The Economics of Alternative Legal Standards for Loyalty Discounts

Benjamin Klein

UCLA and Compass Lexecon

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Should *predatory pricing* or *exclusive dealing* be the controlling legal standard for loyalty discounts?

- ZF Meritor v. Eaton (3^{rd} Cir. 2012) proposes a criterion:

  “[P]redatory pricing principles, including the price-cost test, would control if this case presented solely a challenge to Eaton’s pricing practices.”

- However, the Eaton contracts included:
  - preferential Eaton product listings in truck manufacturer data books (2 of 4 contracts had forms of exclusivity)
  - Eaton right to terminate the supply agreement if the truck manufacturer did not meet the contractually specified share (2 of 4 contracts)

- The court concludes that because “price itself was not the clearly predominant mechanism of exclusion,” exclusive dealing, not predatory pricing, is the applicable antitrust standard.

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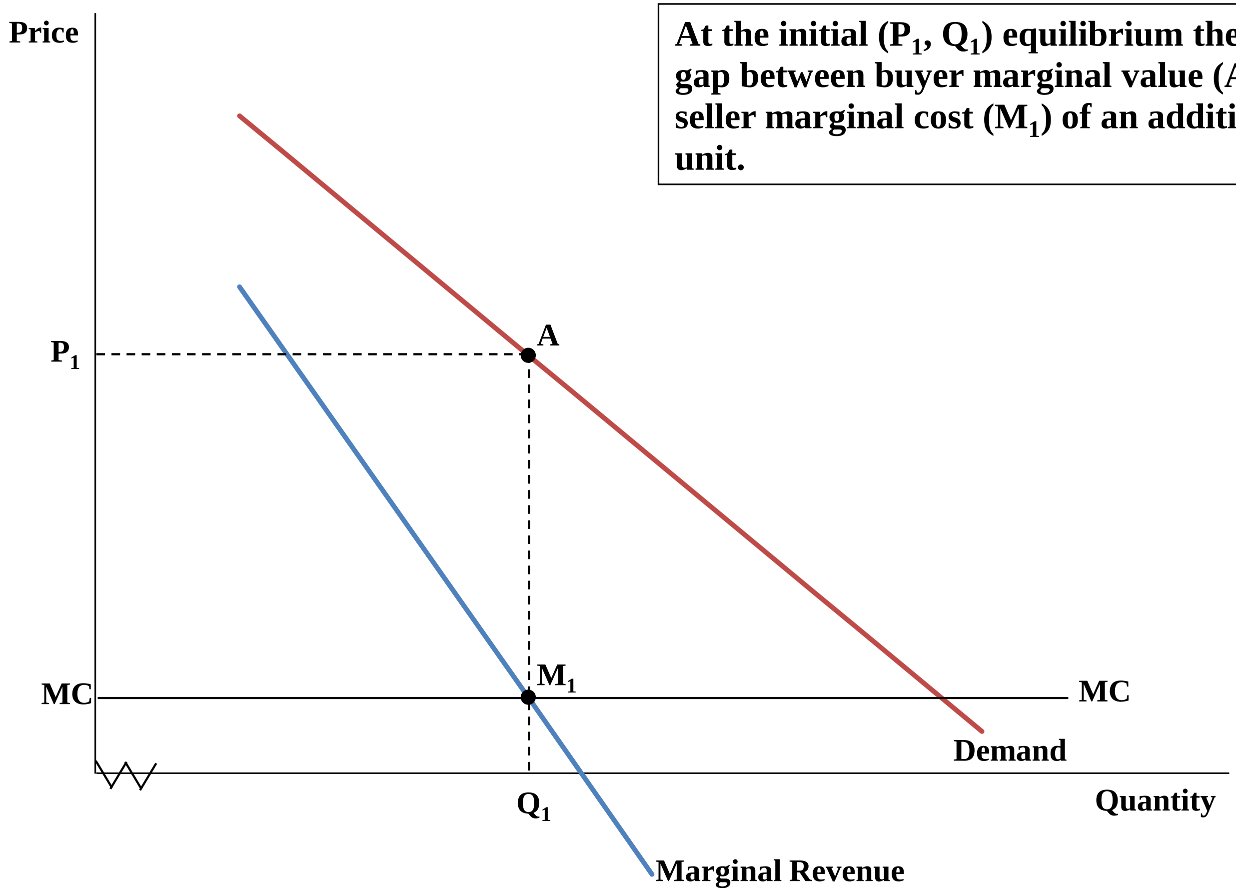
- First decision to apply the *Meritor* principle, Eisai v. Sanofi-Aventis (N.J. 2014), concludes that price discounts were the “predominant mechanism of exclusion.”
  - The court therefore uses the predatory pricing (Brooke Group) standard of price less than incremental cost as a necessary condition for liability and grants summary judgment for Sanofi.

- How does the court determine that price is the “predominant mechanism of exclusion”?
  - The “non-price” elements of the Eaton contracts are not present in Sanofi contracts.
  - However, the Sanofi contracts included formulary/promotional requirements, where non-Sanofi products could not have greater availability and restrictions could not be placed on Sanofi promotional programs.

- Interpreting the distinction in *Meritor* and *Eisai* regarding whether price discounts are the “predominant mechanism of exclusion” requires an understanding of the essential economics of loyalty contracts.

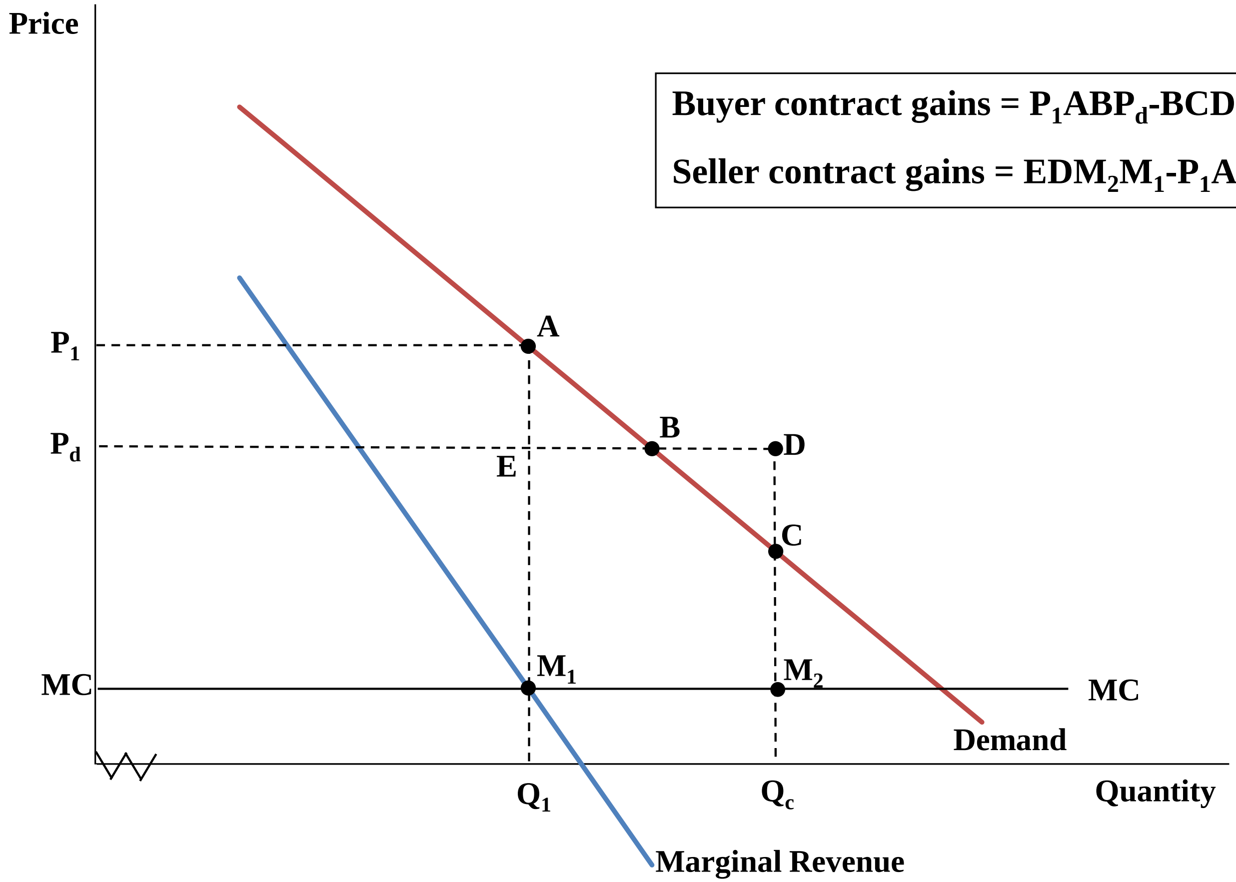
- Loyalty contracts, including contracts that include minimum distribution requirements in addition to sales share requirements, are commonly used as part of the normal competitive process when there is no possibility of exclusion.

Figure 1 – Unrealized Gains From Trade



At the initial (P_1, Q_1) equilibrium there is a gap between buyer marginal value (A) and seller marginal cost (M_1) of an additional unit.

Figure 2 – Contingent Loyalty Contract Creates Mutual Gains From Trade



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- Economic analysis of the contingent contract involves two fundamental economic questions:

  1. What are Eaton and Sanofi purchasing?

  2. How are Eaton and Sanofi paying for what they are purchasing?

- Answer to question 1:

  Eaton and Sanofi are contracting for buyer sales-shifting services

- Buyers have the ability to shift sales between suppliers by acting as the purchasing agent for their loyal consumers, thereby internalizing individual consumer purchase decisions.

  - Klein & Murphy, *Exclusive Dealing Intensifies Competition for Distribution*, ALJ (2008).
  - It is often efficient for buyer sales-shifting services to involve partial, rather than full, exclusivity to take account of customers with strong preferences.

- Answer to question 2:

  The compensation offered buyers for the provision of sales-shifting services may take many particular forms.

  - Price discounts, rebates, upfront payments, etc.

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- Distinguishing between contractual arrangements that involve price discounts and those that involve non-price terms, such as preferred product display restrictions, is confusing the two questions --

  - the form in which buyer sales-shifting services are contractually specified, which may include either or both minimum buyer purchase quantities and preferred distribution provisions (question 1), and

  - the form of the seller's payment for such sales-shifting services, which in all cases involves some form of price discounts (question 2).

- The key economic determinants of the form of contractual specification of buyer sales-shifting services are the ease of specifying and monitoring buyer sales-shifting efforts.

- Some sales-shifting contracts involve solely specification of sales-shifting services
  - Supermarket contracts often specify sales-shifting services in terms of the supply of preferred shelf space as a way to shift “impulse sales.”

- Contracts that solely specify preferred shelf space do not work for many products.

  Meritor:

  - Contrary to supermarkets, a particular shelf space location is not likely to have a large impact because of limited “impulse sales.”
  - Other important point-of-sale promotional efforts

  Eisai:

  - Variability in hospital administration of drug formulary

- Contracts that solely specify minimum buyer purchases are often an imperfect measure of buyer supply of sales-shifting services because of buyer variability in purchases “but-for” the supply of sales-shifting services.
  - Use sales share rather than a sales level to standardize across different sized buyers and changing market conditions.

- Because there is considerable remaining variability, non-quantity requirements are commonly included in the contract to prevent buyers from “selling sales-shifting services twice”
  - For example, consider a hospital with a large “but-for” share of Sanofi purchases.

- The essential antitrust economic question with regard to loyalty contracts is not whether the contract defines the buyer’s sales-shifting services in terms of minimum purchase shares and/or distribution requirements, but whether the contract amounts to an “all-or-nothing” exclusivity demand by the seller.

Two Types of “All-or-Nothing” Exclusivity Demands

- Contractual “all-or-nothing” exclusive

  - If the buyer does not meet the contracted for sales share or non-price restrictions (e.g., preferred product listings), does the firm refuse to deal with the buyer or does the buyer just lose the price discounts?
  - Sanofi contracts did not involve such refusal to otherwise deal terms, and the contracts were not so enforced.
  - Two Eaton contracts included an Eaton right to terminate, but were not enforced as a refusal to deal; did the buyers perceive a termination risk?

- Economic “all-or-nothing” exclusive

  - Even if the contingent contract is not contractually exclusive in a refusal to deal sense, the contract may be economically exclusive if the loyalty discounts that would be lost by not fulfilling either the minimum purchase quantity or preferred distribution contract terms are large enough.

- Attributed price-cost test may be used to determine economic exclusivity.

  - If the firm is setting an attributed price above its costs for the contestable sales induced by the loyalty and preferred distribution requirements, the contract may be considered non-exclusive in the sense that an equally efficient rival can compete for the contestable sales.

Eisai:

- The court infers from Eisai's 85% profit margins that the loyalty discounts did not amount to economic exclusive dealing.
- Moreover, the quantity evidence clearly indicates that Eisai had the ability to compete by increasing its discounts and winning hospital contracts.

Meritor:

- The decision recognizes that Eaton's (average?) prices were greater than its costs, but concludes it is not determinative because the agreement as a whole functioned as exclusive dealing.
- Contrary to Eisai, Meritor exited.

- When attributed price is less than cost, the economic analysis should proceed to an exclusive dealing analysis of the contingent contract.
  - It should not be a sufficient condition for antitrust liability. Cascade Health Solutions v. PeaceHealth (9th Cir. 2007)

- Do the minimum purchase quantities or preferred distribution requirements limit available sales so as to substantially foreclose the market?

- Alternative standard: Does the loyalty contract make it more difficult for rivals to compete?
  - Necessarily the case
  - More difficult for an individual rival v. demonstration of an anticompetitive market effect.

- As part of the exclusive dealing analysis we must recognize that loyalty contracts have procompetitive efficiencies in achieving gains from trade that make both the buyer and seller better off, with buyer gains likely passed on at least partially to consumers. Loyalty contracts therefore involve "competition on the merits."
  - These efficiencies of loyalty discounts are different from the standard efficiencies of exclusive dealing.

- One cannot assert that there are no benefits from the loyalty provision of the contract that cannot be obtained simply by reducing the non-contingent price; without the contingent loyalty provision the price would not be reduced.