FTC-DOJ Conditional Pricing Practices Workshop
June 23, 2014
Segment 6
The Law of Conditional Pricing Practices
Transcript

SPEAKER 1: We have a very distinguished panel for [INAUDIBLE] on the law of conditional pricing practices. I won't go through everybody's bios, but I will note that their distinguished bios are all contained in the material that we have for you. First we'll hear from Einer Elhauge, and then Daniel Crane, Randy Heeb, Robert O'Donoghue, and the discussants will be Richard Brunell and Will Tom. And Einer, we're ready.

EINER ELHAUGE: Does the light turn on for this, or--

SPEAKER 1: No. I don't think it does.

EINER ELHAUGE: Well, thank you very much. So I'm here to talk about the Meritor decision and about how to adjudicate loyalty discounts in general. I want to begin with a point of agreement, since Dan and I are going to disagree about a lot. One thing we do agree on is that the Meritor case held that the price-cost test should only be applied when, quote, "when price is the clearly predominant mechanism of exclusion."

Now, we disagree about whether Meritor was right to cabin the price-cost test in this way. To me, Meritor had it right-- that is, every loyalty discount has two aspects, and everybody likes to emphasize different aspects of it. They both have a pricing element, which defenders like to refer to and emphasize to analogize to predatory pricing. But they also have a condition that's restricting purchases from rivals, which opponents like to focus on to analogize to exclusive dealing.

The question that I think Meritor raises is, well, for this set of loyalty discounts, what is the predominant mechanism what is manually creating an exclusion at issue. Is it price, or is it the condition? So I actually see Meritor as an effort to try to bridge the conflict in the circuits, and to try to create one unified standard.

Now, the factors that Meritor itself pointed to as showing in that case-- that process was not the clearly predominant mechanism of exclusion-- actually have a lot of overlap with the conditions we've been talking about so far today. First, they looked at whether or not the condition bundled contestable demand to incontestable demand. So very similar to Mike Salinger's theory and paper presented this morning. And there's quotes from Meritor that talk about that.

And I'll also point out, LePage's really had that same kind of theory in mind, because LePage's actually defined a single tape market that included branded tape and private label tape. So it was really a bundle of incontestable branded tape to contestable private label tape.

Second, there might be a theory that the condition raises rivals' cost, prevents economies of scale, or some other economy-- there might be evidence of that. And Meritor thought there was

evidence of that in that case. And LePage's they also found evidence of that. So that's obviously-- Steve Salop just vigorously presented that theory, and Mike Whinston summarized some of the economic literature on that.

Or third, Meritor said, you might show that the condition that issue raised buyer switching costs in a way that predatory pricing doesn't, in that case, by requiring looking at some different book in a way that made it more difficult to switch. So I think Meritor already points us to various ways of looking at the economics in order to distinguish which loyalty conditions should be treated differently from predatory pricing.

But there's also some other factors that we might look at. The fourth factor is whether the loyalty condition is excluding sales of an equivalent rival product that's lower priced, or a better rival product that's equally priced. Now this isn't so much a fourth anti-competitive theory as a way of simply caching out the other anti-competitive theories in a more administrable fashion. If a cheaper equivalent rival product is actually unable to compete for certain sales for which would be regarded as equivalent , we can say something wrong is going on-- something anti-competitive happened here.

Meritor itself didn't have that evidence. So in some ways, it was a harder case. I'm not saying it should be necessary, but sufficient to show that something other than low price is what's doing the exclusion.

Fifth, there might be evidence, in fact, that the prices exceed but for prices. So we don't actually have a loyalty discount at all. We have disloyalty penalties. Now the defenders like to emphasize the word discount a lot for loyalty discounts. But I think that's taking unfair rhetorical advantage of the fact that discounts sound good. Really, what we know in the case for sure is, there's a price difference between what the compliant buyer pays and what the noncompliant buyer pays.

The economic question or functional question is, is that above or below but for prices? So we can't assume that from the word discount or from the word penalty. We'd have to have some sort of evidence about it. If this is met, it seems to me, we might say it's out of the loyalty discount category at all.

And note that Meritor stresses that price has to clearly not be the predominant mechanism. And I think part of the reason for that is the price-cost test, even for predatory pricing, is somewhat over-inclusive. And their justification for it is, well, at least we have a very clear short term benefit to consumers. If this is in play, though-- if we think it might actually be a penalty-- we have no clear short benefit to consumers, and thus no reason to apply the book presumption.

Now Dan, in his article, has argued, well, this is just impossible, because you're saying a penalty price is sacrificing profit, because you're charging above the monopoly price when you do it. It seems to me, though, that the economic models show that is profit maximizing, because it leaves most buyers to accept the loyalty agreement. And if that was impossible, it would be equally impossible to have tying or exclusive dealing. Because you make no money when that is rejected, because you don't make the sale at all.

And I've seen it happen in lots of cases. Of all the cases, I can only talk about one that's become public, because I testified in it as the economic expert. But in the RTI case, there was various loyalty programs introduced at different times covering multiple product items. 188 times a loyalty term was introduced. All 188 times, the loyal price was not lowered from the price before. And 187 out of 188 times, the disloyal price was increased from what was before. So they didn't change the price that a loyal customer got. All they did was increase the price that a disloyal customer got.

The Cartel Ringmaster Theory is another clear example of this. We're raising prices with a cartel. And Ben Klein, actually in some work with Jennifer Grenitz, showed that Standard Oil itself entered into loyalty discounts where they agreed to pay railroads 15% more than they had paid previously, in order to get a discount from that relative to what other oil companies were paying. So it was worth it to them to get a competitive edge over the other oil companies.

But there's a case where it was an anti-competitive loyalty discount, and the price was clearly above cost. And particularly important because the Standard Oil case is what prompted, in large part, the Clayton Act, which itself is about pricing on the condition that you not deal with rivals. And I don't think it's plausible to think from that legislative history that they had a price-cost test in mind.

Lastly, a loyalty discount can effectively divide a market in a way that raises prices. Abe Wickelgren already covered in detail the theory that he and I have about this. Dan again argues that he doesn't think these cases actually exist. But I do know of many cases like this that I've been involved in. And I also think there's no reason to reject it categorically, even in cases where it can be shown. Even if it's not true often, when it is true, it should be allowed as a theory.

All right. Price-cost test. I guess a lot of other people have complained about them. But let me throw a few more bits of dirt on the grave. The biggest problem, I think, is that loyalty conditions under a lot of these theories are anti-competitive precisely because they inflate prices, not lower prices.

So if we're going to have a price-cost test, we're going to have this perverse Catch-22, which is, if you don't show that the condition raises prices, then the defendants will say, you haven't shown antitrust injury. And if you show the condition does increase prices, then they'll apply the price-cost test and say, ergo, you fail the price-cost test, so it can't be illegal. So tails I win, heads I also win. It's great if you want per se legality for loyalty discounts, not if you're trying to sort out which are anti-competitive.

Second, you can raise rival's costs in a way that prevents survival from pricing at incumbent costs. People have talked about that. Third, though, it means that at equivalent prices, defendant is often getting sales it didn't deserve on the merits. So people have talked about that as a tax. The analogy I draw is actually to trade law. If somebody imposed a trade tariff that was 10%, we wouldn't say, well, that's not anti-competitive, because you could overcome that if you priced at cost.

Next problem is that defendants can often offset rival price cuts with increased penalties. These price-cost tests tend to assume that the defendant has their hands tied, and won't respond to anything that the rival does. And that's not very plausible. And relatedly, there's an assumption that the rival will have incentives to cut prices down to cost. In fact, a lot of these models show that precisely the problem with loyalty discounts is they can eliminate those rival incentives. You can harm consumers by excluding less efficient rivals as well.

On administrability, I think really proving these factors is not that inadministrable. What really creates the inadministrability problems are the price-cost tests, like the discount attribution tests. I think it should be a rule of reason where you do ask, does it cover a significant share of the market? Or are anti-competitive effects directly shown? But also pro-competitive justifications can be introduced.

Now, in my experience, they're rarely actually offered plausible pro-competitive justifications. What defendants tend to say is just, well, we offered a discount. But that assumes that this difference was a discount to begin with, first. And second, there's always this less restrictive alternative, which is lower your price without the condition. And unless you can prove that the condition lowered your costs somehow, it's not really an efficiency.

All right. Then buyer willingness or terminability00 I think the basic problem with legal tests that focus on this is that they ignore entirely the externalities problems that people have already discussed. Today you can externalize onto the rest of your market, or downstream if you're an intermediary. I know Dan is going to emphasize cases where the buyer is big. But even if you have a big x%, you externalize onto 100 minus x% of your market. And if you're an intermediary, you externalize to even more.

He's also going to talk about the GSA, I think, in the government. But that's a small share of the travel budget, I think, of a firm with its travel market share. And actually in the hospital industry, where I've had most experience in this kind of cases, the government tends to not allow loyalty discounts under its contracts. Anyway, the same reasons why they enter into it also mean that buyers have no incentive to terminate these conditions if they're present. And I analogize this to the Tragedy of the Commons, which is, we don't think the Tragedy of the Commons was averted, because farmers voluntarily brought their goats, or could have terminated at that end.

And lastly, I'll just say, there's also always these old Supreme Court cases that have never been overruled, and are binding, and have a lot to say that cuts against price-cost tests, and I think support a rule of reason for loyalty discounts.

SPEAKER 1: Thank you, Einer.

[APPLAUSE]

SPEAKER 1: Our next speaker is Professor Daniel Crane.

DANIEL CRANE: Well, great. Well, thank you very much to the FTC and Justice Department for inviting me here today. And a big thanks to Einer for previewing my entire argument today as

a very helpful warmup. So I want to talk about loyalty discounts and what I call the hospitability tradition of the United States Supreme Court and the lower courts on the question of unilateral price discounts.

And a lot's been said today about differences between unilateral pricing, discounts of that sort, the predatory pricing variety as compared to loyalty discounts. There are important differences, and I don't want to gloss over those differences.

But the big point I want to make is that, to the extent that there is a hospitability you tradition-- meaning that the federal courts have embraced unilateral price discounts as something that needs to be protected from overly aggressive antitrust intervention-- not categorically, not in every case, but as a general predisposition-- that same hospitability tradition needs to be extended to loyalty discounts, because they also have the effect, in most cases, of benefiting consumers and creating efficiency.

So two quotations from cases. The first one on sort of the standard Frederick pricing analysis-- "low prices benefit consumers, regardless of how those prices are set." And it's important to notice that the Supreme Court has said "regardless of how those prices are set." It could be through resale price maintenance. It could be through price squeezes. It could be through predatory overbidding. The court again and again and again has said, it doesn't matter what the mechanism is of the lower price being set. If it's unilaterally determined, those prices do not threaten competition.

And in the Virgin BA case, the Second Circuit repeated the same idea as a kind of a loyalty discount, "rewarding customer loyalty promotes competition on the merits." So this is the hospitability tradition that I want to focus on as being, in my view, appropriate as a prior belief when it comes to loyalty discounts. Again, not saying that there's never a case for antitrust intervention. But as a prior belief, as a general condition, I would argue for the hospitability tradition.

So my roadmap is four points I want to make. First of all, as Einer, said, I'm going to argue that market share discounts are often driven by clients. And that is important to understanding their pro-competitive benefits.

Secondly, market share discounts often have pro-competitive advantages over volume discounts. So Einer says, well, why not just offer straight up discounts without the condition at all. There are some important reasons why market share or loyalty discounts are actually more advantageous both to big customers and to small customers. And they can also be advantageous to both sellers and buyers at the same time in ways that should not be neglected.

Third point is that market share discounts should be presumed to be true discounts, not penalties for disloyalty. And the fourth point is that, to the extent that foreclosure is the analytical matrix for legal analysis, foreclosure should require objective economic evidence that the rival could not profitably compete, which does require looking at costs and revenues.

Customer driven. So as we've heard repeatedly today, collective action problems may drive customers to demand anti-competitive terms. This is well understood in the economic literature. It's less plausible to be the case. We have large customers who are sophisticated in their buying decisions. It's not impossible. These are just matters of probability where you observe a practice employed by large, sophisticated customers who are exercising their collective buying power often to lower their prices. The story-- this is a cost externalization problem-- is just less plausible.

Einer stole my thunder with the GSA example. Those of you who are federal employees will know that, when you fly in many city pairs, you are directed by the GSA to fly with a preferred airline. Those contracts are structured to give loyalty discounts. If you doubt it, go to the GSA website where they explain this to you. They drive their prices lower, they tell you, by exchanging a high share of the customers who fly for the federal government on that carrier for that city pair. Right?

Very well understood by powerful buyers, by big buyers, by sophisticated buyers, that this is a way in which you could extract lower prices. Does it mean it's never anti-competitive? No. But the fact that large buyers use this strategy is a reason to think about it within the hospitability tradition.

My second point goes to advantages to structuring discounts as loyalty discounts or market share discounts, as compared to other kinds of discounting mechanisms, particularly volume discounting, which we've heard about some today. Now, as was mentioned this morning, it's possible for a volume discount and a loyalty discount to operate identically. Right? If the buyer has completely predictable buying needs in the upcoming cycle, a loyalty discount might be identical to a volume discount.

But when you have unpredictable demand by particular buyers, it could actually be to the benefit of the buyers to structure the contract as a loyalty discount as opposed to a volume discount. It has the effect of shifting the risk from the buyer to the seller.

And in particular, when you have a seller that is trying to plan for the demand for the upcoming cycle, and you have a market where the downstream firms have shifting market shares because of competition among themselves, structuring the discount as a loyalty discount-- as my example in the slide shows-- can have the effect of allowing the seller to predict the volume and needs to make an efficient investment decision in the upcoming cycle.

And it also allows each of the buyers to maintain the lower price, regardless of their exact volume need, depending on the competition that they face and the market conditions they face downstream. And so, one of the pro-competitive benefits of loyalty or market share discounts over volume discounts is that it can allow even a smaller customer, that might not qualify for a volume discount, to obtain the lower price simply by promising to buy a certain percentage of his sales from the seller.

So we've heard other examples today about efficiencies that come from loyalty discounts. What I want to point out here is that these are particular efficiencies that come from loyalty discounts

that you do not obtain from other kinds of discounts, like volume discounts. So again, it's a reason to think about these within the hospitability tradition of unilateral price discounts.

My third point goes to another theme that Einer mentioned, that we've heard already discussed today at some length, which is the penalty theory. Which is, well, these are not necessarily true discounts. There's no a priori reason to think they're true discounts. There's simply price differences. They could be higher prices, they could be lower prices. We just don't know behind the veil of ignorance. So we shouldn't assume anything.

And the basic model here is the monopolist that's already charging the profit maximizing monopoly price raises the price even further, by definition to a unprofitable price for the monopolist, and then lowers the price back down to the monopoly price, but with the additional condition that the customer not buy from rivals, or not buy a certain percentage from rival.

Now, I understand, as I say, this is a possible-- I don't say it's impossible. I say it's not generally plausible that this is the explanation for loyalty discounts. And if not generally plausible, because it has the monopolist exceeding the profit maximizing monopoly price. Now that's true in one of two ways. Either at the penalty price-- the penalty price is clearly a price that's being above the monopoly profit maximizing price-- is unprofitable to the monopolist.

But even charging the monopoly price with a condition for exclusivity that is onerous to the customer-- it's onerous because the customer, by definition, would want to switch to an alternative supplier-- is like imposing a penalty itself. So even monopoly price plus onerous condition restricting the customer's choice exceeds the monopoly maximizing price. If that's true, the implications are that these are presumptively true discounts.

If they are exclusionary-- they could be exclusionary in the sense that there's a short term profit sacrifice for the benefit of obtaining long run monopoly power. But at that point, we're back to all the predatory pricing law, where we look for evidence of recruitment and profit sacrifice.

My fourth point concerns foreclosure and what foreclosure means in legal analysis. Foreclosure needs to mean-- if it means anything-- that the rival cannot profitably match the loyalty discount, and therefore is foreclosed. So at a minimum, it has to be the case that the rival is unable to compete profitably for whatever the allegedly foreclosed segment of the market is. All right? Otherwise, foreclosure becomes a vacuous concept.

So the condition where the consequence is simply a change in the price, as the court in the Sanofi SI case pointed out, that condition is still a price term, right? The mechanism of exclusion cannot be a non-price term, by definition, if the condition is, you lose a lower price if you switch to the competitor. So a 10% loyalty reward is exactly equivalent to the 10% disloyalty penalty. The court in the SI Sanofi case got that exactly right.

So in order for there to be foreclosure, there needs to be economically objective evidence that the rival, in fact, is unable to compete. You should not be able to allege that a segment of the market is foreclosed without some kind of a showing that the rival, in fact, cannot access customers in

that segment of the market. Otherwise, it's simply assuming the conclusion that the word foreclosure suggests.

And my final point simply goes to the need for a structured rule of reason, particularly given the fact that most of the cases we're talking about are jury trial cases asking the jury to decide in a vacuum whether there is foreclosure without the kind of objective economic evidence that rivals cannot compete is really to ask the jury to make up the law on the spur. Thank you.

SPEAKER 1: Thank you, Dan.

[APPLAUSE]

SPEAKER 1: Thank you, Dan. Our next speaker is Randal Heeb.

RANDAL HEEB: All right. Thank you all again. I'm going to take a lot of inspiration from a joint paper with Doug Bernheim. But if you want to know what Doug thinks, ask him. And that goes for anybody else that I work with as well.

This agenda is hopelessly optimistic. So a, I'm going to talk fast, and b, I'm not going to get to any fraction of it. But I'm going to focus instead on a couple of what I think are the key points that Doug and I call out in that paper, which goes through what I would call a structured rule of reason. So I'll take as Dan's last slide the endorsement for what I would suggest is the right way to approach these topics.

So let me just jump in to the first stage of that with respect to the mechanisms that implicate only price here. And I was surprised to find that I think I may be the only person who might actually tolerate a price-cost test, with the exception of Dan, and maybe Ben. And I would suggest that for mechanism where price is the primary mechanism, that it might well be an OK compromise.

Nobody in this room, I think, thinks that that adequately determines whether or not something's pro-competitive or anti-competitive. But in the real world, we have to make tradeoffs. And that's not a terrible compromise. Because we haven't seen a lot of those compromises in actual practice and actual cases, I don't think that we've really dealt with the question of what is the appropriate measure of cost, and what some people claim is a consensus around the average variable cost. I think we'll break down if we actually start testing predatory pricing cases again.

But more interestingly, I want to talk about applying the framework to exclusive conditions, or exclusive dealing, or raising rivals' costs, or contracts referencing rivals, or whatever's your favorite way of describing this particular concern. And it captures all of the various conduct listed there.

And what I want to focus on, instead of going through the details of the test that Doug and I have proposed, is to instead focus on what I think is the most important practical implications of it. And to foreshadow that, it's that there are things that I think are under-appreciated-- empirical consistencies that are under-appreciated that help us take some comfort that these will not lead to a lot of false positives. And I'll talk you through what I mean by that.

So clearly, there need to be all of these necessary conditions for an exclusive contract, or exclusive conditions to be anti-competitive. And I want to focus-- and especially since I think there's not very much controversy around most of these-- I want to focus on the negative contracting externality. And I'm going to jump around in my slides a little bit to make reference to a comment Dan made a minute ago.

The negative contacting externality that has to exist for a contract-- say a contract referencing rivals-- to be anti-competitive is that it's not defeated by the sort of Coasean arguments that if you had all the customers, and these are big sophisticated customers, you've got the rival or the would-be entrant are sort of all at the table. And one would expect that any anti-competitive effects would be competed away.

And there has to be something that stops that from happening. And the typical thing that stops that from happening-- not always. And in every situation, I imagine that there could be a different negative contracting externality. But the one that is most obvious is that it's actually tomorrow's customers that are harmed, not today's customers. And so arguments that depend on the sophisticated customers that are here today-- that could stand up for themselves, that might demand this exclusivity-- ignores the fact that the burden of the anti-competitive conduct-- of this particular type of conduct-- is borne by future consumers.

Similarly, that explains why the rival can't bid away that exclusivity. So if a monopolist is using an exclusive condition in order to diminish future competition, what the rival stands to affect if the rival becomes a more successful competitor is to largely compete away the rents that the monopolist would get in the future.

This is essentially the same point that Steven Salop made just a few minutes ago, that the ability of the rival, when they become better in the future to compete away that rent, means that the rival doesn't have that expected value in its pocket to bid for the exclusivity today. And so, looking for that mechanism, this negative contracting externality that prevents this sort of usual Coasean solution from working is a necessary condition of the anticompetitive effect.

So I want to contrast that contracting externality with another contrasting externality that I think is always important and always lurking in the background of these analyses. And that is the pro-competitive externality. As a matter of practice, most of the pro-competitive justifications for what I would think of as unusual contracts-- and I know that these contracts are not unusual in some absolute sense. They abound in the real world.

But they're not the normal form of competition. The normal form of competition is unrestricted contracts that don't condition on the customer's behavior with respect to the rivals. And so even though we see a lot of these, they're still in relative terms extremely unusual. And typically they are explained-- this unusual contract is explained because it's necessary to overcome a contracting externality, in order to incentivize investments by the downstream firm, would be the most common and easiest one to imagine. There are many, many other permutations of this.

And focusing on what I think is the most common situation is that now we are facing a world in which there are, on both sides of the argument, a discussion about whether or not this externality

exists from the point of view of the side arguing for the anti-competitive externalities, to understand why that negative externality defeats the Coaseant solution that would be there otherwise. And on the pro-competitive side, to explain the nature of the contracting problem that the dominant firm faced, and had to engage in this unusual contract in order to overcome.

And my observation, or my reassurance to those in the defense bar, is that, in fact, both of those externalities leave discernible traces in the record. And so we can actually go to documents, and we can understand what was the nature of the contracting problem that the dominant firm was facing. Why did they feel like they needed to incentivize the downstream firm?

In contrast, we can see alternative explanations in the record often about wanting to win the business, which the business people will often confuse a pro-competitive motivation, I just wanted to sell more. When you drill down on that, as we have done when we've tried the counsel, you often find that, well, it's competitive because I wanted to sell more. Why was I going to sell more? Well, because by undertaking this, my arrival wouldn't be nearly as much of a competitor next time around. And that's the sort of things that you can find the record.

So as you examine the nature of the exclusivity on both sides, you're looking for something that economists recognize that actually is likely to show up-- both in terms of empirical exercises and in the documentary evidence-- that would allow you to then weigh which of these two factors is most likely to be the explanation for the conduct.

That would suggest that dominant firms engaging in legitimate pro-competitive conduct ought to take some comfort. So first of all, I would argue there is-- and even if there isn't, I would argue there should be-- a substantial market power screen. So most firms are not going to face this question anyway. If a firm, in fact, has market power, and has legitimate pro-competitive concern, one, it's probably going to be readily apparent.

Good counseling will suggest that they make it even more obvious and document the explanation for these restrictive kinds of contracts, in which case, they ought to be able to engage it with a fair degree of comfort that they're not going to be called out later as being anti-competitive. And then, conversely, on the other side, just whining failures will not be able to plead that they're being excluded if they have to show the nature of the externality that was present that prevented them from being able to overcome the obstacles to be able to be the competitive force that they claim they would have.

And those are not typical conditions. We would have to see something unusual. Why couldn't they obtain financing? Is there an information asymmetry? Is the nature of the product that they're selling such that you have to have sustained interaction with the customer over multiple generations in order to generate customer loyalty? These are the sorts of things you would find in the evidence.

So back to the question of false positives. I think there should be more optimism than I sense usually about whether or not we can engage in this kind of rule of reason structured analysis, and not be overwhelmed by the possibility of false positives.

[APPLAUSE]

SPEAKER 1: Our final panelist before we turn to our discussants is Robert O'Donoghue.

ROBERT O'DONOGHUE: OK. Good afternoon, everybody. And it's a great pleasure to be here. And thank you to Michael Bloom and to Andrea for inviting me here. As a sort of token European, I was asking myself on the way over, why am I here? And it did strike me that we have much more history in Europe of getting all this wrong. So we started down this process about 40 or 50 years ago with the Sugar Cocktail case. And We've had various iterations in the meantime. So we uniquely in this context may have some information to pass the other way. The information tends to flow from west to east rather than the other way around.

In the 12 minutes available, I want to do two things. First of all, to give you six minutes on what the law says in Europe, and then to give you another six minutes on my own experience as a litigator and as a counselor in these kinds of cases, and some of the pitfalls. Because one thing that struck me-- at least, attending so far-- is that there is a certain lack of practical context with some of the debate. And ultimately, this is an issue for practical counseling and for real-time decision making. And that needs to be borne in mind.

Now, a couple of contextual remarks, because some of you would be very familiar with this. Some of you, this may seem like something from another planet. But just to put this in context, the system in Europe is essentially agency led enforcement. We do not have treble damage litigation. We do not have jury trials. It is typically led by the Commission in Brussels in a centralized fashion.

Now, in my view, that has important implications for the [INAUDIBLE] standards as well. Because in a sense, having a fairly aggressive approach to conditional rebates is perceived-- rightly or wrongly-- to be less problematic where you have omnipotent and omniscient regulators. So the private bar difficulty is less of an issue in Europe.

We have some private litigation. I make a living out of private litigation. But it is by no means as big a feature in Europe as it is in this country. We have a prior requirement of dominance. There is no attempt offense. There is no offense of gaining a monopoly. Typically the enforcement we've seen in Brussels to date has been around very high levels of dominance-- 70%, 80%, 90% market shares. And there is, of course, a parallel stream of enforcement at a national level among the 28 member states, and they vary enormously in terms of sophistication.

Just to sort of in five buckets to summarize what the law says in Europe-- this is all post Intel judgments a couple of weeks ago. So it's pretty up to date. The Canterbury one is the exclusivity rebates, where there is an express condition or there is de facto exclusivity as a condition. These are akin to per se illegal, following the Intel judgment. And rather surprisingly, the Intel general court said that size of rebate covers duration all irrelevant. And you don't even need to show a potential foreclosure effect in these kinds of cases.

The big issue, which I'd like to come back to, because it has some parallels with the dissenting opinion of Meritor, is what on earth does de facto conditionality mean? That to me is pretty

controversial. Bucket two is standardized volume rebates. These are presumed legal on the basis that they have some likely reflection of efficiencies. Bucket three is the sort of classical fidelity rebate, which is a situation where there is no exclusivity condition as such, but there is a commitment on the part of the buyer that has a fidelity building affect. The typical case is where the rebate is contingent on attaining an individual sales objective year on year sales increases.

Now, for this third category, the courts have consistently said for the last 20 years that you need to look at all the circumstances. So it is sort of redolent of something approaching rule of reason. But there is a sort of dichotomy in terms of the enforcement, because at a commission level, one sees with Intel there's certainly a fairly sophisticated and forensic treatment of all the circumstances in the decisions. But then when one goes on appeal to the courts in Luxembourg, it has tended-- so far, at least-- to be, frankly, pretty superficial.

And even evidence that is a contra-indication of foreclosure-- rivals increasing their shares, dominant firm decreasing its share-- is by the by. So there is a potential difference there.

On price-cost tests, the commission, perhaps uniquely, in its guidance paper, it did propose a price-cost test. Now to be clear, this is not a predatory pricing test in the sense that one is looking at total output and a simple price-cost test. It is looking at a subset of output and demand of the contestable and non-contestable shares, and determining an effective price over that subset of demand. So it is something different and inherently more complex.

Now in Intel, again, the general court said, well, this AEC test is extremely interesting, but it is not a necessary part of the legal test. It is something that is, at best, facultative. So clearly what actual weight it has, other than commission enforcement priorities. There is some scope for an efficiency defense, at least in theory. But in practice, because of prior requirement of dominance, that condition is, for all practical purposes, precluded.

And there is a sort of optical problem, in terms of a flaw with the case law. Because if one doesn't need a theory of harm-- if it's akin to per se-- then how does one calibrate offsetting benefits? What is one weight against? If the benefit is 10, but I don't need to calibrate it, and my dis-benefit is something else, what exactly am I weighting? And the sort of damning fact is that there isn't a single decision in Europe that I'm aware of that has ever accepted an efficiency defense. And that seems to me to speak for itself.

Unconditional price cuts is similar to your law in this country. So I won't dwell on that. And a few final remarks to wrap up. And I will pick up on some of these in more detail if we have time. The case law in Europe, for better or for worse, is pretty formalistic for the most part, although the commission-- at least in recent decisions-- has tried to get away from that.

And in a sense, it isn't exactly logical. Because, as was discussed this morning in some detail, the contractual effect of committing someone to dealing with you on an exclusive basis, that can be achieved in exactly the same way through an economic condition. So the idea that my bucket one is per se unlawful, but my bucket three is potentially a rule of reason, that really makes no sense.

And I thing more generally, the idea that there are formalistic categories that are good, bad, or indifferent is really going against the trend of effects analysis in general, which seems to be the predominant theme in antitrust today. Now a point in a different direction as a counselor is that the law is formalistic, but at least it's clear, for the most part. And in my experiences, businesses may prefer something that is clear, even if it is clearly wrong. Because they can deal with that. In real-time decision making, they can work with that. So there's a question of legal certainty that is sometimes forgotten in this debate.

I think the big picture point I would make for today is that there's been a lot of discussion this morning about type two errors. But to me, in terms of real world counseling, I think where the focus needs to be is on type one errors. Because in Europe, what happens-- and this happens not quite every day in my practice, but many days.

You're dealing with a firm that perceives it is at the risk of being found dominant So it is perhaps around 40% market share. And you have this very formalistic case law. And the full hammer of the law bites for the firm who are 40% and the firms who are 99%. And all of these, depending on their approach to risk, are treated in a way that's essentially fungible. And it seems to me that the cost of type one errors in this context must be pretty devastating.

And if I had to say one thing today, it's that you need to bear in mind that it isn't necessarily the sort of bird in the bush that is sort of the objective in the real world when one is counseling. This is the enforcement cost, I'm afraid.

And to sort of tie into that, and then pick certain points made by Dan and by Einer, I mean, in my view, the objective shouldn't be some search for an economic nirvana. I suspect we'll never really get there. And I mean, I entirely accept that, yes, sometimes buyers may ask for a deal that's bad for them. I entirely accept that short duration isn't necessary dispositive, in terms of being a good thing. And I accept that some rebates are not necessarily a discount, if one looks at but for pricing.

But the risk in my view is that one looks at these possibility theorems, or at least things which cannot be excluded. And one then uses that as the basis for the general law. And that, to me, gets things backwards. And I think one can tolerate that there are exceptions where some things are not a discount, where exceptionally some people ask for a bad deal. But in my experience of counseling these firms-- I mean, they're not poor grandmothers-- the customers-- and they're not idiots.

In the Intel case-- I mean, Dell-- is it being suggested that they had no clue in terms of how these rebates might play out? The firms I deal with, their customers are very sophisticated. They have their own ROI analysis. They have very, very sophisticated buying practices and processes. And in my experience, what happens is that they use a combination of rebates offered by different sellers as effecting an a la carte approach for them.

And depending on where they're at in their business cycle-- their quantities, the time of year-- they will mix and match these different schemes. And in effect, for them it is the best of all

worlds. And they play these sellers off against each other. And this dynamic aspect to conditional rebate practices is sometimes forgotten in the modeling, which is essentially static.

Now one final point on this AEC test. I mean, it is one of those tests that is beautiful in theory. But in my experience, particularly in the light of Intel, it is difficult to apply, has a significant risk of error, and is not generally useful for ex ante decision making. And there are a whole bunch of decisions that need to be made which are not obvious or intuitive. I mean, is there a contestable share? How big is it? What are the average avoidable costs? Over what time period? Et cetera, et cetera.

And in Intel, one seller, four OEMs, 150 pages in a decision dealing with just these points. And one of the things I do as a practitioner as well is utilities regulation. And all of this seems to me the kind of thing that the FCC is doing in terms of retail price caps or wholesale price caps. And the idea of doing this in an ex-post environment, in the context of ex ante decision making in real time, I mean, [INAUDIBLE] whether it goes too far.

And fundamentally, of course, unless one is litigating, the possibility of getting the data seems to me quite difficult. And in fact, when you think about it, if competitors had this information on their respective contestable shares and the details of that, in normal circumstances, that itself would be an antitrust violation. And it's worth thinking about that. I've got--

SPEAKER 1: No more time. So just finish up.

ROBERT O'DONOGHUE: I've got 30 seconds. I'm going to wrap up now. Where I come out in all this is that the price-cost test is fine if one has the data. And the scope for error is not as significant as I've observed in cases I have worked on. And it does seem to me that the rule of reason is the least worst of the alternatives. But I entirely agree with Dan Crane that one needs to know what one is measuring against.

Because it is all very well saying there is foreclosure. But if I observe someone's market share reducing, on which side of the ledger does that go? Because the foreclosure I observe may in fact be competition. And I think there's a fundamental lack of precision as to which bucket one puts particular pieces of evidence. And I think one does need a structure, because otherwise it becomes slightly amorphous. And I'm going to stop there, but I'll be happy to come back to these points.

SPEAKER 1: Thank you, Robert.

[APPLAUSE]

SPEAKER 1: Our first discussant is Rick Brunell.

RICHARD BRUNELL: Thanks. It's a pleasure to be here. I think on the discount attribution test first. I see some consensus-- but perhaps not-- that if the discount attribution test is flunked if there's adequate data, that's a problem for most everyone. Right? That is, it's sufficient to at least

get the dominant firm in trouble, or perhaps establish foreclosure, if not establishing presumptive illegality.

And I didn't hear anyone actually today in the entire program talk about a total price total cost analysis-- sort of a traditional profit sacrifice test as being necessary. And I don't think even Ben was arguing that. And I don't think Dan was arguing that. And as far as the luck goes, I don't think-- it's certainly an open question whether some kind of a more strict Brooke Group test would be required if we had to have a price-cost test.

And the Dan's amicus brief in the Meritor case didn't take a position on that. So I'm not going to put him on the spot here. But I sense that's kind of off the table. And most people did think that should get you into trouble. Steve was suggesting that maybe you might have some false positives, even when the discount attribution test is satisfied or implicates the defendant. And I'm not quite sure-- I'll have to speak to him later-- whether he was talking about sort of a profit sacrifice version of that, or the margins on that. So he can explain that to me later.

There seems to be disagreement, of course, as to whether satisfying such a test would be or should be a necessary condition. And certainly Einer and Randy and many others today have suggested that is not the case. And Einer interprets Meritor as not requiring that in order to show that the effective means of exclusion is not price. One could say that Meritor was not requiring or was not saying that the failure to establish the test would be-- make it clear that pricing is the means of exclusion. OK.

Now the less demanding version of that is the contestable and uncontestable [INAUDIBLE]. And Einer interprets this factor as being part of the Meritor case, which would move you out of the price-cost test requirement. And I think that's a reasonable interpretation. But of course, the case that Dan likes, this ASI case in the Northern District of New Jersey, rejected the whole idea of bundling contestable and uncontestable portions of demand as being suggesting that there was any kind of problem.

And it's interesting to see what the generalist district court judge was thinking. And he said, well, if you have an incontestable demand, that sort of a hard earned monopoly. That's actually the result of competition. So the fact that the monopolist is using an incontestable portion of demand-- that's fine. That's competition on the merits.

OK. I want to address now the issue of discount versus penalty. There's obviously significant disagreement on this panel over the extent to which royalty profits are likely to be discounts or penalties. And I'm not going to wade into that. The question is whether it really should matter. When you have a true exclusive dealing arrangement, it doesn't matter whether the exclusive dealing arrangement is purchased with a rebate, or a benefit, or is the product of coercion or threat.

So I'm not sure why it shouldn't matter so much whether the pricing is a discount or a penalty if we're talking about an exclusionary theory. Perhaps it's a rebuttal to an attempted justification that you have lower prices. But that's about it. And Judge Cooper, in the ASI case, did say that this is just a matter of semantics, and didn't really matter whether it was a true penalty or not.

Let me just mention, as well, this issue of that Robert was talking about, and others have talked about how this is a common practice-- these kinds of loyalty discounts. I was discussing this with my wife at dinner last night. And she said, you know, what's the problem? Loyalty rebates or benefits are ubiquitous. She didn't use that word, ubiquitous.

And then I explained, well, the problem arises when you have a monopoly or a dominant firm, and the dominant firm uses its incontestable market share to tax the rival, to make it more expensive for the rival to obtain share of business. And that tax idea, which perhaps-- Will Tom might have--

SPEAKER 1: Joe Farrell.

RICHARD BRUNELL: Joe Farrell. OK. Which has been around for a while just seemed to be the sort of intuitive counter to the this is a ubiquitous behavior. Thanks.

SPEAKER 1: Thank you. Our concluding discussant is Will Tom.

WILLARD K. TOM: Thanks. I'm going to start by disagreeing with something Robert said. And in the spirit of competition here, I will say that we in the US have the Europeans beat by decades in terms of getting things wrong. As I was listening to this panel, and also the panels this morning, I guess I was listening from three different perspectives-- that of counseling, enforcing policy, and litigation. Which maybe is appropriate, since some of my current colleagues say I have not been able to resist going through the revolving door as often as possible.

But those three perspectives are obviously related. Because one of the key questions you're asking as a counselor is, how predictable is the outcome in litigation? And again, in the United States, much of that depends on can you get to a jury or not. And so one thing that struck me that maybe hasn't been emphasized enough with respect to that perspective is that the choices are not, I don't think, limited to PeaceHealth or LePage's.

So the PeaceHealth says discount attribution test. They don't even really add on a recruitment requirement of any kind. You do the discount attribution, and that tells you whether it's lawful or not. LePage's essentially said, look, this is just too hard. Why don't we all send it into the black box called the jury, and let the jury decide. And that will be the end of it.

It seems to me that there are some alternatives to that, that when you're dealing with outright exclusive dealing-- 100% requirement, you don't say, well, this is a jury question-- let's send it to the jury. You might ask, what are the justifications? Or you might ask-- and probably more cases get decided on the basis of how much foreclosure is there. Now, the concept of how much foreclosure is necessary has been kind of vacuous in the case law.

But there is some stuff out there that tries to tie the necessary amount of foreclosure to economic or quasi-economic concepts. And one sign that I'm getting very old is that when I'm looking for an instant example of that kind of specificity, I go to what most of you, I think, would think is really, really obscure-- namely, the analysis to aid public comment in the mid-1990s FTC decision in Time Warner - Turner.

And so one of the things that the commission said there is, well, what we're worried about is what it takes to launch a new programming network. And it takes access to a critical mass of subscribers. And one of the reasons we've got some concerns with the vertical issue here is that if you get control over-- if CNN, the dominant provider of news programming, gets control over a large enough critical mass of multi-channel program distributors, a competing news channel [INAUDIBLE] may not be able to compete, or a current fringe competitor.

And we're worried about that. And so if it takes access to 60% of the households past to launch a viable competitor, then we might start to worry about the dominant news programming facility controlling more than 40% of the subscribers. OK. So then you get Microsoft. And so, well, there were people in the early days who said, oh my god, why should we worry about whatever Microsoft does in browsers? That's ridiculous. Netscape is the one with 90%. Internet Explorer has 10%. They can do whatever they want. We don't care.

Ask there is true doubt, at least if you polled every single active judge in the DC Circuit. Some of us [INAUDIBLE], they kind of disagreed with that. And so you ought to be looking at how much foreclosure do you need in the particular theory that you're talking about. So a related point is, remember, the question is not raising rivals' costs. And Steve Salop made this point, but maybe not emphatically enough.

And maybe the problem is that the acronym RRC sort of floats off the tongue reasonably easily. But RRC [INAUDIBLE] does not. But the issue is raising [INAUDIBLE] cost to gain power over price. And there are a lot of questions that can be asked with respect to the to gain power over price part that is susceptible-- or could be susceptible-- to judicial determination even before getting to the jury.

I see that I have less than 30 seconds left. I will end with a completely pie in the sky proposal that will never happen in our judicial system. But it's kind of worth thinking about anyway. Which is, if you remember back into your ancient administrative law history, Kenneth Culp Davis suggested the distinction between legislative facts and adjudicative facts.

And I kind of wish, given the distinctive roles of the common law judge in saying what the law means, and looking to economics to figure out what the law means, versus the jury figuring out what the facts are. I kind of wish you could submit economist declarations along with your motion to dismiss. Because a lot of the questions that we're grappling with here really are economic questions about what the law means. But you won't glean the answers to that from the case law.

And one of the great things about the FTC and what it's doing, and DOJ in terms of what they're doing together in workshops, and what they're doing in issuing reports, is that it can offer some guidance to courts that our judicial structure doesn't currently permit.

SPEAKER 1: Thank you, Will. Please join me in thanking our panel and discussants.

[APPLAUSE]