



Federal Trade Commission

**Simple but Wrong or Complex but More Accurate?
The Case for an Exclusive Dealing-Based Approach to Evaluating Loyalty Discounts**

**Remarks of Joshua D. Wright*
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Good evening. I'm very pleased to be here today and would like to thank Bates White, and especially Joe Farrell, for the invitation to speak with you today.

As many of you already know, this conference will henceforth be known as the Hal White Antitrust Conference in commemoration of the tenth anniversary of the

* The views stated here are my own and do not necessarily reflect the views of the Commission or other Commissioners. I am grateful to my advisors, Derek Moore and Joanna Tsai, and my intern, Brady Cummins, for their invaluable assistance in preparing this speech. I also thank Dan O'Brien, Thomas Lambert, and Steve Salop for helpful discussions on this topic.

conference that Professor Hal White founded. It is a tremendous honor for me to participate in this conference today. Professor White was one of the world's most brilliant and innovative economists and wielded unparalleled expertise in the field of econometrics. Professor White's contributions to econometric methods and modeling have had a profound impact across all varieties of applied economics, including industrial organization and antitrust economics. I, too, have been a beneficiary of Professor White's work – starting from the time I took my first econometrics course from Professor White as an undergraduate student at University of California at San Diego.

Today I am going to talk about the antitrust economics of loyalty discounts, the best legal framework for analyzing loyalty discounts and other types of partially exclusive contractual arrangements, and the FTC's approach to loyalty discounts in a number of recent cases.

I. The Antitrust Economics of Loyalty Discounts

Loyalty discounts are “a particular form of non-linear pricing in which the unit price of a good declines when the buyer's purchases meet a buyer-specific minimum

threshold requirement.”¹ Put simply, loyalty discounts are rebates a supplier pays to a customer conditional upon the customer’s purchase of a specified threshold.

Loyalty discounts can take many forms and vary upon at least three important dimensions. The first dimension is the nature of the purchase thresholds a customer must satisfy in order to qualify for the discount. For example, a discount obligation might be triggered by a customer satisfying a purchase threshold based upon volume, volume growth over the previous period, the percentage of the customer’s requirements purchased from the supplier (market-share discounts), or the percentage of shelf space a retailer commits to the supplier’s product (shelf-share discounts).

A second dimension of variation involves which units the discount will be applied to once the purchase threshold has been met. For example, so-called all units discounts are loyalty discounts in which the rebate amount owed is calculated by applying the discount to all of the units purchased by the customer. This is in contrast to traditional volume discounts in which the rebate is applied only to those incremental purchases in excess of the threshold requirement.

A third dimension is the number of products that are included in the variable upon which purchase thresholds are based. My focus today will be single product loyalty discounts – that is, and as the name implies, discounts triggered by satisfying

¹ Bruce H. Kobayashi, *The Economics of Loyalty Discounts and Antitrust Law in the United States*, COMPETITION POL’Y INT’L, Autumn 2005, at 115, 116.

thresholds involving the purchases of a single product. Bundled rebates conditioning the discount level upon satisfying volume, market-share, or shelf space share thresholds across multiple products will be left for another day.

Loyalty discounts are ubiquitous in today's marketplace and a common form of competitive rivalry among suppliers vying for more business. They are prevalent across a broad variety of industries including medical devices, pharmaceutical products, airlines, computers, and many consumer products. Loyalty discounts are common at both retail and wholesale levels, and are used in both highly competitive and highly concentrated industries.

At the retail level, many stores offer customer loyalty programs to compete for additional, repeat business from their customers – for example, Chop't Creative Salad Company, a popular salad spot here in town, offers a "frequent chop'r" card where customers get rewards such as \$10 off of the 10th salad.² Many beverage shops also offer loyalty programs giving customers a free beverage for every X number of beverages purchased. Airlines instituted frequent flyer programs to help draw in customers to travel on their flights whenever possible.

At the wholesale level, loyalty discounts help to induce retailers to sell more of a given supplier's product or services. In the airline industry, airlines encourage travel

² *Frequent Chop'r*, CHOP'T CREATIVE SALAD COMPANY, <http://www.choptsalad.com/loyalty/> (last visited June 3, 2013).

agents to make additional passenger bookings on a particular airline by paying override commissions to travel agencies for surpassing set sales goals.³ The structure of the override commissions are based upon the airline's share of the travel agent's total airline bookings.⁴ In the medical devices industry, Tyco Health Care Group employed market-share discount agreements with its customers for its pulse oximetry sensors and monitors. Customers committing to purchase a minimum percentage of their pulse oximetry requirements from Tyco would be eligible for discounts, with the level of discount increasing as the customers' percentage of requirements purchased from Tyco increased.⁵ Cigarette manufacturers such as RJ Reynolds and Philip Morris used market-share discount programs to distribute lower priced cigarettes, offering increasing tiers of discounts to retailers based upon the shelf space share of each of these brands.⁶

The significant benefits loyalty programs offer consumers at the retail level is intuitive to most people – even economists. Not surprisingly, economic analysis of loyalty programs at the retail level shows loyalty programs can reduce costs to both

³ U.S. GEN. ACCOUNTING OFFICE, GAO-03-749, AIRLINE TICKETING: IMPACT OF CHANGES IN THE AIRLINE TICKET DISTRIBUTION INDUSTRY 9 (2003).

⁴ See *Define Market Share Override Program*, TRAVEL INDUSTRY DICTIONARY, <http://www.travel-industry-dictionary.com/market-share-override-program.html> (last visited June 3, 2013).

⁵ See *Allied Orthopedic Appliances Inc. v. Tyco Health Care Grp.*, 592 F.3d 991 (9th Cir. 2010).

⁶ See *R.J. Reynolds Tobacco Co. v. Philip Morris Inc.*, (M.D.N.C. 2002), *aff'd per curiam sub nom. RJ Reynolds Tobacco Co. v. Phillip Morris USA, Inc.*, 67 F. App'x 810 (4th Cir. 2003).

suppliers and customers, and in turn may benefit both.⁷ While these loyalty programs aimed at end users raise some interesting economic issues,⁸ they generally have not raised significant antitrust concerns. My remarks will focus instead upon those loyalty discounts offered to distributors and retailers.

a. Competitive Concerns With Loyalty Discounts

The primary competitive concerns with loyalty discounts are similar to those that arise with exclusive dealing. In short, the concern is that a monopolist might utilize such discounts as a strategy to protect its market position by excluding rivals, raising rivals' costs, and ultimately harming consumers.

In fact, exclusive dealing is essentially a special case of market-share-based loyalty discounts, where the market-share threshold is equal to one. From an economic perspective, loyalty discounts that require a substantial, but less than 100 percent, threshold to be satisfied are best thought of as an example of partial or *de facto* exclusive dealing.⁹

⁷ See David Bell & Rajiv Lal, *The Impact of Frequent Shopper Programs in Grocery Retailing*, 1 QUANTITATIVE MARKETING & ECON. 179 (2003); Kobayashi, *supra* note 1.

⁸ Paul Klemperer, *The Competitiveness of Markets with Switching Costs*, 18 RAND J. ECON. 138 (1987).

⁹ See, e.g., Andrew Gavil, *Exclusionary Distribution Strategies for Dominant Firms: Striking a Better Balance*, 72 ANTITRUST L.J. 3 (2004) (examining loyalty discounts as vertical control devices); Willard K. Tom, David A. Balto & Neil W. Averitt, *Anticompetitive Aspects of Market-Share Discounts and Other Incentives to Exclusive Dealing*, 67 ANTITRUST L.J. 615, 636-38 (2000) (discussing market-share discounts as a form of *de facto* exclusive dealing); see also Dennis W. Carlton, *A General Analysis of Exclusionary Conduct and Refusal to Deal—Why Aspen and Kodak Are Misguided*, 68 ANTITRUST L.J. 659, 664 (2001) (stating that non-linear

The primary competitive concern with loyalty discounts is that they can, under certain conditions, impair competitors' access to distribution and other sales outlets, which could in turn have negative implications on their competitive viability. The possibility of anticompetitive exclusion generally arises only if a supplier is able to foreclose rival suppliers from a large enough fraction of the market to deprive rivals of the opportunity to achieve minimum efficient scale, potentially raising rivals' costs, and possibly harming competition and consumers.¹⁰ Loyalty discounts are potentially exclusionary precisely because they pose strong incentives for distributors to purchase a large share – whether in terms of volume or shelf space – from a single supplier.

One might usefully think about these incentives in another way, that is, by focusing on the costs loyalty discounts impose upon a distributor contemplating incremental purchases from a rival supplier. These include not only the cost of the products or services themselves, but also the discounts the distributors would forgo by failing to meet the threshold. A distributor's purchase of an additional unit from a rival supplier beyond the threshold level can result in a loss of rebates large enough to render rival suppliers unable to attract a distributor to purchase the marginal unit at

pricing could achieve the same ends as exclusive dealing but suggesting that antitrust intervention "should be used rarely and apply only to extreme pricing conditions").

¹⁰ Alden F. Abbott & Joshua D. Wright, *Antitrust Analysis of Tying Arrangements and Exclusive Dealing*, in *ANTITRUST LAW AND ECONOMICS* 183 (Keith N. Hylton ed., 2010); Thomas G. Krattenmaker & Stephen C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price*, 96 *YALE L.J.* 209, 234-38 (1986).

prices at or above the marginal cost of producing the good. In the case of all-units discounts, a sharp non-linearity in the discount schedule can further decrease distributor incentives to purchase marginal units from rival suppliers.¹¹ Thus, loyalty discounts can be employed by a supplier with substantial market power to engage in anticompetitive foreclosure, to diminish rivals' competitive significance, to drive out rivals entirely, or to prevent potential entrants from entering the market in which it competes.¹² The key economic point is that the antitrust concerns potentially arising from loyalty discounts involve anticompetitive exclusion rather than predatory pricing and thus, their competitive risks are best understood when viewed through the lens of the modern raising rivals' costs literature.¹³

¹¹ My focus here today is on the traditional raising rivals' costs-based theories of exclusion. Another anticompetitive theory of market-share discounts is based on alleged "tax" effects. *See, e.g.*, Reply Brief, *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8th Cir. 2000) (No. 00-379); *see also* Joseph Farrell, Janis K. Pappalardo & Howard Shelanski, *Economics at the FTC: Mergers, Dominant-Firm Conduct, and Consumer Behavior*, 37 REV. INDUS. ORG. 263 (2010). Under this theory, market-share discount programs are used by a manufacturer to impose a "tax" on distributors and retailers who purchase products from other rival manufacturers equal to the all-units discounts these purchasers give up by not buying from the manufacturer. This "tax" can have the effect of forcing rival manufacturers to charge substantially lower prices in order to convince customers to forgo the all-units discounts and purchase from them. The discount programs, combined with market power, can enable a manufacturer to capture a large share of the market and deter entry.

¹² *See* Krattenmaker & Salop, *supra* note 10; Steven C. Salop & David T. Scheffman, *Raising Rivals' Costs*, 73 AM. ECON. REV. 267 (1983).

¹³ This refers solely to the competitive risks that may arise from loyalty discounts. Indeed, the raising rivals' costs literature explicitly excludes the possibility of efficiencies that can arise from vertical contractual arrangements such as loyalty discounts. There is a separate economic literature on the procompetitive efficiencies of exclusive dealing and partial exclusives that discusses the benefits and efficient uses of exclusive dealing. *See, e.g.*, Benjamin Klein & Kevin M. Murphy, *Exclusive Dealing Intensifies Competition for Distribution*, 75 ANTITRUST L.J. 433 (2008); Howard Marvel, *Exclusive Dealing*, 25 J.L. & ECON. 1 (1982).

Economic models exploring the possibility of a supplier using exclusive dealing to reduce competition and harm consumers generally require strict assumptions concerning the existence of significant economies of scale, barriers to entry, and the absence of procompetitive efficiencies.¹⁴ There are further limitations on the loyalty discount-induced foreclosure result described above. For example, that result requires rival firms to be constrained from competing to satisfy a large or complete portion of the distributor's requirement. If not, rival firms would be able to evade the costs imposed by the structure of the loyalty discount.

Additionally, Robert Bork's contention that it would not be in a distributor's best interest to agree to contracts that would create a monopoly within its supply chain undermines the theory that exclusive dealing or partial exclusives would result in foreclosure of rival suppliers in some cases.¹⁵ This limitation is especially pertinent when the number of distributors is small and they are likely to internalize the potential impact of their purchase decisions upon competition. Similarly, it may be especially difficult to implement an exclusion strategy with loyalty discounts involving short-term

¹⁴ For a more expansive summary of the various anticompetitive theories and models of exclusive dealing, see, e.g., Abbott & Wright, *supra* note 10; Daniel O'Brien, *The Antitrust Treatment of Vertical Restraint: Beyond the Possibility Theorems*, in *THE PROS AND CONS OF VERTICAL RESTRAINTS* 40, 72-73 (2008); see also James Cooper, Luke Froeb, Daniel O'Brien & Michael Vita, *Vertical Restrictions and Antitrust Policy: What About the Evidence?*, *COMPETITION POL'Y INT'L*, Autumn 2005, at 45.

¹⁵ Abbott & Wright, *supra* note 10.

distribution contracts.¹⁶ Significant economies of scale in distribution also mitigate the possibility of exclusion because a potential entrant may need to attract only a single buyer in order to achieve minimum efficient scale.¹⁷ Moreover, a small number of buyers may be able to coordinate in order to support the excluded rival,¹⁸ and downstream competition at the retail level can dissipate incentives to exclude as one buyer becomes large enough to support the entry or viability of a rival.¹⁹

Next I will turn to a discussion of the procompetitive efficiencies of full and partial exclusives, including loyalty discounts.

b. Procompetitive Efficiencies of Loyalty Discounts

Although exclusive or partial exclusive arrangements, including loyalty discounts, have the potential to foreclose or exclude rivals, they are generally a byproduct of the normal competitive processes. One well-understood procompetitive rationale for exclusive dealing is that it minimizes distributor free-riding on the supplier's investments to promote rival suppliers' products and can help to better align

¹⁶ See, e.g., Benjamin Klein, *Exclusive Dealing as Competition for Distribution "On the Merits,"* 12 GEO. MASON L. REV. 119, 122-28 (2003).

¹⁷ See, e.g., Eric B. Rasmusen, J. Mark Ramseyer & John S. Wiley, Jr., *Naked Exclusion*, 81 AM. ECON. REV. 1137 (1991); Ilya R. Segal & Michael D. Whinston, *Naked Exclusion: Comment*, 90 AM. ECON. REV. 296 (2000).

¹⁸ See, e.g., Rasmusen et al., *supra* note 17; Segal & Whinston, *supra* note 17.

¹⁹ See, e.g., Chiara Fumagalli & Massimo Motta, *Exclusive Dealing and Entry, When Buyers Compete*, 96 AM. ECON. REV. 785 (2006).

the supplier's and the distributor's incentives.²⁰ Exclusive dealing can also intensify competition among suppliers in order to win committed access to distributors' customer base.²¹ In particular, while economists have shown that exclusives can impose some costs on consumers by not satisfying their preferences for a particular brand of product, those costs could be outweighed by the increase in consumer welfare from lower prices that result from the competitive bargaining that distributors engage in with suppliers.²² Economists have also shown that all-units discounts can be used to address double-marginalization problems. The minimum threshold becomes a tool for the distributor to choose the selling price that would maximize the supplier's and the distributor's joint profits, thereby eliminating double marginalization and increasing welfare.²³

II. Exclusive Dealing Law Provides the Best Legal Framework for Analyzing Loyalty Discounts

As discussed, there is some consensus among economists as to the economic mechanisms through which loyalty discounts may harm or enhance competition. The legal treatment of loyalty discounts, however, reflects fundamentally disparate views

²⁰ See, e.g., Jonathan M. Jacobson, *Exclusive Dealing, "Foreclosure," and Consumer Harm*, 70 ANTITRUST L.J. 311, 357-60 (2002); Marvel, *supra* note 13.

²¹ See, e.g., Abbott & Wright, *supra* note 10; Klein & Murphy, *supra* note 13.

²² Klein & Murphy, *supra* note 13.

²³ Sreya Kolay, Greg Shaffer & Janusz A. Ordover, *All-Units Discounts in Retail Contracts*, 13 J. ECON. & MGMT. STRATEGY 429 (2004).

among commentators regarding whether the law should evaluate loyalty discounts the same way it evaluates other discount-based claims – that is, by subjecting such claims to a screen requiring proof of below-cost pricing. The alternative viewpoint – the one I happen to support – is that, to the extent loyalty discounts raise competition concerns, the concerns are about anticompetitive exclusion and, as a result, the legal framework developed to evaluate exclusive dealing claims ought to be used to evaluate claims relating to loyalty discounts. The recent split decision by the Third Circuit in *ZF Meritor* is reflective of this longstanding debate.²⁴

The relevant aspects of the case involve a monopolization claim by ZF Meritor against Eaton Corporation related to Eaton’s contracts in the heavy-duty truck transmissions market. According to the court, Eaton had been the only supplier of heavy-duty truck transmissions from the 1950s until 1989, when Meritor entered the market.²⁵ In 1999, Meritor held about 17 percent share of the market and had plans to expand through a joint venture with a large German company called ZF Freidrichshafen that had not entered the North American market.²⁶ The plan was for the joint venture to adapt and introduce to North America ZF’s 12-speed, two-pedal

²⁴ *ZF Meritor, LLC v. Eaton Corp.*, 696 F.3d 254 (3d Cir. 2012).

²⁵ *Id.* at 264.

²⁶ *Id.*

transmission to differentiate itself from Eaton, which did not have a two-pedal transmission at the time.²⁷

ZF Meritor's lawsuit claims its competitive efforts were undermined by Eaton's exclusive contracting practices. Eaton entered into what the court termed "long-term agreements" with each of the four direct purchasers of heavy-duty truck transmissions that conditioned rebates from Eaton on whether the buyers purchased a specified percentage of their requirements from Eaton.²⁸ The four agreements varied in their terms, but several included up-front payments from Eaton and set the market-share requirement from 70 percent to above 90 percent.²⁹ Between 1999 and 2005, ZF Meritor's market-share dropped from 19 percent to 4 percent. Also during this period, however, a severe downturn in the heavy-duty truck market resulted in demand plummeting by as much as 50 percent.³⁰ Nevertheless, the joint venture fell apart and, believing that market-share above 10 percent was necessary for long-term viability, Meritor exited the business in 2007.³¹

As in most cases involving allegations of anticompetitive conduct by a firm with monopoly power, at first glance the effect of the conduct is equally consistent with

²⁷ *Id.*

²⁸ *Id.* at 265-66.

²⁹ *Id.*

³⁰ *Id.* at 265.

³¹ *Id.* at 267.

competition on the merits as it is with exclusionary and anticompetitive consequences. One view of the case is that Eaton responded to increased competitive pressure by ZF Meritor and developed a successful discounting program to attract OEMs. Another view is that Eaton contractually induced OEMs to deal with it exclusively – or “almost” exclusively – with the purpose and effect of preventing ZF Meritor from maintaining minimum efficient scale, leading to its exit from the business and allowing Eaton to earn monopoly rents and harm consumers going forward.

In deciding upon a legal framework by which to analyze the questions raised in the case, a court ought to consider selecting the most useful tool to enable it to answer the question of whether the monopolist’s conduct is anticompetitive, or whether it is benign or even procompetitive. In my view, the most useful tool is the legal framework that is most likely to minimize the costs to consumer welfare in its application. Those costs include all of the social costs arising from erroneous condemnation of procompetitive loyalty discounts, the failure to condemn anticompetitive conduct, and the cost of administering the antitrust system.³²

Eaton, of course, argued that ZF Meritor’s claim was about discounted pricing and therefore required allegations and proof that Eaton’s prices were below some

³² See Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1 (1984); see also James C. Cooper, Luke M. Froeb, Daniel O’Brien & Michael G. Vita, *Vertical Antitrust Policy as a Problem of Inference*, 23 INT’L J. INDUS. ORG. 639 (2005); Geoffrey A. Manne & Joshua D. Wright, *Innovation and the Limits of Antitrust*, 6 J. COMPETITION L. & ECON. 153 (2010).

relevant measure of cost to satisfy the standard set forth by the Supreme Court in *Brooke Group*.³³ The Third Circuit rejected application of the *Brooke Group* test, holding that test is appropriate “when price is the clearly predominant mechanism of exclusion.”³⁴ The relevant question in deciding whether to require evidence of below-cost pricing is, according to the court, whether “pricing itself operat[es] as the exclusionary tool.”³⁵ In deciding not to apply the *Brooke Group* test, the court identified three features of Eaton’s agreements with OEMs that allowed it to conclude that price was not the predominant mechanism of exclusion in Eaton’s contracts: (1) Eaton’s position as a supplier of a necessary input for heavy-duty truck OEMs; (2) the five-year duration of the agreements; and (3) the fact that some of Eaton’s agreements required OEMs to remove ZF Meritor’s products from the OEMs’ data books, which were a source truck buyers used to customize their purchases from OEMs.³⁶

Judge Greenberg – the same Judge Greenberg that dissented from the Third Circuit’s infamous *en banc* decision on bundled discounts in *LePage’s*³⁷ – disagreed with the court’s decision to reject a price-cost test in favor of applying the rule of reason. In particular, Judge Greenberg cited the “fundamental” “principle that above-cost pricing

³³ *Brooke Grp. Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

³⁴ *ZF Meritor, LLC v. Eaton Corp.*, 696 F.3d at 275.

³⁵ *Id.*

³⁶ *Id.* at 277.

³⁷ *LePage’s Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003) (en banc).

practices, even those embodied in discount and rebate programs . . . generally are not anticompetitive” and therefore courts must “tread lightly” when asked to condemn such pricing practices.³⁸ Ultimately, he concluded that a price-cost test “should apply and be given persuasive effect regardless of whether a plaintiff identifies non-price elements of a defendant’s conduct that it alleges were anticompetitive.”³⁹

The Third Circuit’s decision in *ZF Meritor* is of course not the first time a court has confronted the issue of how to analyze a claim that loyalty discounts have harmed competition.⁴⁰ Moreover, economists, lawyers, and courts have been debating for years about the appropriate legal rule to apply. Those that support a price-cost test do so in large part because of a belief that “[i]f a seller offers aggressive but above-cost prices, equally efficient rivals will not be excluded from matching and hence attracting customers. The price-cost test brings discipline to antitrust cases by preventing less

³⁸ *ZF Meritor, LLC v. Eaton Corp.*, 696 F.3d at 311-12.

³⁹ *Id.* at 324.

⁴⁰ Some courts have analyzed loyalty discounting using both exclusive dealing precedent and a price-cost test. *See NicSand, Inc. v. 3M Co.*, 507 F.3d 442, 447-48, 455 (6th Cir. 2007); *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039, 1062-63 (8th Cir. 2000) (using the rule of reason to evaluate claim under § 1 and the *Brooke Group* test to evaluate claim under § 2); *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227 (1st Cir. 1983). Other courts have analyzed loyalty discounting programs under the rule of reason only. *See, e.g., Conwood Co. v. U.S. Tobacco Co.*, 290 F.3d 768 (6th Cir. 2002); *R.J. Reynolds Tobacco Co. v. Philip Morris Inc.*, 199 F. Supp. 2d 362 (M.D.N.C. 2002), *aff’d per curiam sub nom. RJ Reynolds Tobacco Co. v. Phillip Morris USA, Inc.*, 67 F. App’x 810 (4th Cir. 2003). Still, other courts have analyzed loyalty discounts using a price-cost test. *See, e.g., Virgin Atl. Airways Ltd. v. British Airways Plc*, 257 F.3d 256 (2d Cir. 2001) (using the *Brooke Group* test where plaintiff had alleged below-cost pricing). Finally, courts have also applied a version of a price-cost test in the context of a challenge to a *bundled* discounting program. *See, e.g., Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883, 909 (9th Cir. 2008).

efficient rivals from resting on a characterization of the effect of the defendant's prices (i.e., 'exclusivity,' 'foreclosure') without regard to the fact that a non-predatory price was the mechanism of 'exclusion'."⁴¹ Others advocate applying the rule of reason to loyalty discounts.⁴²

Arguments in favor of applying a price-cost test to loyalty discounts are not without merit. It is likely true on balance that a price-cost test would be easier to administer than a more thorough analysis using existing exclusive dealing jurisprudence. Further, it is conceivable that a variant of price-cost test would result in both fewer false positives *and* fewer false negatives than would exclusive dealing law.

In my view, however, both points are overstated and the second is almost certainly incorrect. First, in practice, administering a price-cost test to evaluate an

⁴¹ Brief for Eighteen Scholars as *Amici Curiae* in Support of Petitioner, *Eaton Corp. v. ZF Meritor LLC*, No 12-1045, (U.S. Mar. 28, 2013), 2013 WL 1309073; *see also* 1A PHILLIP E. AREEDA & HERBERT H. HOVENKAMP, *ANTITRUST LAW* ¶ 768b (2d ed. 2000) ("For single-item discounts, no matter how measured or aggregated, injury to an equally efficient rival seems implausible provided that the fully discounted price remains above the seller's costs. . . . [W]e would test illegality by the ordinary rules applying to predatory pricing and allow all above-cost single item discounts."); Daniel A. Crane, *Mixed Bundling, Profit Sacrifice, and Consumer Welfare*, 55 EMORY L.J. 423 (2006); Thomas A. Lambert, *Evaluating Bundled Discounts*, 89 MINN. L. REV. 1688 (2005).

⁴² *See* Jacobson, *supra* note 20 (treating loyalty discounts as a form of exclusive dealing and suggesting a rule of reason approach); Tom et al., *supra* note 9, at 615 ("[M]arket-share discounts structured to produce total or partial exclusivity should be judged according to the same economic principles that govern exclusive dealing."); *see also* Nicholas Economides, *Loyalty/Requirement Rebates and the Antitrust Modernization Commission: What Is the Appropriate Liability Standard?*, 54 ANTITRUST BULL. 259, 276-77 (2009) ("[T]he court should look at a number of variables to ascertain whether a requirement/loyalty program violates antitrust law, with the central question being whether the introduction of the requirement/loyalty program reduces consumer surplus."); Louis Kaplow & Carl Shapiro, *Antitrust*, in 2 HANDBOOK OF LAW AND ECONOMICS 1073, 1203 n.198 (A. Mitchell Polinsky & Steven Shavell eds., 2007) ("[A] variety of seemingly distinct contractual arrangements, without explicit exclusivity, can have very similar economic effects [as exclusivity].").

antitrust challenge to a loyalty discounting program may prove difficult. Some have argued that the appropriate price-cost test ought to be modified to align with the cost-attribution approach taken by some courts in evaluating challenges to bundled discounting by a multi-product seller with market power.⁴³ Under this framework, a single-good seller with market power that implements loyalty discounts would in effect be selling a bundle comprised of “non-contestable” units, which buyers would demand from the monopolist even without a discount, and “contestable” units, the marginal units up for grabs between the monopolist and its competitors. The modified test would attribute the entire discount only to the contestable units and then ask whether those units are sold below cost.⁴⁴ This approach raises the difficult question of how to define “contestable units.” And if the plaintiff’s job is merely to plead that price is below cost for contestable units, then the price-cost screen may not deter as many non-

⁴³ See, e.g., *Cascade Health Solutions v. PeaceHealth*, 515 F.3d at 909.

⁴⁴ U.S. DEP’T OF JUSTICE, COMPETITION AND MONOPOLY: SINGLE-FIRM CONDUCT UNDER SECTION 2 OF THE SHERMAN ACT 107 (2008), available at <http://www.justice.gov/atr/public/reports/236681.htm> (“[A]s with predatory pricing, single-product loyalty discounts may be anticompetitive in certain circumstances, such as where the resulting price of all units sold to a customer is below an appropriate measure of cost. Further, commentators and panelists generally agree that even 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.”); see also Jonathan M. Jacobson, *A Note on Loyalty Discounts*, ANTITRUST SOURCE, June 2010, art. 2, at 1; Communication from the Commission - Guidance on the Commission’s enforcement priorities applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings, 2009 O.J. (C 45) 7, 13 (“A conditional rebate granted by a dominant undertaking may enable it to use the ‘non-contestable’ portion of the demand of each customer (that is to say, the amount that would be purchased by the customer from the dominant undertaking in any event) as leverage to decrease the price to be paid for the ‘contestable’ portion of demand (that is to say, the amount for which the customer may prefer and be able to find substitutes).”).

meritorious claims as its advocates predict. Moreover, determining the appropriate measure of cost in important industries where marginal costs are unusually low and research and development costs are high is difficult and renders any price-cost test much more difficult to administer in practice in the loyalty discount setting than one might expect.⁴⁵

More fundamentally, the price-cost approach sacrifices economic accuracy in the hope of more efficient administration. It would be one thing to choose a simple legal framework over a more complex one when both are based upon the correct underlying economic analysis. But the choice in this context is between a simple legal test based upon the wrong economic model and a legal test – albeit a more complex rule of reason analysis – based upon a more accurate set of economic models. The trend in antitrust law over the last three-plus decades has been increasingly to incorporate more accurate economic models into the design of legal rules; it would be a curious choice indeed to choose deliberately a rule that ignores economic analysis telling us that anticompetitive exclusion can occur even in scenarios where price is above a relevant measure of cost. Specifically, in the raising rivals' costs literature discussed earlier, net prices need not be below cost for the exclusion of rivals to occur.⁴⁶ This should not be surprising if one

⁴⁵ See Jonathan M. Jacobson, Wilson Sonsini Goodrich & Rosati, PC, Cost-Based Rules in the New Economy (March 25, 2009), *available at* <http://www.wsgr.com/publications/PDFSearch/jacobson032509.pdf>.

⁴⁶ See, e.g., Rasmusen et al., *supra* note 17.

accepts the economic proposition that predatory pricing and raising rivals' costs are distinct paradigms of potentially exclusionary conduct.⁴⁷ There simply is not a stable relative relationship between price and cost in raising rivals' cost models that form the basis of anticompetitive exclusion, and hence it does not follow that below cost pricing is a necessary condition for competitive harm.

In my view, loyalty discounts elicit the same concerns about raising rivals' costs that "total" exclusive dealing does and, for that reason, ought to be analyzed under the same legal rubric as exclusive dealing. Indeed, one can view an exclusive dealing arrangement as a specific form of loyalty discounting whereby the discount is triggered only if the buyer commits 100 percent of its purchases to the seller, rather than 90 percent or some smaller figure.⁴⁸ A court, therefore, ought to ask whether a given loyalty discount program did or is likely to increase or maintain a defendant's market power and harm competition through increased prices, reduced output, and/or diminished quality. In a similar vein, an antitrust enforcement agency confronted with investigating a firm with market power engaging in loyalty discounting ought to analyze the conduct through the same lens. A court should not focus on whether the defendant's discounting has resulted in prices below cost.

⁴⁷ See Steven C. Salop, *Exclusionary Conduct, Effect on Consumers, and the Flawed Profit-Sacrifice Standard*, 73 ANTITRUST L.J. 311, 315 (2006) ("Predatory pricing is one paradigmatic type of exclusionary conduct. Raising rivals' costs is another paradigm.").

⁴⁸ See Abbott & Wright, *supra* note 10.

As I have explained, there is a robust economic literature modeling scenarios in which a dominant supplier can induce downstream retailers or dealers to deal with it exclusively and cause harm to competition. These models generally assume that the manufacturer supplies a product that is essential to retailers' viability and that there are significant economies of scale in manufacturing.⁴⁹

In deciding whether or not to pursue an action based upon loyalty discounting by a dominant firm, an antitrust enforcement agency ought to focus primarily on three issues. First, the agency should select an appropriate theoretical model of harm and consider seriously whether the assumptions underlying that model fit the reality of the marketplace under investigation.

Second, the agency must consider whether the loyalty discounts have resulted in efficiencies. Just as loyalty discounts and other "partial exclusives" raise the same competitive concerns as exclusive dealing, they also raise the possibility of creating a more efficient distribution chain. Loyalty discounts and partial exclusives can be an efficient method to satisfy twin consumer demands for low price and at least some brand variety at the retail level.⁵⁰ Even if the buyer does not commit 100 percent of his

⁴⁹ See Abbott & Wright, *supra* note 10.

⁵⁰ Klein & Murphy, *supra* note 13.

purchases to a single seller, efficiencies similar to those arising from exclusive dealing nonetheless can occur.⁵¹

Finally, the agency must ask and answer whether the discounting has resulted in anticompetitive effects. Here the agency can take advantage of the fact that the discounting often has already taken place and can use industry data to evaluate empirically whether the conduct has had adverse effects on price and output in the industry. It goes without saying that the agency should focus more of its enforcement efforts on challenging conduct that has had a demonstrable anticompetitive effect on the marketplace. Moreover, this approach is consistent with the general trend in antitrust law and economics toward assessing actual competitive effects.

A related question is how “foreclosure” – the lodestar of the Supreme Court’s jurisprudence on exclusive dealing – ought to fit into the analysis.

Modern exclusion cases focus intensely upon measuring foreclosure. It is now widely recognized that a monopolist may be able to use exclusive contracts to raise its rivals’ costs and, if those arrangements foreclose a share of distribution such that the remaining distribution assets are insufficient to support a rival of minimum efficient scale, the exclusives may result in the acquisition or maintenance of market power and yield competitive harm. The foreclosure requirement in exclusive dealing cases is

⁵¹ See Klein & Murphy, *supra* note 13; Kobayashi, *supra* note 1; Joshua D. Wright, *Antitrust Analysis of Category Management: Conwood v. United States Tobacco Co.*, 17 SUPREME CT. ECON. REV. 311 (2009).

consistent with modern economic models of exclusion within the raising rivals' cost framework. The foreclosure requirement provides a rough measure of a firm's ability to prevent rivals from achieving minimum efficient scale and potentially harming competition. The foreclosure requirement in the law, however, has not evolved to fully embrace the economic framework established by raising rivals' costs theories. Most courts measure foreclosure simply by counting up the fraction of the input supply (or customers) under contract with the monopolist and presume those inputs are foreclosed from rival suppliers.

Improving foreclosure analysis to align more closely with the raising rivals' cost framework and thereby to focus more intensely upon the ultimate competitive effects of the contracts at issue would significantly improve the existing legal framework. For example, I have suggested elsewhere that measuring the foreclosure attributable to the defendant's conduct in loyalty discount cases – and all cases alleging contracts create market power via the raising rivals' cost mechanism – should require a “counterfactual” analysis of the degree of foreclosure without the contracts in question.⁵² The crucial point is that to appropriately measure foreclosure and its impact, one must account for the distribution that would be dedicated to the defendant in the absence of the agreement, so that the impact from the agreement itself can be isolated and measured.

A counterfactual foreclosure analysis is also consistent with the foreclosure analysis

⁵² Joshua D. Wright, *Moving Beyond Naïve Foreclosure Analysis*, 19 GEO. MASON L. REV. 1163 (2012).

contemplated within the raising rivals' cost framework.⁵³ Focusing upon actual impact rather than the traditional naïve foreclosure measure adopted by courts in exclusion cases would also be consistent with the broader trend in modern antitrust enforcement toward prioritizing actual effects over rougher proxies such as market definition and inferences of competitive effects derived from market-share?⁵⁴

Of course, foreclosure itself is only the starting point for an assessment of the potential anticompetitive effects of loyalty discounts.⁵⁵ The finding of substantial foreclosure is a necessary but not a sufficient condition of competitive harm. The overarching focus of the antitrust analysis of loyalty discounts consistent with the raising rivals' cost framework is to determine whether the contracts enable the firm to acquire or maintain monopoly power, increase market prices, reduce output, or otherwise harm competition. The economic assessment must also include the duration of the relevant contracts, entry conditions for the input allegedly foreclosed from rival suppliers, the ability of rivals to compete for exclusives, and consideration of the myriad procompetitive efficiencies associated with loyalty discounts, other forms of

⁵³ See Krattenmaker & Salop, *supra* note 10, at 259-60 (contemplating a before-and-after analysis in which the share of distribution foreclosed by the defendant prior to the adoption of the exclusionary rights agreement serves as the "but-for" world and the competitive benchmark to which the competitive realities under the relevant agreement must be compared).

⁵⁴ See, e.g., Deborah A. Garza, *Market Definition, the New Horizontal Merger Guidelines, and the Long March away from Structural Presumptions*, ANTITRUST SOURCE, October 2010, art. 7, at 1.

⁵⁵ See, e.g., Jacobson, *supra* note 20; Wright, *supra* note 52.

partial exclusive dealing, and exclusive dealing contracts. Once again, the law clearly already incorporates these considerations into the rule of reason framework applied to exclusive dealing contracts.⁵⁶

In sum, economic theory teaches that there are two paradigms of exclusion: raising rivals' cost and predation.⁵⁷ As Professor Salop has explained, "RRC generally describes conduct to raise the costs of competitors with the purpose and effect of causing them to raise their prices or reduce their output, thereby allowing the excluding firm to profit by setting a supracompetitive price."⁵⁸ When plaintiffs allege that loyalty discounts, market-share discounts, or partial exclusive dealing contracts violate the antitrust laws because they deprive rivals of access to a critical input, raise their costs, and ultimately harm competition, they are articulating a raising rivals' cost theory of harm rather than price predation.⁵⁹ The rule of reason analysis applied in exclusive dealing cases sets forth a framework consistent with the economics of raising rivals' costs to assess the potential anticompetitive effects of loyalty discounts and related contracts; that framework also contemplates the efficiencies associated with the same

⁵⁶ Abbott & Wright, *supra* note 10.

⁵⁷ Salop, *supra* note 47, at 315.

⁵⁸ *Id.*

⁵⁹ It is, of course, possible to allege a predatory theory of harm arising from loyalty discounts or bundled discounts. A price-cost-based standard such as *Brooke Group* is appropriate for analyzing such claims.

contracts. For those reasons, the exclusive dealing framework is generally superior to a price-cost framework for assessing loyalty discounts.

It may well be the case, as *amici* in ZF Meritor argue, that a price-cost standard is easier to administer than the rule of reason – but the same could be said for a standard of *per se* legality or *per se* illegality. The question to be answered is which rule minimizes the sum of the social costs of both types of errors *and* the costs of administration. It is hard to imagine circumstances under which a price-cost rule detached from the modern economics of exclusion would do a better job in minimizing the costs of errors. While the exclusive dealing framework leaves considerable room for improvement, my own assessment of the relative merits of these two approaches to analyzing allegations that loyalty discounts exclude rivals is that the price-cost standard is simple, but wrong, whereas the exclusive dealing framework is more complex, but much more likely to point agencies and courts in the right direction.

I now turn to how the Federal Trade Commission has analyzed loyalty discounts in recent years.

III. Loyalty Discounts at the FTC

Over the years, the FTC has investigated a number of cases involving loyalty discounts, market-share discounts, or other partial exclusives. I want to highlight some variation in the Commission's approach in a handful of these cases to make the point that they appear to leave open the issue of whether the Commission endorses a price-

cost or exclusion-based approach to these contracts. To the extent that question has been left open, I endorse the exclusion-based approach.

a. McCormick & Co.⁶⁰

In 2000, the FTC charged McCormick with illegal price discrimination in violation of the Robinson-Patman Act and unfair methods of competition in violation of Section 5. McCormick & Co. was, and remains, the largest American producer of herbs, spices, and spice combinations. McCormick's supply agreements with supermarkets allegedly required the supermarket's shelf space to consist of a large percentage of McCormick products. In exchange, McCormick provided supermarkets with slotting payments, discounts, rebates, deductions, free goods, and other financial benefits, which increased upon the commitment of a specific share of shelf space to McCormick's products. In some cases, McCormick's shelf space share contracts specified that the retailer would provide 90 percent of its shelf space devoted to spices to the manufacturer.

I begin with *McCormick* because the Commission chose not to allege predatory pricing or exclusion. Rather, the FTC charged McCormick with Robinson-Patman Act and Section 5 violations. The FTC's chosen theory of harm was that McCormick's discriminatory pricing decreased disfavored retailers' capacity to compete against

⁶⁰ McCormick & Co., No. C-3939, 2000 WL 521741 (F.T.C. Apr. 27, 2000).

avored retailers. It did not allege that the discriminatory prices charged by McCormick were below cost and that McCormick had a reasonable prospect of recouping its losses.⁶¹ The Commission pointed to McCormick's market power and the fact that the discounts were conditioned upon the retailer's commitment to devote all or a substantial portion of shelf space to the McCormick line of products. However, the Commission did not allege the contracts were unlawful exclusive dealing arrangements under the antitrust laws. The consent order prohibited McCormick from discriminating in pricing its products absent a lawful defense.

b. Intel Corporation⁶²

In December 2009, the FTC filed a complaint against Intel Corporation ("Intel") alleging its loyalty discounts in the microprocessor and graphic processor markets violated the antitrust laws. The Commission's theory of competitive harm was based upon the raising rivals' cost framework. Specifically, the Commission alleged Intel's loyalty discounts provided original equipment manufacturers ("OEMs") with an incentive to purchase almost all of their microprocessors and graphic processor units ("CPUs" and "GPUs") from Intel, thus disadvantaging rivals by raising their costs, rendering them unable to achieve minimum efficient scale, and ultimately harming competition.

⁶¹ See, e.g., Joshua D. Wright, *Antitrust Law and Competition for Distribution*, 23 YALE J. ON REG. 169 (2006).

⁶² Intel Corp., No. 9341, 2010 WL 4542454 (F.T.C. Nov. 2, 2010).

Specifically, the Commission alleged Intel's various rebates deprived other chip manufacturers of the opportunity to compete for distribution, thereby deterring entry and expansion by rival manufacturers into the computer and graphical processor markets. The Commission alleged that "Intel entered into anticompetitive arrangements that were designed to limit or foreclose [manufacturers'] use of competitors' relevant products."⁶³ Intel allegedly "punished" OEMs that purchased products from Intel's chief rival, AMD, with higher prices, while rewarding OEMs who purchased all or nearly all of their requirements from Intel. Intel's loyalty discounts, the Commission alleged, had the effect of foreclosing competition in the microprocessor market to the detriment of consumers.⁶⁴

The Commission's allegations appear consistent with an analytical approach based upon a raising rivals' cost theory of exclusion. Elsewhere I have criticized the Commission's actions in pursuing the Intel case as well as the attendant consent decree.⁶⁵ I will not repeat those criticisms in detail here other than to note that they were based upon my view that available evidence during the time period in which

⁶³ Complaint ¶ 6, Intel Corp., No. 9341, 2010 WL 4542454 (F.T.C. Nov. 2, 2010), *available at* <http://www.ftc.gov/os/adjpro/d9341/091216intelcmpt.pdf>.

⁶⁴ *Id.* ¶ 7.

⁶⁵ See JOSHUA D. WRIGHT, AN ANTITRUST ANALYSIS OF THE FEDERAL TRADE COMMISSION'S COMPLAINT AGAINST INTEL (June 8, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1624943.

Intel's loyalty discounts were in operation was not consistent with the competitive theory of harm.

c. Transitions Optical⁶⁶

Transitions Optical Inc. ("Transitions") is a manufacturer of a popular brand of photochromic treatments for ophthalmic lenses. The treatments cause lenses to darken in response to exposure to sunlight. In response a rival's introduction of a competing product, and new entry into the production of these treatments by a vertically integrated rival, Transitions began to require exclusivity from lens casters and *de facto* exclusivity from retailers and wholesale labs.⁶⁷ The Commission alleged the practices effectively foreclosed perhaps as much as 85 percent of lens making capacity and more than 40 percent of the downstream wholesale and retail optical market from rival photochromic lens makers.⁶⁸

The Commission's approach relied heavily upon the estimated foreclosure percentages and the likelihood that the contracts deterred new entry or expansion by existing rivals. Here, again, it appears clear that the Commission's analytic approach to Transitions' exclusive and partially exclusive arrangements was consistent with the

⁶⁶ Transitions Optical, Inc., 149 F.T.C. 1281 (2010).

⁶⁷ For a more comprehensive description of this case, see Analysis to Aid Public Comment, Transitions Optical, Inc., 149 F.T.C. 1281 (2010) [hereinafter Analysis to Aid Public Comment], *available at* <http://www.ftc.gov/os/caselist/0910062/100303transopticalanal.pdf>.

⁶⁸ The FTC also examined but ultimately rejected the potential procompetitive efficiency rationales for Transitions' exclusive and partial exclusive contracts. *See* Transitions Optical, Inc., 149 F.T.C. 1281 (2010).

raising rivals' cost framework. The Commission also explicitly relied upon the exclusive dealing legal framework rather than any price-cost test to analyze the contracts at issue.⁶⁹

d. Church & Dwight⁷⁰

Church & Dwight ("C&D") is the marketer of Trojan brand condoms. C&D's shelf space share arrangements with distributors were challenged in private litigation and investigated by the FTC. I was C&D's economic expert in both cases, which were resolved before I joined the Commission. In the private litigation, rival condom marketer Mayer Labs, Inc. ("Mayer") alleged that C&D's planogram rebate program foreclosed competition from vital retail display space and hence the sale of condoms.⁷¹ Judge Chen in the Northern District of California rejected Mayer's arguments and granted C&D summary judgment, concluding that the planogram agreements did not substantially foreclose rivals and did not cause antitrust injury. C&D's planogram agreements involved a percentage rebate off its wholesale price in exchange for a retailer's commitment to devote a certain percentage of the condom shelf space to C&D's products. Judge Chen entertained three variations of the basic foreclosure

⁶⁹ See Analysis to Aid Public Comment, *supra* note 67, § II.

⁷⁰ Church & Dwight Co. v. Mayer Laboratories, Inc., 868 F. Supp. 2d 876 (N.D. Cal. 2012) *order vacated in part on reconsideration*, No. C-10-4429 EMC, 2012 WL 1745592 (N.D. Cal. May 16, 2012).

⁷¹ Mayer also alleged that C&D has engaged in other anticompetitive conduct, including abusing its position as category captain to exclude its rivals from, or at least disadvantage them in, the condom retail market. *See id.*

measure but ultimately held that each overestimated the competitive impact of the arrangements because they were of one year duration, easily terminable, and did not require retailers to allocate C&D any specified amount of shelf space.

The FTC investigation largely followed the contours of the private litigation, focusing on the competitive effects of C&D's tiered shelf space share contracts. The investigation was closed soon after Judge Chen's summary judgment decision was issued.⁷² I do not know whether the Commission's investigation pursued a theory of harm that contemplated that C&D's shelf space share agreements harmed competition via predatory pricing, raising rivals' costs-based exclusion, or something else.

This sample of modern loyalty discount and partial exclusive cases suggests the Commission sometimes – and in my view properly – evaluates these contracts with an eye toward whether they exclude rivals. In other words, the Commission appears more likely to adopt an exclusion framework than a price predation framework in its analysis of loyalty discounts – though the Commission's actions in McCormick and C&D suggest caution in confidently concluding the exclusion approach will be applied generally.

⁷² Closing Letter from Donald S. Clark, Sec., Fed. Trade Comm'n, to Carl W. Hittinger, Counsel, Church & Dwight Co. (June 25, 2012), *available at* <http://www.ftc.gov/os/closings/comm/120625churchdwightletter.pdf>.

IV. Conclusions

To sum up my remarks tonight, I want to re-emphasize that, in my view, exclusive dealing law is superior to price-cost legal standards for evaluating loyalty discounts. Raising rivals' costs and predation are two different economic paradigms of exclusionary conduct, and economic models within each paradigm establish the necessary conditions for each practice to harm competition and give rise to antitrust concerns. Loyalty discounts and other forms of partial exclusives such as market-share discounts and shelf space share contracts are properly analyzed under the exclusive dealing framework. Price-cost tests in the predatory pricing tradition are more problematic to administer in practice than their advocates suggest and, most importantly, simply do not comport with the underlying economics of exclusive dealing. Loyalty discounts – as with all hybrid conduct involving both price and non-price elements – present an interesting and complex challenge for antitrust law. They raise the important question of which legal test should apply to conduct involving both discounting and exclusivity. In my view, the correct answer ought to be a test that moves the legal and economic analyses of the underlying conduct closer together rather than further apart. The exclusive dealing framework – while it can be improved – does so. The predatory pricing framework does not. Finally, thus far, the FTC's recent approach to loyalty discounts has been more likely to apply an exclusion-based

framework than a price predation approach. I believe the Commission should consistently take that approach moving forward.

Thank you all for your time and attention tonight.

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