

On the use of price-cost tests in loyalty rebates and exclusive dealing arrangements

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The Pros and Cons of Rebates
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The question

SHOULD PRICES ABOVE COSTS BE A SAFE HARBOUR FOR LOYALTY/EXCLUSIVITY REBATES?

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- **Predation based on scale economies:** predatory prices below costs when the prey is more efficient than the incumbent (over total production).
 - ▶ Ingredients and underlying mechanism.

Predation based on scale-economies

Crucial ingredients:

- If rival denied access to critical number of buyers, sales, profits, it is poorly competitive.
- Instead, if rival achieves critical scale, it will be viable and more efficient than the incumbent.
 - ▶ Demand-side and supply-side scale economies, learning effects.
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- **BELOW COST** pricing to early buyers.

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 - ▶ However, above-cost predation if the rival is **LESS EFFICIENT** than the incumbent (and product differentiation).
 - ▶ Moreover, if buyers approached **SIMULTANEOUSLY**, exclusion based on **BUYERS' COORDINATION FAILURES**. Exclusion may take place **WITHOUT** incumbent's losses (or profit sacrifice).

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The price-cost test **JUST** a piece of evidence that **COMPLEMENTS THE THEORY OF HARM**:

- provision of a convincing mechanism explaining why predation is profitable;
- facts of the case are consistent with that mechanism;
- mechanism corroborated by the price-cost test.

Contracts that allow to discriminate

Pricing schemes that allow to target **SPECIFIC BUYERS** facilitate exclusion:

- Selective price cuts allow to implement a divide-and-conquer strategy.
- Quantity discounts induce asymmetric buyers to self-select into the different pricing schemes (Karlinger and Motta, 2012).
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Pricing schemes that allow to target **SPECIFIC PORTIONS** of buyers' demand facilitate exclusion (Fumagalli and Motta, JLawE 2012):

- Quantity discounts or market share discounts allow to target the discount on the contestable demand of early buyers.

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- Price-cost test not applied mechanically but complementary to the theory of harm.

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- In the scale-economies setting, they allow the incumbent to secure the crucial buyers while **LIMITING THE DISTORTIONS** on sales to those buyers (Bernheim and Whinston, 1998).
 - ▶ Buyers approached sequentially; suppliers use two-part tariffs.
 - ▶ Exclusionary equilibrium: incumbent offers to early buyers linear price equal to own marginal cost and **negative** fee + **exclusivity requirement**.
 - ▶ Without exclusivity, below-cost linear prices which entail allocative inefficiency.
 - ▶ Exclusion less profitable for the incumbent.

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Discounts conditional on exclusivity raise more severe anti-competitive concern:

- Calzolari and Denicoló (2013,2015, 2018a, 2018b) propose a different mechanism.
 - ▶ Dominant firm **MORE EFFICIENT** (or higher quality product, or bigger capacity) than the rival.
 - ▶ In their setting exclusivity rebates are not profitable **INDIRECTLY** because they impair rivals' ability to compete (in the future or in adjacent markets), like it happens in the scale-economies setting.
 - ▶ Rather, exclusivity rebates may be **DIRECTLY** profitable.
 - ▶ **WHY?** Because of a **DEMAND-BOOSTING EFFECT**.
 - ▶ When **MARGINAL PRICES EXCEED MARGINAL COSTS** (for asymmetric information or any other friction that prevents firms from using efficient pricing schedules), the upward jump in demand may increase the dominant firm's profits, even accounting for the discount.

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IMPLICATION FOR THE PRICE-COST TEST: price-cost tests are **CONCEPTUALLY FLAWED**:

- They are designed to detect low prices, whereas demand-boost theories imply that they are anti-competitive to the extent that they result in **HIGH PRICES**.

Exclusive dealing contracts

Exclusive dealing contracts \neq exclusivity rebates:

- ED bilateral contracts that involve a **COMMITMENT** by the buyer not to purchase from alternative suppliers during a given reference period.
- Exclusivity rebates are unilateral offers in which the supplier commits to offer different terms of trade depending on how much the buyer purchases.
- This difference matters for the exclusionary effect (Ide, Montero, Figueroa, 2016)

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- When buyers approached sequentially **NO PROFIT SACRIFICE** (as well as when buyers are approached simultaneously and suffer from coordination failures).
- Sequentiality allows the incumbent to exploit in the most profitable way the **NEGATIVE EXTERNALITY** that a buyer exerts on the others by entering into an ED contract.

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- However, the incumbent must rely on a **DIVIDE-AND-CONQUER STRATEGY**, compensating richly **SOME** buyers (and suffering losses on them):
 - ▶ when buyers communicate and coordinate their decision;
 - ▶ when buyers are asymmetric and large ones alone make entry profitable.

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- Richer contracts facilitate exclusion: the anti-competitive potential of ED (and loyalty rebates) is stronger than that of predation.
- Reasonable to treat ED (and loyalty discounts) **DIFFERENTLY** from predation.
 - ▶ Prices above costs **SAFE HARBOR** for predation but not for ED (and loyalty discounts).
 - ▶ Price-cost tests **STILL RELEVANT** for ED (loyalty discounts).

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- Where do we draw the line?

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- No safe harbor does **NOT MEAN** that the price-cost test is **IRRELEVANT**.
- Finding that prices are above/below costs anyway informative because it is a piece of evidence that **MUST GO** hand-in-hand with the theory of harm.
- If incumbent suffers no loss (or profit sacrifice) on any ED contract: why did the incumbent manage to secure all buyers into ED? Why couldn't the rival outbid the incumbent's offer?
 - ▶ Strategic asymmetry?
 - ▶ Buyers' fragmentation?
 - ▶ Buyers' coordination failures?
 - ▶ Non-contestable part of the demand? Credible threat not to supply that part if exclusivity rejected?

- If the incumbent suffers losses on the ED contracts offered to **SOME** buyers:
 - ▶ What is the mechanism that makes exclusion profitable?
 - ▶ Are those buyers particularly important for the rival's success?
 - ▶ What is the asymmetry between the incumbent and the rival that allows the incumbent to make offers that cannot be matched?
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The ingredients for spelling out a coherent theory of harm **CAN BE DEALT WITH** by competition lawyers and judges (and no more complex than what is routinely done in merger control).