OK? The platypus is a duck-billed, beaver-tailed, otter-footed, egg-laying mammal. And when it was first discovered, people thought it was a hoax.

Scientists thought it was a hoax because they didn't know what to do with it. But over time, they figured out what it was and they categorized it. Same is going to be true with conditional pricing practices. Just, over time, we're going to figure out what to do with them even though we've been dealing with these things for 50 years-- 30 or more years. Thanks very much.

SPEAKER 1: Thanks, Sean. Now we hear from Leah Brannon.

LEAH BRANNON : So I know it's very late in the day. And I'll try to be brief. But I do want to say some words in defense of the price cost test.

I won't spend much time on background principles because people have talked about these points before. I agree with the plates Dan Crane made about the Supreme Court law and the background principles favoring price discounts. And I think those apply not just to price discounts by a dominant firm, but also discounts by a rival.

And the economist this morning I think did a very nice job about talking about all the various reasons for conditional discounts. I think they made the point that these are often used in industries by firms that don't have market power. And there are a lot of efficiency reason for using these types of pricing structures. So I'll turn to the much discussed Meritor case in the Third Circuit

And as everyone knows, and as they discussed this morning, with the LePage's decision in 2004, the Third Circuit became something of an outlier with a very plaintiff friendly, let's throw it to the jury kind of test, and accordingly became a real magnet for plaintiffs filing these types of actions. In 2012 in the Meritor case, the Third Circuit substantially limited its prior decision in LePage's and noted it was joining its sister circuits in holding that the price cost test applies to market share or volume rebates offered by suppliers within a single product market. So a very important clarification or movement in the law in the Third Circuit.

Unfortunately for the defendant in that case, even though the court had adopted the price cost test for single product loyalty discounts, the defendant ultimately did not fare well because the court, as others have discussed, concluded that in that case, price was not the clearly predominant mechanism of exclusion. And I think I have a somewhat different interpretation of that case from Professor Elhauge. In my view, some of the things that the court really found to be key determinants were the fact that the defendant was threatening to cut off supply.

That's the way customers perceived it. There were aspects of the contracts-- for example, an ability in two of the four contracts with the customers, an ability for Eden, the defendant, to cut off their supply if they didn't hit their market share purchase levels.

There were also requirements that the customers favor Eden's product over competitor's product in their data books. So the court found that price was not, in that case, a clearly predominant mechanism of exclusion, which brings us to the decision earlier this year in Eisai versus Sanofi. And I'll offer a disclaimer here that I and my firm do represent Sanofi US in this case. But my comments here today reflect only my own views.

In this case, others have discuss the facts. So I won't spend much time on them.

Eisai contacted with Pfizer, a third party, for the US rights to market Fragmen, an anticoagulant drug. So Eisai did not innovate and develop this new drug. It just contracted for the rights to distribute it.

And it sued Sanofi US for billions of dollars in damages alleging that Sanofi's market share and volume discounts limited Eisai's sales. And I think this case was brought years before the Meritor decision. But after Meritor came out, Eisai argued at that point that there were six mechanisms of exclusion that were non-price in nature.

And therefore, they argued at summary judgment that the price cost test should not apply. And the court, if you haven't read the opinion already, I recommend that you do. I think the court did a really nice job of walking through the law in this area and then very carefully applying it to the facts.

And the court walked through all six mechanisms and found that they all come back to price. So things like imposing disloyalty penalties and charging higher prices to customers who didn't hit market share targets, the courts said, thats price. And the court then added that there was no threat of non-supply and there was no requirement to favor Sanofi US's product over competitors' products. And therefore, the court granted summary judgment in favor of Sanofi US.

The court also went on to analyze this in the alternative under the framework that Eisai was [? urging ?] in treating these as exclusive dealing contracts and concluded that even under that approach, Sanofi would have won. But I don't think that can be used as a reason to argue that it doesn't matter which test you pick. Because I think everyone knows that there are pretty significant differences, practical differences, in terms of the test that's adopted.

And I think the others have made this point-- I think Robert O'Donoaghue made this point-- that in counseling clients, you really do get these questions on a very regular basis from a large range of companies that have market shares. It might be a 40% and market share I think was the example you gave. And that might be the case.

It might be a company with a 30% market share that hopes to increase that market share over time. And they want to know what type of pricing practices they can use. It might be a company with a 80% or 90% share. And I think the price cost test is actually extremely useful in that context.

The companies can figure out what their costs are. And for counseling purposes, they can figure out if they're anywhere close to their costs. A risk averse company might want to avoid anything that's even questionably below cost.

so I think even if the economists can debate about precisely how you measure cost, for practical purposes for companies, I think it's quite useful to have that type of a test for counseling purposes. And I think it's also useful for rivals when they're thinking about their strategy. Do they want to aggressively compete on price? Do they feel like they need to do that?

Or can they file a lawsuit and seek billions of dollars in damages and maintain 85% profit margins? And that's a choice that a company could make. So I wanted to focus just for a minute on this notion of incontestable demand.

People have used this term off and on throughout the day. And I don't think anyone's really paused on it to define it very clearly. And I looked for definitions of incontestable demand. And I haven't really found a very satisfactory one.

And I would urge the economists out there to help us and come up with a really clear definition of what incontestable demand is if this concept is going to drive the legal treatment of a category of pricing practices. We've got a couple of definitions on this slide. The part of demand that's always purchased from the dominant firm-- things like that.

But I don't find those to be really helpful. Questions that I have that maybe some of the economists can help with is, you know, what if the rival can win over demand by discounting by 50% and be above its cost? Is that demand incontestable?

I mean, to me, that seems pretty contestable if you can discount and win and still be well above your cost. What if you don't even have to discount 50%? What if you discount an extra 10 percentage points or one percentage point? I think there are very few people in this room who would say that if a rival can discount by 1% and win sales that that demand is incontestable.

There may be others in this room who take the different view. But I think it would be helpful to have a clear definition here maybe focused on elasticity of demand, maybe somehow breaking this down so we can understand it in practical application if this is going to drive our rule. Because I think if we were talking about a product that was completely fungible, if we were talking about wheat, I don't think anyone would be worried about loyalty discounts. It's because of the incontestable demand that people have concerns about these types of pricing practices in the first place.

But people don't seem to be able to define what incontestable demand is. Looking at these cases, I wonder why demand is incontestable in the first place. These are typically in differentiated product markets.

So is it the case that the rival's product is just not as good? If you've got a drug product and the new drug is largely sawdust and it's not very effective and a small portion of customers will buy it because it's cheaper-- there may be some very strong differences in the product. And if you

have a rule that turns on incontestable demand-- for example, if you were to do a discount attribution test and distinguish-- I understand John you're not arguing for. But if you were to try to break apart the contestable and the incontestable part and allocate the full discount to the incontestable portion, you'd be creating a rule that gave more protection to a really bad rival who had a very low quality product.

If the reason why the demand is allegedly incontestable is that the rival doesn't have the same brand or reputation, are you creating an incentive for the rival not to go out and advertise its product? All of these things, I think, are real questions. And then, to the extent this is driving the legal treatment, what kind of structure does that create for the allegedly dominant firm?

How do they figure out how to price their own product? Do they have to figure out how good or bad their rivals are? Because if they have a really bad rival, they're going to have to be much more careful about how they create loyalty discounts.

Maybe they can't use loyalty discounts at all. And going back to the beginning, I think there are a lot of efficiency reasons for these types of practices. So I think for practical reasons and to encourage rivals to compete aggressively, I think the price cost test is extremely useful. And I would encourage all the economists who came up with hypothetical examples to look at the facts of the case like Eisai Versus Sanofi US and to think about whether that's the type of case you want to see coming into court where you've got a company that is pricing very far above its cost.

Going to Steve, I know all of your examples, Steve, involve distributors. But someone who's selling directly to customers, to take that type of an example and think about how that affects your analysis. Thanks very much.

SPEAKER 1: Thanks, Leah. Now we hear from Fiona Scott Morton.

FIONA SCOTT MORTON: Hello and thank you, as others have said to all the organizers, for putting on a very enjoyable day. You may notice that this is a legal panel and I'm an economist. So I'm obviously here by mistake. But I will try to be entertaining nonetheless.

The opinions I'm going to give are of course mine and not affiliated with any other organization that might have other people at it. I was impressed that Sean thought that in contrast to other parts of antitrust law, here we didn't have consensus among the economists and policymakers about-- I actually, those parts-- most of what we talk about it is characterized by that disagreement. So I wanted really to make one point in this session, which is I think it's very important that all these tests and concepts that we're talking about are linked at some point back to competitive effects.

If the contract in question isn't impacting competition, it's hard to see how you would have an antitrust violation. So what I think is really important is to actually look at the detail of the contract and figure out what it is doing. What is the effective price it's creating relative to marginal cost, relative to the but for world, relative to recoupment? What does the contract exclude?

I'm thinking here about a full product line that's driven by economies of scope. I think unlike Leah, I don't have a problem with uncontestable share. The examples that I have seen have are pretty clear. You've got medical devices that are different one from the other and can't be used on the same patients.

But they all can be made in the same kind of plant because they're slightly different one from the other or the FDA has approved a drug for five uses in one case and one use in another case. Or you have flavors of truck transmissions. And some are for long haul trucks and some are for short haul trucks.

And in the long run, the entrant could make everything. But in the short run, the entrant actually just cannot supply the other variants in the product line. And so that is an incontestable share because there's a monopoly seller.

So one of the things I think is helpful to do in these cases is to look at the arithmetic and see if the arithmetic actually supports a theory of harm. Because if it doesn't, then I think that's a quick way to simplify the situation. So I'm just going to give you a numerical example loosely based on ZF Meritor. I also think it's interesting we have a real pronunciation problem in this part of the antitrust world.

A-Sai, E-Sai, Zed-Ef, Zee-Eff, La-Pages, La-Pajes. Anyway, so I'll just say what I'm used to and hope that it's right. This is loosely based on ZF Meritor.

Trucks come in five flavors. The dominant Firm A makes all flavors and charges \$100 per truck. When the entrant arrives, it changes its price to \$105 per track. The entrant Firm B makes only flavor number five. It charges \$95 per track.

And notice here, we're clearly defining the contestable share. The entrant B does not make the other flavors yet. And I'm thinking along Randy's lines of there's a long term problem here.

Firm A really doesn't want Firm B to move into flavors four, three, two, and one. The buyer purchases 100 trucks a year and needs 20 of each flavor. To date, Firm B, because of its innovative and relatively inexpensive truck, has 15% market share-- so in other words, most of flavor five.

And then, we have the contract. This is a contract that references rivals. It's a loyalty rebate.

And the buyer's contract says the price is \$105 for each track. But there's a 5% discount on all units if the buyer purchases at least 90% of its needs from A, OK? It's need here is what draws us in the horizontal direction, OK? Its needs are going to come from A and B.

So we have the rival involved. The buyers contact this Firm B, says the price is \$95 per truck, OK? Firm B is just doing linear pricing.

The buyer would, in the case of competition on the merits of linear prices, buy 15 trucks from B and 85 trucks from A. OK, so now let's look at the effective price for the buyer once you have

this contract in place, OK? What is the effective contract price going to look like for buying from Firm A?

Well, trucks one through 89 are going to cost \$105.27 each, OK? And you'll see why I picked that number. Truck 90 costs its list price minus the total discount received for crossing the threshold. So that's \$105 minus the discount of \$5.26, which is a negative number-- negative 368.

OK, now trucks 91 through 100, we continue to get the discount if we continue to buy. And those are going to be \$100 each, which is our ex-ante price. So if you wanted to apply a price cost test, which I think has limited usefulness. But if you wanted to do that, you could look and you could see that at the contestable moment, over the unit that the entrant is trying to sell, the effective price generated by this contract is negative \$368.

And that is less than marginal cost of \$50, which I just picked arbitrarily. OK, if you graph it, that's what it looks like. So I hum along here from trucks one through 89 at \$105. And then I suddenly have this cliff.

OK, so the cliff, the question is, is the cliff doing anything? Is the cliff keeping the entrant from crossing the cliff? OK, the entrant can get to truck number nine. But the entrant is going to have a very difficult time selling truck number 10.

Because truck number 10 is going to have an effect-- well, let's look at that. So before we get to the entrant, let me just point out the shape of this thing. I think one of the things that's a little bit misleading when undertaking these analyses is that people tend to focus on the average price. So a 5% discount is not very big.

It doesn't sound very dreadful. But what the loyalty rebate is doing is changing the shape of the price schedule, OK? So it looks in this funny way with this funny dip rather than just thinking about it as 5% off, in which case we have a line of 100 all the way from zero to 100.

Now let's turn to Firm B. The effective contract price if the buyer buys from B, trucks one through nine are \$95. But then the buyer's going to think, uh oh, I'm getting to truck 10. And if I buy truck number 10 from Firm B, I forfeit my loyalty rebate from firm A.

So not only do I pay \$95, but then I'm going to give up my \$5.27 on the 85 trucks which we're assuming I would like to have from firm A. This is duplicative of the previous analysis. You can either do it up or you can do it down.

But I'm just pointing out that either way, it looks pretty bad for Firm B. Because here they have no trouble selling the first nine trucks. But the contract induced price for the 10th truck is very high.

OK, so again, it's the shape of the schedule. Firm B's prices are somewhat lower than Firm A's in this example. But here, the contract bumps up the effective price of firm B, OK?

So I think what you can do with a numerical example like this is ask yourself, does this satisfy-- does this match my theory of harm? Does it tell a story? Does it match the story I'm trying to tell about the competitive effects that I'm worried about in this context?

So if you think that jurisprudence requires you to have a price cost test, you could use this one. You could say, OK, [INAUDIBLE], I have some information about market shares. I have some information about demand.

The relevant point where the two firms are competing is around this 85 to 90 window. And what's the effective price induced by the contract and how does that relate to marginal cost? Also, as Steve pointed out earlier, this strategy is not very costly for the dominant firm.

So the X anti linear price was \$100. And Firm A was making \$9000 in that case. In the contract, I raised my price to \$105. I add a 5% discount.

I sell 90 trucks. And I'm still making \$9000, OK? If on the other hand there had been entry and I didn't adopt this shape of a price schedule and I just continued with my linear pricing, I would make \$8,500

OK, so I can adopt this kind of cliff, keep average price the same and prevent the entrant from getting those few extra sales. So, nowhere recoups required. There's no discount relative to the but for world.

What does the contract exclude? In this case, a few flavor five trucks that the buyer would like to buy from Firm B. Is that so terrible? Well, I think that if you're the dominant term, the issue really often is, in these cases, are there economies of scale for Firm B in flavor five? And then perhaps even more importantly, are there economies of scope across flavors?

Can I make more medical devices, more drugs, get approval for more drugs, make more different types of transmissions if I have a sense that I can sell to-- if I can sell to buyers? And then part of what's important about being clear about the contestable market-- which I called uncontestable. I'm not quite sure what's correct.

But that section of the market where the monopolist is selling is, how large is that? Because the larger it is, the smaller the discount I need to create a lump of money that I can apply to the marginal units. So if I have 80 units of type one through four, this is a tool that Firm A can use. That's \$8000 of uncontestable revenue.

I can make up some contract that applies some of that to the marginal unit. And I can get perhaps some action on the part of the buyer because of that kind of money. Now, some other things that I think the FTC wanted to raise in this conference that hasn't come up yet are some business school-ish sorts of things.

Since I teach in business school, I thought I'd bring those up. OK, so there's a couple of issues. One would be measurement error and uncertainty.

Do I really know what my needs are at the end of year? So there's some, you know, am I going to consume 100 trucks or 106 trucks? And am I going to miss the threshold because I consume a few more trucks than I thought? So you might want to set this thing up to have a margin of error so that the buyer doesn't tumble over the cliff if they're really trying not to.

And the cliff might not be quite so steep. If you wanted to say, well, we're not sure whether it's truck 90 or trucks 89 through 91. And then you might shrink the cliff but make it a little bit fatter if there's a little bit of measurement error uncertainty in the dollars.

The other thing that we see in the record is sometimes firms doing upfront payment. So in ZF Meritor, you get the \$1 million up front. You booked it. Now your division has book money.

And you're going to be the manager who buys the 10th truck from firm B. And the \$1 million has to be given back in the fourth quarter. OK, so then we get to things like behavioral biases. Do we have an endowment effect by the firm?

We get to managerial compensation. Do I get a bonus at the end of the year? Do I want to be the manager that caused us to lose the loyalty rebate? Do I want to be the manager who had to give back the loyalty rebate?

Buying patterns over the contract year-- I told you we're moving along from truck one to truck 89. Well, do we know how much we're buying? Could we bid out the whole contract-- all 100 trucks at the same time?

Now, if we could do that, then we're back to sort of typically no harm. You compete for the contract if everybody can supply all five flavors. Here, we don't have this situation. So the entrant can't bid for the whole contract.

But the buying patterns over the contract year are going to depend on how sophisticated the firm is. Is the firm thinking ahead to having 90 trucks and getting the loyalty rebate? Or is the firm reacting to demand shocks as the year goes along and then discovering itself at this cliff and finding its behavior bound by that? So that's just, I think, some other factors that are very real and that serve to constrain corporate behavior and are a reason why these contracts might work to affect behavior. And that's it

**SPEAKER 1:** Thanks, Fiona. Now we'll turn to our discussion starting with Abe Wickelgren.

**ABE WICKELGREN:** OK. So we've had a lot of discussion about price cost tests and some discussion of other tests. I want to spend a little time just talking about the idea of simple tests in general. There seems to be a lot of attraction to a simple test as some sort of a screen.

But I'm going to question whether that might be not quite as attractive as people think. So first of all, as there's been some discussion with the price cost test, they're not always that simple. They're certainly not always that error free.

So the idea is that it provides clear guidance. But of course, if we don't know exactly how costs are going to be measured or how the price is going to be measured, then we still have a fair amount of uncertainty. I think sort of more generally, when we have these tests, right, no one is suggesting that ultimately, what we care about, right, is how price relates to cost or whether an equally efficient rival could compete.

What we care about is a more general question like maximizing consumer surplus. Maybe it's maximizing total surplus, depending on where you come down. The idea behind these tests is that somehow, we gain something from this simplicity in terms of how it affects the deterrence or chilling trade off, how it affects administrative costs.

But as far as I can tell, at least I haven't seen any real detailed analysis of what we gain from these sort of supposedly simpler tests and how they affect that deterrence chilling trade off. And I want to suggest that absent that, we might want to focus more on answering the question that we ultimately care about, which is how does the contract in question affect consumer surplus relative to some plausible, feasible alternatives? Not to suggest that issues of what people call false positives, or I would refer to-- Lewis Kaplow's phrase is chilling effects.

But that there's other ways to manage that, right, then using questions that are in some sense not in 100% correlated with what we actually care, right? So we can manage the deterrence chilling trade off through other sorts of levers like adjusting the burden of proof. We can manage tradeoffs on litigation costs through restrictions on evidence and things like that.

And it's certainly not to say it's conceivable. I could imagine there's a world with a plausible model where asking what is to some extent the wrong question gives us better results than asking the right question and trying to tweak the burden of proof. But it seems like without some sort of showing of that, we got to at least be somewhat more inclined with asking the more direct question. And if we're worried that it's too expensive, right, we can adjust other levels. If we're worried about false positives, we can adjust the burden of proof and hopefully manage those tradeoffs a little bit better.

STEVE SALOP: Thank you. I take it you're ceding your three minutes to me.

ABE WICKELGREN: Well, we were going to go back and forth potentially.

STEVE SALOP: Well, I want to-- I-- that's called--

ABE WICKELGREN: We know how that works out.

STEVE SALOP: That's called opportunism.

ABE WICKELGREN: He told me he believed in commitment. But we'll see.

STEVE SALOP: I agree with Abe's comments. And I just want to add seven other summary points, but in the spirit of speaking to lawyers and the clarity with which John spoke. I've got these down to seven sentences, many commas.

First, because the monopolist exclusion value and the entrant's coordination or externality problems involve a distributor case, there can be no effective competition for the contract. That seems to me to be point 1 in disagreement with John. Dan was very close to John.

In response to Dan, showing that the entrant has no rational economic incentive to outbid incumbent should be considered objective evidence. So objective evidence is not simply comparing prices and costs. Third, such entrants are not lazy or incompetent.

They're only rational in the face of an effective exclusionary conduct strategy by the monopolist. Fifth, CPPs raise greater competitive concerns than predatory pricing, and so should entail a more intrusive legal rule, and not one that's hard to administer because it's so difficult to measure a contestable versus incontestable demand. It's hard to see how you can support a price cost test when you say you can't measure the underlying factors that are used. And based on my own experience in the Intel case, it is really hard to measure contestable versus incontestable demand.

In short, creeping Brooke-ism – which is what this is – creeping Brooke-ism in the form of an incremental price cost standard is not the way to maximize consumer welfare or maintain a competitive process. I do counseling too. And I think for counselling purposes, Leah, you should just tell them to cut prices across the board instead.

If, for example, if they wanted to fix prices with their rivals, I hope you would just say no rather than tell them to be really careful to not violate the subtleties inherent in the agreement requirement. Those are my seven points on why we should stick with the rule of reason – a harm to competition standard – rather than looking under the lamppost for a seemingly simple but actually quite complex price cost standard. Thank you.

ABE WICKELGREN: Yeah, I guess sort of – not to have too much agreement back and forth. But to build on this concern about the price cost test, I think there's also a question from a counseling standpoint, to the extent that we have a price cost test. And as Leah said, firms may be risk averse.

But there's actually a risk that having a price cost test can actually lead to higher prices. So yes, it's better for the firm. It gives them some certainty.

But if part of getting that certainly is because we know that courts are going to measure these things with error, you can eliminate any sort of marginal risk of liability by increasing your price above some level. We might actually, even though the point of price cost test is to provide a safe harbor for price cutting, it could potentially lead to higher prices in equilibrium if we have enough uncertainty in terms of how courts are likely to measure price.

STEVE SALOP: What I would add to that as a counseling issue is if you do the rule of reason, it's really not simple for the plaintiff to prove harm to competition. So I think the counselling concern that Leah was raising was really, take a firm without market power, no prospects of market power. It wants to use these CPPs in order to get into the market, be more effective – a rather Slovenia-like use of vertical restraints.

Well, I don't think they're going to have a problem. The problem is when the CPPs are suddenly discovered by a monopolist as a great way to increase consumer welfare just at the moment that the entrant appears in the market or four months before the entrant appears. I mean, what I was struck with in Ven's talk was he wasn't saying we see all these two part tariffs-- nonlinear pricing-- when the monopolist did not face a threat of entry. It was only when he faced the threat of entry that he began to institute the CPPs. And that's suspicious.

SPEAKER 1: Can we have one minute of discussion of the discussants?

SPEAKER 2: Do we have a minute left in time? Sure. Of course.

SPEAKER 3: So Steve, I just wanted to make one point, which is in the real world, a firm without market power can face a lawsuit based on the Fortas-like definition of a relevant market in his dissent in Grenell. The red haired, one eyed, man with a limp market in which the firm that in the real world has 30% share in the world of litigation may find itself with 100% share. So the counseling issue is not limited to firms that we would agree are dominant. It's something that really, you have to look at across the board, particularly in differentiated products cases.

STEVE SALOP: I think this real world argument worked really well when I was 35 years old. But I'm not anymore. I've been in the real world for a really long time too. And what I see in the real world these days is that firms with 100% of the market are getting called-- that the market's defined broadly so that the market is 30%, not the other way around. And I would take as a case in point the argument made by the defendants in Bazaarvoice that the market was very broad when it seemed pretty obvious, both to the judge and to other observers, that the market was really pretty narrow and had a very high market.

SPEAKER 3: Our principal argument was that whatever the market was buying, the government couldn't identify a single customer that was susceptible to harm. Now, we have a long opinion holding otherwise. But market was not our argument.

SPEAKER 1: OK, well, I'd like to thank our panelists and presenters.

SPEAKER 4: Thank you, everybody, thank you.