

FTC-DOJ Conditional Pricing Practices Workshop

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Segment 5

Integrating the Economics of Exclusion with Current Legal Policy – Two Paradigms

Transcript

STEVEN C SALOP: My job today is to turn this complex economic analysis into concepts and language that a bright law student, or maybe a judge, can understand and manipulate. So I'm going to talk about several points. I mean, the fact, the main point is that there are two paradigms for looking at exclusionary conduct, Predatory Pricing and Raising Rivals' Costs. I'm going to try to apply them to [INAUDIBLE].

I'm going to talk about how it could be possible that a discount or something called framed as a discount could harm consumers. Talk about counter-strategies and bidding for the contract. And then talk about the flaws in the price-cost test.

So my secondary goal is to answer Ben Klein. So let me just go right into the two paradigms. We've got the standard Predatory Pricing paradigm based on the war of attrition. The predator reduces prices and investment, it causes the rival to exit. The predator then might be able to recoup its investment with a higher price in the future. Maybe consumers are harmed on balance.

In contrast, the Raising Rivals' Cost paradigm. The paradigmatic scenario is that you raise the competitor's costs, which leads the competitor to reduce its output or restrict its output, raise its own price, which permits the dominant firm to raise its price or maintain it at a super-competitive level, and thereby, consumers are harmed, OK? So that's the, as Joe put, the elevator speech.

There are two varieties to raising rivals' costs arguments that I call input foreclosure and customer foreclosure. Input foreclosure is that you raise the rival's input cost. Customer foreclosure is that you reduce the rival's output and reduce the rival's revenues. So the first corresponds to, sort of, narrowly [INAUDIBLE]. The second is really the naked exclusion concept of knocking customers' outputs down.

OK, the two variants, in practice, interact. The harm to competition does not require total foreclosure, most importantly. A partial foreclosure's enough.

Simply raising the rival's costs can lead to customer losses. The customer losses can lead to higher costs. And there can be not just unilateral, but it could also be coordinated effects. So there's kind of a connection between what Joe was doing and the Raising Rivals' Cost paradigm.

Comparing them, so when you think about it in terms of the law, the left-hand side is the conventional view in [INAUDIBLE] or Brooke Group, rarely attempted, and even more rarely successful. Why? Success requires the victim to exit, requires short-term profit sacrifice as an investment recoupment.

The harm is speculative because rival may not exit, because the price may not go up enough, and, as been stressed, there's an inherent short-term benefit from lower prices. Discounts are a good thing, and therefore, consumer harm's unlikely. We should have a light hand against this.

In contrast, the Raising Rivals' Cost conduct. Look at it, sort of, column-by-column. Exit's not required, there does not necessarily need to be short-term profit sacrifice because there can be simultaneous recoupment, there's immediate consumer harm from the high prices, and there may not be, certainly not inherent, consumer benefits. There may not be any consumer benefits.

The classic case that I always like to talk about is the case of arson, burning down your rival's factory. But there's also a case like Conwood, or lots of other cases where the claimed efficiency benefits are not really cognizable. OK, so if we were to apply these two paradigms to CPPs, the application of Predatory Pricing is really simple, straightforward.

It's only going to work if it causes exit. You're only going to cause exit if it fails the below-cost test. What I call the incremental revenue, incremental cost. The discount attribution test, OK?

And most importantly, entrants can compete for either exclusive distribution or nonexclusive distribution. And so the counter-strategy is the need to price below cost. Consumer harm really unlikely.

OK, in contrast, apply the Raising Rivals' Costs paradigm. Well, first of all, distributions an input, I think is a way to think about it. They sell distribution services. And the CPPs can reduce the entrant's ability to compete.

Higher distribution costs. So it could be input foreclosure, output revenue loss from restricting its scale. That's the customer foreclosure.

And then, in terms of what we were talking about before, if you could lower the maximum scale of the entrant, that can lead to less of a threat to the monopolist sales, what I've called Judo economics, or the puppy dog ploy. If you limit the maximum output that the entrant can get, then the monopolist does not need to lower price. It could just accommodate the small scale entry.

So as a result, the monopolist, the incumbent, can maintain monopoly power. Maybe he won't have to lower price at all, or maybe not as much. And the weakened entrant may have an incentive to coordinate rather than compete hard. If you've got barriers to expansion, you might as well coordinate.

And lastly, that the counter-strategy of bidding often fails. And note, I'm saying the counter-strategy of bidding for nonexclusive distribution, because, usually in these cases, the entrant doesn't have a broad-enough product line or high-enough consumer demand for its brands that it could really compete effectively for exclusive distribution. So there's not going to be the standard competition for the contract. It's going to be that the dominant firm is going to try to get exclusivity. The entrant is going to try to get non-exclusivity, nonexclusive distribution.

So how does the Raising Rivals' Cost paradigm work? Well, it suggests greater concerns. You don't need exit. You don't need short-term profit sacrifice. And indeed, with simultaneous recoupment, or in general, a greater bang for buck than you get from predatory pricing.

The monopolist doesn't need to lower the price of every unit. It only needs to lower the price of marginal units. So it's going to be cheaper for the monopolist not to deter entry.

The benefits to consumers? Well, there can be penalties for non-exclusivity rather than discounts for exclusivity. There could be lump sum payments that are less likely to be passed on. And more generally, and I think sort of in answer to Ben, the discounted price might exceed the price that would occur in the but-for world. You're not just supposed to look whether price went down relative to what it was yesterday, but the issue is whether the discount goes below the across the board price that would occur in the but-for world.

And look, and the main point is that just because a firm can frame a CPP as a discount, that doesn't make it pro-competitive. The word, discount, is not a magic bullet for a defendant, OK? So the real issue here, I think, where the real disagreement is, is the ability of the entrants to engage in counter-strategies. Why can't the entrant bid for the nonexclusive while the dominant firm is bidding for the exclusive? If it's an equally efficient entrant, why isn't it just simple, equal, head-to-head competition?

Well, several reasons are possible. One is that the incumbent often gets the exclusives preemptively. Before the entrant really comes on the scene, before all the distributors become aware of the entrant, the incumbent gets an exclusive. Second, very generally, if the entrant has to bid for distribution and its costs are going to be higher, it's going to be less likely to enter.

But these last two are the ones that I want to stress. The first is that the monopolist gets an exclusion value from exclusivity. It's purchasing market power. It's purchasing the ability to maintain its market power, not just distribution. And that factor is very important, and I'll show you an example of how it works in a second.

And the second is this idea of externalities. That if the entrant needs wide distribution, multiple distributors, then the entrant's going to face a coordination problem. And that can be a separate problem that gives the monopolist, the dominant firm, a bidding advantage. Now, if the entrant only needs very limited distribution, if all you need is one distributor per city, then this Raising Rival's Costs story, as you'll see, is going to be somewhat less compelling.

OK, so how does this exclusion value work? And this is actually a slide I use with my students. So suppose the story is that you've got a monopolist, you've got an incumbent, and it's earning profits of \$220.

And if it gets the exclusive, we're going to bid for a distributor, and if the monopolist wins, it's going to maintain its profits of \$220. Whereas, if the entrant gets distribution from this single distributor, nonexclusive distribution, then you'll have head-to-head competition, they're equally efficient, they'll make equal profits. Here, I've got \$70 each.

Now, so total profits, if the entrant survives, if they're a successful entrant, total profits fall here from \$220 to \$140. That's no surprise. Competition's good for the consumers, bad for profits.

Now, suppose they get into a bidding competition for this distributor. Well, the entrant would only be willing to build up to \$70. That's its profits. But the monopolist would be willing to bid more than \$70. The monopolist is willing to bid up to \$150 because that's the profits than it would lose if the entry occurs. It's willing to pay more because it's protecting its monopoly profits.

And so in this model, the monopolist will win the bid. If there were a actual auction, it would win the bid at \$71. And the entrant would fail and the monopoly power would be maintained. Why?

What's going on here is the entrant's only bidding to get duopoly profits. The monopolist is bidding to maintain its monopoly profits. Because competition reduces profits, the monopolist is willing to bid more. And you could put in any numbers you want here. As long as total profits fall from entry, this will work, OK?

OK. Well, the second big issue is the coordination issue. If the entrant needs wide distribution, then maybe its entry will fail if it only get some of the distributors, but not all them. And therefore, if doing a non-exclusive with the entrant rather than taking exclusivity from the incumbent is a risky proposition for each distributor, their expectations matter.

Well, I'll do it if I think other people will do it. That creates not a pricing coordination problem, a classic Coasian coordination problem. And that will make it less likely that the entrant will succeed, OK? So how does that work?

Well, here's an example. Suppose you have three distributors and the entrant needs distribution from all three, but it's happy to get nonexclusive distribution. And if the entrant gets distribution for all three distributors, it will earn profits of \$70, the duopoly profits from that earlier slide.

Well, my claim is that a rationally foresighted entrant would not bid. Why? Because if he wins on the first two, he's sure to lose the third one. The incumbent can outbid him \$71 on the third one. Knowing that he's going to get outbid on the third one, he won't bid on the first two, OK?

So I don't know what it would be in Latin, Joe, but I'm sure there's a nice Latin phrase for why, here, the entrant would not even try to bid. Therefore, the incumbent does not need to go below cost. It does not have to offer a price so the incremental revenue is incremental cost, because the entrant's not going to bid more than \$1, OK?

Oh, I'm sorry. OK. Suppose the entrant only needs two distributors, not all three. Well, depending on the distribution of profits, it can still work. In this case, the entrant would be willing to bid up to-- no, that's not right. The entrant would have to bid at least \$140.

No. The entrant would still only bid \$70. The monopolist would bid \$150. So it's still might still not going to work for the entrant. That's what happens when you do the slides a week in advance.

OK. But at the same time, all entrants are not doomed. If the new entrant is efficient enough so that joint profits, joint duopoly profits exceed the single firm monopoly profits, then, actually, the entrant can outbid. So that can occur if the entrant's more efficient, or it can occur if there is significant enough differentiation. Which really means that the entrant's preferred by some customers, or for some units. That's what product differentiation means.

It can also work, and I think that the case that people often look at, is one where we only need one distributor, OK? So in this case, suppose the entrant only needs one distributor. The incumbent would have to bid \$71 for each of the three distributors.

So it would have to bid a total of \$213 in order to deter entry. But deterring entry is only worth \$150, so the incumbent would give up. Therefore, the incumbent would not try to outbid the entrant there. So this is not a story that says entrants always lose in the bidding. It just says sometimes, and ones that we want to be concerned about.

OK. So now we get to the flaws, and what are the implications of this for the use of the price-cost test? So the issue here is errors. The incremental revenue less than incremental cost test leads to errors. And where you have errors, that leads to improper deterrence, and in particular, under-deterrence.

Interestingly, not only do false negatives cause under-deterrence, but false positives cause under-deterrence, too. And I didn't say that, Posner said that first, actually. Because if there are false positives, then there's less to gain from complying with the standard, so you have lower incentive to comply. And both I and Ben Klein know that if you're equally likely to be ticketed if you're going 50 miles an hour, you might as well go 80.

And these errors for the price-cost test are not surprising. Because the price-cost test, in the end, is a test of anti-competitive purpose. It's a test of intent, not of effect. And that's true because we care about less-efficient entrants, but it's also true in general. It's a test of intent. That's the way Reed and Turner thought about it in the beginning, and that remains true now.

So what about the false negatives and false positives? Well, someone mentioned this earlier. Dan mentioned this earlier. If you have coerced or required exclusive dealing, it always satisfies the incremental revenue, incremental cost test. Because if the distributor chooses non-exclusivity, the incumbent will earn revenue of \$0, because it won't sell any quantity.

The price will be infinite. The quantity will be 0. Revenue will be \$0. And since, with exclusivity, the incumbent earns some revenue, therefore, incremental revenue's positive, so it could easily exceed incremental cost, OK?

Where there's simultaneous recoupment, whether it's a price penalty or whether it's simply simultaneous recoupment because the entrant doesn't come in, incremental revenue always exceeds incremental cost. You don't need to go below cost.

Third example? That exclusion value example I gave you earlier. The monopolist only had to bid \$71, but its profits were \$220, and the profits that it was protecting were \$150. It didn't nearly need to go to cost. So the incremental revenue, incremental costs test is not going to predict.

And finally, in my examples with multiple distributors, it's not going to work there either. A rational entrant, the one we worship in antitrust, that rational entrant has no incentive to bid more than a \$1. And it's not that the entrant is failing to protect itself and should be taken to task for failure to protect itself. It's the fact that a rational entrant has no incentive to try to bid.

On the other hand, there can be false positives. The case in which the entrant only needed a single distributor, that I talked about earlier, is one where, if the monopolist did bid and won the first bid, it might have bid to a point where incremental revenue was incremental cost, but it would lose in the end. And so therefore, there would be a false positive to go after that monopolist.

Second, a classic example where an entrant only needs a single distributor is where they're going for a lead customer to certify the quality of their product. And if they get that lead customer, they'll be able to earn very high profits in the future. If the incumbent's in the same situation, if there's not a symmetry as in, sort of, the standard monopolist-entrant case, competition could easily reach an equilibrium where they're both bidding below cost for that lead customer, OK? So there could be false positives as well.

So to summarize, should we use the Predatory Pricing paradigm? No. Why? Because CPPs have more exclusion benefits per dollar of the monopolist's exclusion costs relative to predatory pricing. Michael used the term "cheaper exclusion" this morning. I think it's a really good term.

So it's cheaper for the monopolist. There are fewer consumer benefits. If you've gotten a across-the-board price cut as in Brooke Group, then consumers get the benefit on lower prices on all those units. Whereas, with CPPs, they only get the benefit of the lower price on those marginal units. So you put these two things together, and consumers collectively expressing their voice through the antitrust laws, have fewer collective incentives to permit CPPs than they would to permit potential predatory pricing.

Couple on top of that, we don't just need a more intrusive rule, but the Predatory Pricing test leads to substantial false negatives, some false positives, and systematic under-deterrence. So you put that all together, we should not be using the Predatory Pricing paradigm.

So where do I come out on this? Well, we all know this story. You can look for the key under the lamppost where it's an easy task. There's plenty of light. Or you can look for the keys where you've actually lost them.

And so, I think we shouldn't be using this cheap and inaccurate test. What we should be using is the rule of reason. We should apply the Raising Rivals' Cost paradigm, the now-standard, four-prong analysis. The plaintiff would need to show harm to competitors which could literally be raising rivals' costs or reducing rivals' revenue, restricting the rivals' output.

You'd need to prove harm to competition. It's not enough to prove harm to competitors. You'd need to prove harm to competition as market power effect, what I've called power over price. You'd need to take efficiencies into account, and where there are efficiencies, you'd need to figure out the net effect or the likely net effect on consumers. And of course, the primary focus is harm to competition, not harm to competitors.

You should look into counter-strategies. You'd like to know whether the entrant did attempt to protect itself, and if not, why not? That can throw light on the effect.

Is there any role for the price-cost standard? Well, it certainly shouldn't be a safe harbor, but it could go the other way. Should it be sufficient for illegality? And I would say no. I'd say, if incremental revenue is less than incremental cost, that suggests anti-competitive intent.

But we shouldn't be focusing on intent. We should be focusing on effect. So that might be a useful fact, but it's not sufficient for the plaintiff. If incremental revenue exceeds incremental cost, that's good for the defendant. It's good because it could be worse, right? it could've been incremental revenue less than incremental cost, but it certainly should not be, per se, legal, should not be a safe harbor.

And you know, it's helpful, but not so helpful, because it's consistent with exclusionary effect, and indeed, even exclusionary intent where you don't need to go down to cost. So we should be focusing on evidence of harm to competition, not the price-cost test for intent.

OK, so how do you do it. What are the details? Well, here's a long list for you to study later. So be a quiz on this later on. General, two steps. You need to show injury to the competitors, and then a second step, injury to competition. The latter is more important.

The facts vary, and not every piece of evidence is relevant for every case, but here's a set of evidence that would be relevant for analyzing the plaintiffs' claim. So the constraint's on the input to output level, the ability of the entrant to expand. If the incumbent can hold the entrant to a small enough level of output, then that's sufficient to allow the monopolist, allow the incumbent to maintain high prices. You don't want to just look at the issue of whether the rivals' costs are raised for the output they produce, but the question is whether the output's costs are higher to expand beyond some level. If there are barriers to expansion, that can be enough to permit the incumbent monopolist to maintain high prices.

I see I'm running out of time. I'll skip that. But if the excluding firm lacks market power, you can use this conduct to gain market power, but that's obviously going to be a harder case than when you use the exclusion to maintain market power. There are efficiencies. I don't want to say there are not efficiencies. Ben talked about them. The Mikes talked about them as well.

If you're going to say that the lower prices are discounts that are good, you need to focus on the but-for world. You need to make sure the price is not a penalty. You need to make sure that it's anticipated by the retailers. But most of all, you need to compare the but-for world. You can't just frame it as a discount in order to win.

OK, so I'm actually gone a little early, and I'll just leave you with the main conclusion, I think, that comes out of the distinction between the two paradigms. Thank you.

[APPLAUSE]