



The American Antitrust Institute

COMMENTS OF THE AMERICAN ANTITRUST INSTITUTE IN CONNECTION WITH CONDITIONAL PRICING PRACTICES WORKSHOP

The American Antitrust Institute (AAI) is an independent non-profit education, research, and advocacy organization devoted to advancing the role of competition in the economy, protecting consumers, and sustaining the vitality of the antitrust laws in the United States and around the world. See <http://www.antitrustinstitute.org>. It submits these comments in response to the Notice Announcing Public Workshop and Requesting Public Comments in connection with the joint workshop of the Federal Trade Commission (FTC) and Department of Justice (DOJ) on conditional pricing practices held June 23, 2014.

Introduction and Summary

AAI has long opposed a cost-based safe harbor for dominant firms' use of "discounts" linked to market-share requirements. See, e.g., *The Next Antitrust Agenda: The American Antitrust Institute's Transition Report on Competition Policy to the 44th President* 71-75 (Albert A. Foer ed., 2008); Brief of Amicus Curiae American Antitrust Institute in Support of Plaintiffs-Appellees, *ZF Meritor LLC v. Eaton Corp.*, 696 F.3d 254 (3d Cir. 2012) (No. 11-3301). Insofar as market-share rebates (also called "loyalty rebates") or similar conditional pricing practices are used by dominant firms to foreclose competitors or raise rivals' costs, they should be analyzed like exclusive dealing arrangements and be condemned when they help preserve or extend a dominant firm's market power, and the exclusionary conditions are not justified by countervailing procompetitive benefits. Neither policy nor precedent supports an above-cost safe harbor for conditional pricing practices that induce full or partial exclusivity, whether the price-cost test is of the "traditional" *Brooke Group* variety or the "discount attribution" type.¹

¹ Under a "traditional" *Brooke Group* (or "profit sacrifice") analysis, the incremental revenues and costs for "first dollar" rebates might arguably be applied to all the sales of the monopolist to a particular customer, while under a "discount attribution" version, the incremental revenues and costs would be applied separately to the contestable volume of the customer's demand. There seemed to be widespread consensus at the workshop that, in most cases, a monopolist flunking the "discount attribution" test raises significant competitive concerns. Even the Justice Department's now-withdrawn "Section 2 Report," which recommended that a predatory pricing test be used for single-product loyalty discounts "in most cases," noted that "commentators and panelists generally agree that . . . where a single-product loyalty discount is above cost when measured against all units, such a discount may in theory produce anticompetitive effects, especially if customers must carry a certain percentage of the leading firm's products and the discount is structured to induce purchasers to buy all or nearly all needs beyond that 'uncontestable' percentage from the leading firm." U.S. Dept. of Justice, *Competition and Monopoly: Single-Firm Conduct Under Section 2 of the Sherman Act* 107, 117 (2008) (internal quotation marks omitted). Subsequently, the Justice Department brought a case involving loyalty "discounts" in which it analyzed the anticompetitive effects using the discount-attribution test. *United States v. United Regional Health Care System*, No. 7:11-cv-00030 (N.D. Tex. Feb. 25, 2011). Importantly, however, the Department did not take the position that such a test is a *required* element of a plaintiff's case, or that the test is an appropriate tool in all cases. See *id.*, Competitive Impact Statement at 15 ("measuring the contestable volume may in some cases be impractical").

Loyalty rebates by dominant firms are easily structured to produce de facto exclusive or partial exclusive dealing. For example, “first dollar” or “retroactive” loyalty rebates are rebates applied to all the purchases made by a customer during a period, provided a specified market-share threshold is maintained, not just to those in excess of the threshold. This can make it very costly, if not impossible, for rivals to compete for a portion of the customers’ demand beyond that permitted by the specified market-share threshold.² A rival must not only match the monopolist’s prices on the sales it can reasonably contest,³ but compensate the customer for its lost rebates on all of the customers’ purchases. The rebate is effectively a “tax” the rival must pay to compete for a customer’s volume in excess of that permitted by the market-share threshold. Thus, as with explicit exclusive dealing arrangements, a rival may be foreclosed from significant portions of the market, and such foreclosure (or higher cost) may harm consumer welfare by reducing competitive pressure on the dominant firm. And, as with explicit exclusive dealing arrangements, but unlike predatory pricing, the strategy may be fully profitable for the dominant firm in the short run. Moreover, while loyalty conditions, like exclusive dealing, could have pro-competitive benefits, the benefits are not comparable to unconditional price cuts. Accordingly, a predatory pricing price-cost test plainly is not appropriate.

Economists at the workshop articulated several versions of this theme.⁴ Indeed, a growing body of legal and economic scholarship and commentary agrees that loyalty rebates should be treated as a form of exclusive dealing, and not like predatory pricing. *See, e.g.*, Remarks of Joshua D. Wright, Commissioner, Federal Trade Comm’n, at the Bates White 10th Annual Antitrust Conference, June 3, 2013, Simple but Wrong or Complex but More Accurate? The Case for an Exclusive Dealing-Based Approach to Evaluating Loyalty Discounts, *available at* <http://www.ftc.gov/public-statements/2013/06/simple-wrong-or-complex-more-accurate-case-exclusive-dealing-based>; Einer Elhauge, *U.S. Antitrust Law and Economics* 406 (2d ed. 2011)

² For example, a monopolist may charge \$100 for a product without any loyalty conditions, and offer a “small” 10% rebate on all purchases as long as the customer maintains a 90% “market share” with the monopolist. If the customer normally purchases 100 units, any purchase by the customer of more than 10 units from the monopolist’s rival will entail foregoing \$900 (10% x 90 units x \$100). If the rival sought to supply 20% of the customer’s needs, it would have to compensate the customer for this loss, which would mean discounting the 20 units by at least 45%. Any loyalty condition that makes the marginal units in excess of the permitted market share threshold expensive to contest will have a similar effect.

³ It is not uncommon that a certain portion customers’ demand for the dominant firm’s products will be incontestable. However, even if a rival is theoretically capable of bidding for all of a customer’s business, it may be unduly costly or practically impossible for the rival to avoid foreclosure by outbidding the dominant firm for many reasons, not least of which is the “exclusion value” of the foreclosure to the monopolist. *See* Steven C. Salop, Conditional Pricing Practices and the Two Anticompetitive Exclusion Paradigms at 12 (“Monopolist’s ‘exclusion value’ provides incentive to bid higher than equally efficient entrant” for exclusivity) (workshop slides); *see also id.* at 14-15 (where rival entrant needs wide nonexclusive distribution, “coordination problem” among distributors may prevent entry by equally efficient rival).

⁴ Loyalty rebates can also lead to higher prices, even in the absence of exclusion of rivals, when they involve a commitment by the incumbent to maintain a higher “list” price for customers that do not agree to the loyalty condition. In that event, both the incumbent and the rivals have less of an incentive to cut prices to “disloyal” buyers. *See* Einer Elhauge & Abraham L. Wickelgren, *Anticompetitive Market Division Through Loyalty Discounts Without Buyer Commitment*, Harvard Discussion Paper No. 723 (August 2012), *available at* <http://ssrn.com>.

(“Loyalty discounts can raise the same anticompetitive concerns as exclusive dealing.”); Jonathan M. Jacobson, *A Note on Loyalty Discounts* at 4, Antitrust Source, June 2010 (“loyalty discounts are designed to create results essentially the same as exclusive dealing arrangements”); Statement of Commissioners Harbour, Leibowitz and Rosch on the Issuance of the Section 2 Report by the Department of Justice 6-7 (Sept. 8, 2008) (criticizing price-cost test for loyalty discounts); Robert H. Lande, *Should Predatory Pricing Rules Immunize Exclusionary Discounts?* 2006 Utah L. Rev. 863, 880 (recommending that “retroactive” or “all purchases” loyalty discounts be banned unless justified by significant efficiencies); Willard K. Tom et al., *Anticompetitive Aspects of Market-Share Discounts and Other Incentives to Exclusive Dealing*, 67 Antitrust L.J. 615, 615 (2000) (“market-share discounts structured to produce total or partial exclusivity should be judged according to the same economic principles that govern exclusive dealing”); see also Louis Kaplow & Carl Shapiro, *Antitrust*, in 2 Handbook of Law & Economics 1073, 1203 n.198 (A. Michell Polinsky & Steven Shavell eds., 2007) (explaining that “a variety of seemingly distinct contractual arrangements, without explicit exclusivity, can have very similar economic effects [as exclusivity]”).

In these comments, we first address the legal issues surrounding loyalty rebates, arguing that precedent supports applying a rule of reason and treating loyalty rebates like exclusive dealing when the loyalty conditions are in fact structured to produce exclusive dealing or partial exclusive dealing. Then we address some of the policy considerations, explaining why the *Brooke Group* predatory-pricing policy arguments for an above-cost safe harbor are inapt. Loyalty rebates are a much less costly way to exclude than predatory pricing, and the benefits of conditional pricing practices are much more ambiguous than unconditional price cuts. Moreover, a *Brooke Group* predatory-pricing safe harbor is not justified by appeals to an equally efficient competitor standard. Such a standard is not the general rule under Section 2, and for good reason. A *Brooke Group* test would allow the exclusion of competitors that are equally efficient at producing part of a customer’s demand. And even a “discount attribution” price cost-test would allow a monopolist to exclude rivals that may *become* equally, or more, efficient if they were not foreclosed by the monopolist’s conduct, as well as higher-cost rivals that would otherwise constrain a monopolist’s exercise of market power. A price-cost test for loyalty rebates is also not advisable because such tests are notoriously difficult to apply.

I. The Law Does Not Support A Cost-Based Safe Harbor For Loyalty Rebates Structured to Produce Exclusive Dealing

It is well settled that exclusive dealing arrangements may be illegal without proof of below-cost prices. See, e.g., *United States v. Dentsply Int’l, Inc.*, 399 F. 3d 181, 187 (3d Cir. 2005). It does not matter whether the exclusive dealing agreement is obtained by a threat to penalize the customer, see *id.* at 190 (Dentsply threatened to sever access to its teeth and other dental products); *United States v. Microsoft Corp.*, 253 F.3d 34, 73 (D.C. Cir. 2001) (en banc) (Microsoft “exclusive deal” with Apple to make Internet Explorer the default browser on Macs under threat by Microsoft to cancel Mac Office), or by the payment of a discount, rebate, or other valuable consideration, see *id.* at 68 (internet access providers agreed to promote Internet Explorer exclusively and keep rival browser shipments below 25% in exchange for valuable promotional treatment); *Standard Fashion Co. v. Magrane-Houston Co.*, 258 U.S. 346, 351-52 (1922) (retailer received 50% discount off retail prices as part of deal for unlawful exclusive); *United Shoe Machinery Corp. v. United States*, 258 U.S. 451, 457 (1922) (exclusionary lease

conditions, including a lower royalty rate for lessees that agreed to use only lessor's machines, held unlawful).

Indeed, section 3 of the Clayton Act expressly makes it illegal for a firm to make a contract for the sale of goods "or fix a price charged therefor, or *discount from, or rebate upon,* such price," on the condition that the purchaser not deal in the goods of a competitor where the effect may be to substantially lessen competition. 15 U.S.C. § 14 (emphasis added). So, if a monopolist pays a distributor an upfront fee or offers a discount for an exclusive dealing contract, antitrust law has never inquired whether the "net" prices to the distributor, after deducting the fee, are below the monopolist's costs. See 11 Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law* ¶ 1807b1, at 133 (3d ed. 2006) ("A discount conditioned on exclusivity should generally be treated no different from an orthodox exclusive-dealing arrangement.").

The fact that loyalty rebates do not preclude customers from buying some of their requirements from the monopolist's rival does not immunize them from liability under Section 2. See, e.g., *Dentsply*, 399 F.3d at 185 (unlawful "exclusive" dealing arrangement permitted dealers to continue to purchase "grandfathered" products from competitors); *Microsoft*, 253 F.3d at 68, 70-71 (unlawful "exclusive" dealing arrangement allowed internet access providers to offer competing internet browser to limited extent); see also *FTC v. Brown Shoe Co.*, 384 U.S. 316, 321 (1966) (retailers' agreement to deal *primarily* with Brown in exchange for valuable services "obviously conflicts with the central policy of both § 1 of the Sherman Act and § 3 of the Clayton Act"); *United States v. Standard Oil Co.*, 362 F. Supp. 1331, 1340-41 (C.D. Cal. Oct. 26, 1972) (60% requirements contract violated section 3 of the Clayton Act), *aff'd*, 412 U.S. 924 (1973); see Jacobson, *supra*, at 5 (noting that partial exclusivity arrangements that cover all of the market can be more anticompetitive than complete exclusivity agreements that cover less than 100% of the market). In fact, loyalty rebates that create partial exclusivity generally have less of a legitimate business justification than exclusive dealing agreements with 100% exclusivity. See *id.* at 2 ("Because some competitive product purchases are permitted, the supplier generally is not trying to get its dealer to provide an entirely dedicated focus to the distribution of its products.").

Some argue that Supreme Court cases involving "pricing practices"⁵ dictate the use of a price-cost test for loyalty rebates. See, e.g., Brief for Eighteen Scholars as *Amici Curiae* in Support of Pet'r at 5-7, *Eaton Corp. v. ZF Meritor LLC*, 133 S. Ct. 2025 (2013) (No. 12-1045) ("Scholars' *Meritor* Amicus Br."). This is a significant misreading of the cases. *Matsushita* and *Brooke Group* are predatory pricing cases, while *Weyerhaeuser* applies predatory pricing rules to predatory bidding by buyers, which is the obverse of predatory pricing by sellers; nothing in these cases suggests a predatory pricing analysis should apply to conditional pricing practices. Nor do the other "pricing practices" cases support extending predatory pricing rules to exclusionary loyalty rebates or contradict the Supreme Court precedent treating discounts

⁵ *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986); *Cargill, Inc. v. Monfort of Colo., Inc.*, 479 U.S. 104 (1986); *Atl. Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328 (1990); *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993); *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co.*, 549 U.S. 312 (2007); *Pac. Bell Tel Co. v. linkLine Commc'ns., Inc.*, 555 U.S. 438 (2009).

conditioned on exclusivity as exclusive dealing arrangements without regard to whether the resulting prices are above cost. *See Standard Fashion*, 258 U.S. 346; *United Shoe*, 258 U.S. 451.

Cargill and *Atlantic Richfield* stand for the uncontroversial proposition that competitors do not suffer antitrust injury (and hence lack standing under the Clayton Act) from a rival's low, but not predatory prices. But just as basic is the proposition that competitors *do* suffer from antitrust injury when they are foreclosed from a market as result of exclusive dealing or other exclusionary conduct. *See LePage's Inc. v. 3M*, 324 F.3d 141, 158 (3d Cir. 2003) ("The foreclosure of markets through exclusive dealing contracts is of concern under the antitrust laws."); *Sprint Nextel Corp. v. AT&T Inc.*, 821 F. Supp. 2d 308, 320 (D.D.C. 2011) ("Where a defendant, by means of anticompetitive conduct, restricts or forecloses a competitor plaintiff's access to a necessary input, courts have found that the resulting loss is injury of the type that the antitrust laws were designed to prevent.") (collecting cases). Nothing in the jurisprudence of antitrust injury suggests that standing should be denied to a competitor when its injury arises from the exclusionary conditions associated with loyalty rebates, let alone that the government somehow is required to establish antitrust injury and prove below-cost prices to challenge those exclusionary conditions.

linkLine held that a "price squeeze" by a vertically integrated monopolist against the monopolist's downstream rival (charging a "high" wholesale price to the rival and a "low" retail price to common customers) is not actionable if the monopolist has "no antitrust duty to deal" with the rival. 555 U.S. at 445-46. *linkLine* did note that "[r]ecognizing a price-squeeze claim where the defendant's retail price remains above cost would invite the precise harm we sought to avoid in *Brooke Group*: Firms might raise their retail prices or refrain from aggressive price competition to avoid potential antitrust liability." *Id.* at 451-52. However, *linkLine* is distinguishable because a price squeeze excludes rivals through prices themselves, whereas the exclusion from a loyalty rebate results from the exclusionary conditions linked to the rebates. Moreover, it is clear that the basis of the decision was the assumption that AT&T had no antitrust duty to deal with *linkLine* in the first place, which the Court emphasized numerous times in the opinion. *See, e.g., id.* at 450 ("*Trinko* thus makes clear that if a firm has no antitrust duty to deal with its competitors at wholesale, it certainly has no duty to deal under terms and conditions that the rivals find commercially advantageous."). Indeed, the Court expressed doubt that even a *Brooke Group* predatory pricing claim could be brought in the absence of antitrust duty to deal: "For if AT&T can bankrupt the plaintiffs by refusing to deal altogether, the plaintiffs must demonstrate why the law prevents AT&T from putting them out of business by pricing them out of the market." *Id.* at 456-57. In short, *linkLine* provides no support for extending predatory pricing rules to loyalty rebates or other exclusive dealing arrangements.

The Third Circuit's recent decision in *ZF Meritor* stated "the price-cost test applies to market-share or volume rebates offered by suppliers within a single-product market." *ZF Meritor, LLC v. Eaton Corp.*, 696 F.3d 254, 274 n.11 (3d Cir. 2013). However, the court made clear that such a test only applies "when price is the clearly predominant mechanism of exclusion," *id.* at 275, and that price is not the predominant means of exclusion when the loss of rebates may be fairly characterized as a penalty for failing to comply with the exclusionary condition, *see id.* at 277; *Scholars' Meritor Amicus Br.*, *supra*, at 8-13, or when the condition bundles contestable and incontestable demand. 696 F.3d at 278, 282-83; *see also* Einer Elhauge, *The Merit of Meritor* at 3-4 (setting out six factors when price is not clearly the predominant mechanism of exclusion) (workshop slides). *But see Esai Inc. v. Sanofi-Aventis U.S., LLC*, 2014

WL 1343254, at *27, 28 (D. N.J. Mar. 28, 2014) (narrowly construing *Meritor*; appeal pending). In rejecting a price-cost test for the loyalty rebates at issue, the Third Circuit was bolstered by its conclusion that “[n]othing in the case law suggests, nor would it be sound policy to hold that above-cost prices render an otherwise unlawful exclusive dealing arrangement lawful.” 696 F.3d at 278.

Then-Judge Breyer’s opinion in *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227 (1st Cir. 1983), does not support requiring a price-cost for loyalty rebates. It is true that *Barry Wright* involved a loyalty discount: the putative monopolist, Pacific, “agreed to sell its product (mechanical snubbers) to Grinnell at a specially low price and Grinnell agreed to take nearly all its snubber requirements from Pacific.” 724 F.2d at 228. The plaintiff challenged the low prices as predatory pricing, which the court rejected in the absence of a showing of prices below cost. However, the plaintiff *also* challenged the arrangement as anticompetitive exclusive dealing, and the court pointedly did not apply a cost test to the exclusive-dealing theory. *See id.* at 236-238 (finding no violation because of insufficient foreclosure and legitimate business justifications). If anything, *Barry Wright* recognizes that a challenge to exclusionary conditions required to obtain discounts *does not* require proof of prices below cost.

Virgin Atlantic is similar. In that case, the Second Circuit applied the *Brooke Group* predatory pricing test to plaintiff’s predatory pricing theory, but not to plaintiff’s claim that British Airways’ incentive agreements with corporate clients and travel agents violated Section 1. *See Virgin Atl. Airways Ltd. v. British Airways PLC*, 257 F.3d 256, 263-65 (2d Cir. 2001). The latter claim was dismissed where the plaintiff failed to show an adverse effect on the relevant market, which is not surprising given that the agreements covered tiny percentages of the bookings in the relevant markets. *See id.* at 261-62 (maximum of 3.79%).

Other appellate cases cited by advocates of a price-cost test are also inapposite. *NicSand* dismissed a challenge to exclusive dealing agreements obtained in exchange for up-front payments where plaintiff never alleged below cost prices *or* that the exclusive agreements had adverse anticompetitive effects. *See NicSand, Inc. v. 3M Co.*, 507 F.3d 442, 454 (6th Cir. 2007) (en banc). Likewise, the Eighth Circuit in *Concord Boat* held that plaintiffs’ claim involving market-share discounts was wanting in part because defendant’s prices were not below cost, but also because the loyalty conditions had not “foreclosed a substantial share” of the market. *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039, 1059 (8th Cir. 2000). The court did not consider the question of below-cost prices in analyzing the discount program as exclusive dealing under section 1 of the Sherman Act.

II. The Policy Rationale for *Brooke Group* Does Not Apply to Loyalty Rebates

The *Brooke Group* predatory-pricing policy arguments for an above-cost safe harbor do not apply to loyalty rebates. Loyalty rebates are a much less costly way to exclude than predatory pricing, which ordinarily requires across the board price cuts and profit sacrifice. In fact, the use of loyalty rebates can be an attractive exclusion strategy because it is fully profitable in the short run. At the same time, as we discuss below, the benefits of loyalty rebates are much more ambiguous than the unconditional, across-the-board price cuts associated with predatory pricing schemes. Moreover, a cost-based test cannot be justified by appeals to an equally efficient competitor standard, and the difficulties of administering such a test militate against its adoption.

A. Loyalty Rebates Are Not Like Unconditional Price Cuts

There is a fundamental difference between unconditional price cuts, which provide unambiguous benefits for buyers, and bundled or loyalty “discounts,” which impose exclusionary conditions on purchasers in order to obtain certain “price” benefits. As Professor Elhauge notes, “unlike with predatory pricing, what requires justification in the case of loyalty and bundled discounts is not the pricing, but the loyalty or bundled condition attached to the pricing.” Elhauge, *U.S. Antitrust Law and Economics*, *supra*, at 413; Jacobson, *supra*, at 2 (“a loyalty discount is not a simple price cut. . . . By conditioning the discount on a percentage requirement, the supplier is inducing the customer to take more from the supplier and also to take less from rivals.”); *cf.* Brief for the United States as Amicus Curiae at 12, *3M Co. v. LePage’s Inc.*, 542 U.S. 953 (2004) (No. 02-1865) (“U.S. *LePage’s Br.*”) (“[T]he bundling of rebates (as distinct from price reductions that may result) is not necessarily procompetitive.”).

Indeed, loyalty rebates do not necessarily involve lower prices at all. The monopolist may simply raise the “disloyal” price, so the “discount” for adhering to the exclusivity condition makes the customer no better off. As Professor Elhauge explains:

Without some comparison to but-for prices [i.e., those prices that would be charged in the absence of the loyalty condition], any loyalty discount or rebate could equally be called a disloyalty penalty imposed on buyers who refuse to restrict purchases from the seller’s rivals. Rather than call them either loyalty discounts or disloyalty penalties, it would be more neutral to call them price differences conditioned on loyalty

Elhauge, *U.S. Antitrust Law and Economics*, *supra*, at 404; *see also* Andrew I. Gavil, et al., *Antitrust Law in Perspective* 682 (2d ed. 2008) (“Although loyalty discounts may initially result in lower prices to some customers, they may actually lead to higher prices for others, especially those who do not qualify for (or decline to accept) the discounts, when compared to prices that were available before the program was implemented.”). Furthermore, even if a loyalty rebate program results in lower prices in the short term for buyers who accept the terms,⁶ lump-sum loyalty rebates may be less likely to be passed on to the ultimate consumers than unconditional price cuts. *See* Barry Nalebuff, *Exclusionary Bundling*, 50 *Antitrust Bull.* 321, 347 (2005); *cf.* *LePage’s*, 324 F.3d at 163 (noting that 3M’s rebate programs did not benefit the ultimate consumers).

B. An Equally Efficient Competitor Standard Is Unwarranted

A cost-based test cannot be justified on the basis that if prices are above the monopolist’s cost, an equally efficient competitor can match them. In the first place, a firm with a small market share may be an equally efficient competitor for part of the market, yet it may not be able to match the monopolist’s loyalty rebates because it cannot realistically compete for all of a customers’ business for which the customer receives a rebate—just as an equally efficient single-

⁶ Over the long term, buyers collectively will be harmed by the elimination of competition among suppliers, but buyers may agree to the terms or even seek out loyalty rebates because of a collective-action problem. *See* Einer Elhauge, *Tying, Bundled Discounts, and the Death of the Single Monopoly Profit Theory*, 123 *Harv. L. Rev.* 397, 456 (2009); Joseph F. Brodley & Ching-to Albert Ma, *Contract Penalties, Monopolizing Strategies, and Antitrust Policy*, 45 *Stan. L. Rev.* 1161 (1993).

product firm cannot match a monopolist's bundled rebates because it does not offer the range of products on which the monopolist provides a rebate. *See LePage's*, 324 F.3d at 155 (firm that does not manufacture an equally diverse group of products may be foreclosed); *Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883, 898-99 (9th Cir. 2008) (same). A traditional *Brooke Group* test would exclude equally efficient competitors in these circumstances.⁷

Second, loyalty rebates, like bundled rebates, may prevent a rival from *becoming* an equally efficient competitor by denying it the economies of scale it needs to be equally (or more) efficient. *See Elhauge, U.S. Antitrust Law and Economics, supra*, at 411 (“Rivals that are equally efficient (in the sense of having a long run cost curve that is as low as the defendant) might be unable to achieve a price as low as the defendant’s costs precisely because the foreclosure has relegated them to the high cost portion of their cost curve.”); *cf. Kaplow & Shapiro, supra*, at 1203 (“Anticompetitive exclusion most plausibly arises [from exclusive dealing] when [a monopolist] requires its dealers to purchase only from itself, these dealers constitute a large proportion of the market, and profitable entry or continued survival requires the rival to achieve a scale greater than is possible if sales must be limited to dealers not subject to exclusive-dealing contracts.”).

Even Judge Posner, a prominent advocate of an “equally efficient competitor” standard, recognizes that exclusion of a competitor that is “less efficient” because it is prevented from attaining economies of scale is an antitrust problem. In discussing *LePage's*, Judge Posner commented:

There is a difference from the standpoint of economic welfare between efficiency based on lower labor or materials costs, superior management, better quality, and other firm-specific attributes, and efficiency based on scale, which is attainable by any firm that is able to increase its output to the efficient scale. Economies of scale are a market rather than a firm attribute. To the extent that the loyalty rebates raised *LePage's* average costs by shrinking its output and thus preventing it from achieving the available economies of scale, this was not a consequence of 3M being a more efficient company in a sense relevant to antitrust policy.

Richard A. Posner, *Vertical Restraints and Antitrust Policy*, 72 U. Chi. L. Rev. 229, 240 (2005); *see also U.S. LePage's Br.* at 13 n.10 (“Firms with equal costs at any common level of output may have different costs because they produce different levels of output, perhaps as a result of allegedly exclusionary conduct, which calls into question their comparative efficiency.”).

Third, antitrust law ordinarily has not immunized anticompetitive conduct by monopolists when it excludes only less efficient rivals. *See, e.g., United Shoe*, 258 U.S. at 462 (discriminatory royalty clause providing lower royalty for lessees who agreed to use only lessor’s machines violated section 3 of Clayton Act; “[n]o matter how good the machines of the United Company may be, or how efficient its service, it is not at liberty to lease its machines upon conditions prohibited by a valid law”); *Microsoft*, 253 F.3d at 79 (Sherman Act protects

⁷ When a rival cannot compete against an unconditional above-cost price cut, one can assume that is because its costs are higher than the monopolist’s. However, when a rival cannot compete against a loyalty rebate linked to market share, it says nothing about rival efficiency because of the added “tax” the rival must assume if it is to compete for part of the customer’s business beyond that permitted by the market-share threshold. *See Tom et al., supra*, at 628 (providing example of negative prices).

“nascent, albeit unproven, competitors” from monopolistic abuse); *cf. Northern Pacific Ry. Co. v United States*, 356 US 1, 11-12 (1958) (tying arrangement not immunized merely because rival could avoid foreclosure by charging slightly less than the price for the tied good). And this is good policy because even less efficient competitors can provide important checks against the exercise of market power. *See* Steven C. Salop, *Exclusionary Conduct, Effect on Consumers, and the Flawed Profit-Sacrifice Standard*, 73 *Antitrust L.J.* 311, 328 (2006) (“The fundamental problem with applying the equally efficient entrant standard to [exclusionary] conduct is that the unencumbered (potential) entry of less-efficient competitors often raises consumer welfare.”); Elhauge, *U.S. Antitrust Law and Economics*, *supra*, at 463-64 (“The equally efficient rival test seems oddly focused on the competitive virtue of the rival, rather than on the effects of the defendant’s conduct on consumer welfare and efficiency.”); Steven C. Salop et al., *The Appropriate Legal Standard and Sufficient Economic Evidence for Exclusive Dealing Under Section 2: the FTC’s McWane Case 17* (August 7, 2014), available at ssrn.com (“[A] legal standard for exclusive dealing (or other non-predatory pricing conduct) by a dominant firm that would fail to condemn cost-raising conduct that targets even less efficient competitors would lead to significant false negatives and under-deterrence.”); John Vickers, *Abuse of Market Power*, 115 *Econ. J.* F244, F256 (2005).⁸

To be sure, the *Brooke Group* below-cost pricing test does not ordinarily protect less efficient rivals against predatory pricing. But *Brooke Group* was largely premised on the difficulty of fashioning a rule that would not chill *unconditional* price-cutting. *See Brooke Group*, 509 U.S. at 223 (“As a general rule, the exclusionary effect of prices above a relevant measure of cost either reflects the lower cost structure of the alleged predator, and so represents competition on the merits, or is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price-cutting.”).⁹ Applying a rule of reason to loyalty rebates that create exclusive or partial exclusive dealing arrangements does not impinge on legitimate price cutting activity by a monopolist. Even if a loyalty rebate involves a true discount, the monopolist can always cut prices without the loyalty condition, or offer uniform volume discounts. *See* Jacobson, *supra*, at 9 (“[L]oyalty discounts generally involve no cost-saving or similar customer benefit that cannot be achieved with equal effectiveness through simple price reductions without associated loyalty conditions.”).¹⁰

⁸ An equally efficient competitor standard also makes no sense when the theory of harm is that the loyalty conditions are imposed not exclude a rival but to divide markets and soften competition. *See supra* note 4.

⁹ As Professor Elhauge notes, “Pure above-cost pricing should be allowed, but that is not because excluding less efficient rivals cannot be anticompetitive. Rather, it is because a firm cannot avoid setting some price, and the systematic effects of banning above-cost price cuts that exclude less efficient rivals would harm consumers and efficiency. . . . The same analysis does not extend to exclusionary conditions that lack any redeeming justification and are thus eminently avoidable and can be banned without systematic ill effects.” Elhauge, *Tying*, *supra*, at 464 n.198.

¹⁰ Professor Crane points out that market share discounts have certain advantages over volume discounts, for either buyers or sellers. *See* Daniel A. Crane, *Bargaining Over Loyalty*, 92 *Tex. L. Rev.* 253 (2013). These include shifting the risks of changing market circumstances from buyers to sellers, guaranteeing the supplier a minimum volume of sales when the requirements of a group of customers are unpredictable, or enabling small buyers to obtain discounts. *Id.* at 260-64. It is not clear that in the real world loyalty rebates have been used by dominant for these reasons. In any event, the real question is not whether

C. Cost-Based Tests Are Unworkable

Finally, a cost-based test for loyalty rebates is not advisable because cost-based tests are so difficult to apply in practice. *See* Gavil et al., *supra*, at 672 (“Determining whether a dominant firm’s prices are ‘below cost’ . . . has proven to be a challenging task.”); 3A Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law* ¶ 740d, at 198 (3d ed. 2006) (“The difficulties of measuring costs are notorious.”); *see, e.g., United States v. AMR Corp.*, 335 F.3d 1109, 1120-21 (10th Cir. 2003) (rejecting all four tests of variable costs proposed by the government). This difficulty not only makes it hard for courts and juries to determine a monopolist’s costs, increases expenses for litigants, and undercuts the usefulness to businesses of cost-based safe harbors, but it also makes it exceedingly difficult for a plaintiff to succeed. As Professor Lande notes, using a cost-based test would “snare the parties into the expensive, unpredictable, daunting quagmire” of predatory pricing litigation “that almost always ends in a finding of legality.” Lande, *supra*, at 880; *see id.* at 869 (“the world of predatory pricing has become a monopolist’s paradise” despite the view of many respected scholars that predatory pricing is not rare).

Conclusion

Loyalty rebates are not equivalent to price discounts. They are policies that link the price paid by a buyer to the maintenance of the supplier’s market share. By imposing a tax on buyers for giving business to the supplier’s rival, they can effectuate exclusive (or partially exclusive) dealing arrangements. As such, loyalty rebates should be condemned when used by a dominant firm to foreclose rivals (or soften competition) and thereby to preserve or extend the firm’s monopoly power, and the loyalty conditions are not justified by countervailing pro-competitive benefits.

Respectfully submitted,

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market share discounts have advantages over volume discounts, which themselves can be structured to achieve exclusivity. *See* Competitive Impact Statement at 18, *United States v. Microsoft Corp.*, 56 F.3d 1448 (D.C. Cir. 1995) (where a volume discount by a monopolist is structured “in such a way that buyers, who must purchase some substantial quantity from the monopolist, effectively are coerced by the structure of the discount schedule (as opposed to the level of the price) to buy all or substantially all of the supplies they need from the monopolist . . . the volume discount structure would unlawfully foreclose competing suppliers from the marketplace . . . and thus may be challenged”). Rather, assuming the partial exclusivity has anticompetitive effects, the real question is whether the exclusionary conditions are reasonably necessary to achieve lower costs or other pro-competitive benefits. *Cf.* Hans Zenger, *When Does Exclusive Dealing Intensify Competition for Distribution? Comment on Klein and Murphy*, 77 *Antitrust L.J.* 205 (2010) (suggesting that the competition-intensifying effect of exclusive dealing is least significant with asymmetric firms, when the danger of foreclosure is the largest).