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ROUNDTABLE ON FIDELITY REBATES

-- Note by the United States --

15-17 June 2016

This document reproduces a written contribution from the USA submitted for Item 6 of the 125th meeting of the OECD Competition Committee on 15-17 June 2016.

More documents related to this discussion can be found at http://www.oecd.org/daf/competition/fidelity-rebates.htm

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UNITED STATES

1. Introduction

1. There are several distinct pricing practices in business-to-business transactions in which a supplier's effective price to a particular customer is explicitly or effectively conditioned on the customer's cumulative purchases. This paper focuses on all-units share-based discounts that reduce the effective price paid on all units purchased if a target level of purchases is made, with the target specified as a percentage of the customer's total purchases within a specified product category over some time period. For example, a supplier might offer a discount if a customer makes 80% of its total 2016 purchases within a product category from that supplier. This paper uses the term "loyalty discount" to describe this practice, although elsewhere that term sometimes is applied to other sorts of discounts as well. Loyalty discount practices can have multiple targets and offer greater discounts for meeting higher targets.

2. This paper does not address ordinary volume discounts in which the price in a particular transaction depends on the transaction's size. Nor does it address cumulative volume discounts in which the discounted price only applies to purchases made after a purchase target is reached. Finally, this paper does not address retailer loyalty programs that reward consumers when a cumulative purchase milestone is reached. For example, the paper does not cover a loyalty program offering a free cup of coffee after the purchase of nine cups.

3. The U.S. antitrust agencies, the Department of Justice (Department) and the Federal Trade Commission (Commission) (collectively "the Agencies") are not aware of any data on the prevalence of loyalty discounts in the United States, but anecdotal evidence suggests that they are common in business-to-business dealings. The Agencies also are not aware of any data on the typical terms of U.S. loyalty discount arrangements. This paper focuses on the loyalty discounts that have been the subject of federal antitrust litigation[1] and is informed by the Agencies' June 2014 conditional pricing practices workshop.[2]

2. Basic Insights on the Use of Loyalty Discounts

4. A loyalty discount can induce a customer to purchase more by reducing the price that the customer pays for marginal units below the average price that the customer pays on all units. Simply reducing a single price charged on all units also can induce the customer to purchase more; however, a supplier likely can generate more revenue for a given quantity sold by using a pricing schedule with multiple prices and by reducing only the price for marginal units. With loyalty discounts, the same customer is effectively charged different prices on different units purchased, with the highest price

1 *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993), however, is not discussed below even though it involved all-units, retroactive rebates. The rebates were tied to volume rather than market share and were analyzed under the rubric of predatory pricing.

2 The details of the event, speakers' slides, a transcript, a video, and public comments are available on the agencies' websites: https://www.justice.gov/atr/events/public-workshop-conditional-pricing-practices; https://www.ftc.gov/news-events/events-calendar/2014/06/conditional-pricing-practices-economic-analysis-legal-policy.

charged on the first units. Suppliers might prefer loyalty discounts to alternative pricing practices with similar impact because a single schedule of targets and discounts can be applicable to all customers and can give all of them an incentive to increase their purchases from that supplier.

5. Loyalty discount practices have the potential to be exclusionary in much the same way that exclusive dealing can be exclusionary, and they have the potential to promote competition in much the same way that exclusive dealing can promote competition. As with exclusive dealing, loyalty practices can better align incentives of customers and suppliers, and thus promote cooperation between them. They also can stabilize sales and thereby facilitate suppliers' planning. And the use of loyalty discount contracts can intensify competition among suppliers, just as the use of exclusive contracts can.

6. The ways that loyalty discounts can intensify or weaken competition may be easiest to understand through an analogy to exclusive dealing. Suppose two competing suppliers offer a differentiated product to a downstream buyer at $100 per case, which exceeds the suppliers' marginal costs. Now suppose one supplier offers to sell its product to the buyer at a given price only if the buyer accepts an exclusive dealing contract. Given the supplier's exclusive contract offer, the buyer cannot purchase from both suppliers. This changes wholesale price competition because the suppliers are now effectively competing for the right to supply the buyer exclusively. If the positions of the suppliers are relatively symmetrical (that is, if the buyer values the differentiated products roughly equally), then competition for this right will be intense and the resulting wholesale prices will be less than $100. The winning (excluding) supplier may benefit from the exclusive contract even though the price falls because it will have captured a larger share of the buyer's purchases.

7. Loyalty discounts can operate in an analogous way. Suppose that instead of offering an exclusive contract, the seller offers a price and a loyalty discount conditioned on the buyer purchasing at least 90% of its needs from the discounting seller. If the rival seller pursues the same loyalty strategy, then the firms are essentially bidding for the right to supply 90% of the buyer's needs. Again, competition may be more intense than it would be if the loyalty discounts were not used, and prices may fall.

8. Under conditions different from those posited in the preceding two paragraphs, loyalty discounts (like exclusive dealing) can have anticompetitive effects. Suppose that loyalty discounts with a 90% share target are instituted by a supplier that is dominant in that every customer prefers to satisfy a portion of its needs (more than 10%) from that supplier and no customer has a similar preference for the rival supplier. In such a situation, the rival supplier might not be able to compete successfully simply by matching the dominant supplier's loyalty discount. In some examples, every customer would select the offer of the dominant supplier. Of course, the rival supplier may be able to make sales by cutting prices instead of adopting loyalty discounts, but the rival might be able to compete effectively only for a small portion of the buyer's total purchases. In this case, the discounted prices under the loyalty discount may be higher than the prices that would result if loyalty discounts were not used. The basic insight is that the competition induced by loyalty discounts for the 90% share will not be very intense if the smaller supplier is not well positioned to compete for such a large share of the business. The dominant supplier may benefit in this case both from capturing some of the smaller supplier's business, and from a higher price. The analogy between loyalty discounts and exclusive dealing in paragraph 6 carries over to this case as well. Exclusive dealing by a dominant supplier will not intensify competition if the smaller supplier is not well-positioned to compete for 100% of the business, and the dominant supplier may benefit from capturing some of the small supplier's business at potentially a higher price.

9. If customers prefer to divide their purchases among suppliers, loyalty discount practices, even when used by a dominant supplier, might not have much competitive impact because customers might be willing to forgo the discount to maintain multiple sources of supply. Of course, loyalty discounts with share targets well below 100% still could be used to capture marginal sales, and with targets exceeding 50%, each customer could qualify for a discount from just one supplier. But an

exclusionary effect would not necessarily follow because, for example, multiple suppliers could have customers meeting their market-share targets.

3. U.S. Antitrust Framework for Analyzing Loyalty Discounts

10. If a loyalty discount practice injures competition by unreasonably depriving rivals of sales, U.S. antitrust law can be used to challenge it. Section 1 of the Sherman Act prohibits agreements unreasonably restraining trade (and the practice would be seen to employ an agreement between the supplier and its customer); Section 2 of the Sherman Act prohibits monopolization; Section 3 of the Clayton Act prohibits discounts and rebates conditioned on not purchasing from a competitor when the effect may substantially lessen competition; and Section 5 of the Federal Trade Commission Act prohibits unfair methods of competition (including violations of Section 1 and 2 of the Sherman Act).

11. In both form and competitive impact, a loyalty discount practice can resemble exclusive dealing, at least when it has a high market share target. U.S. courts recognize that "[e]xclusive dealing can have adverse economic consequences by allowing one supplier of goods or services unreasonably to deprive other suppliers of a market for their goods."[3] U.S. courts have considerable experience in assessing the competitive impact of exclusive dealing arrangements.[4]

12. The first significant U.S. court decision on single-product loyalty discounts is *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8th Cir. 2000). The case concerned the pricing of engines used in recreational powerboats. Brunswick was the leading supplier, and for many years, it offered boat builders a loyalty discount of 1-3% depending on the percentage of their purchases satisfied by Brunswick engines. Boat builders filed suit, alleging that Brunswick's loyalty discount program violated Sections 1 and 2 of the Sherman Act. A jury found in favor of the plaintiffs and awarded damages, but the award was set aside. The appeals court held that, under Section 1 of the Sherman Act, the plaintiffs had "failed to produce sufficient evidence to demonstrate that Brunswick had foreclosed a substantial share of the . . . market through anticompetitive conduct." The court viewed Brunswick's conduct as "cut[ting] prices in order to attract additional business," which is "the very essence of competition" and "a normal competitive tool." When "a firm has discounted prices to a level that remains above the firm's average variable cost," the court held that the conduct could violate Section 2 of the Sherman Act, but the plaintiff failed to overcome the "strong presumption of legality."

13. Because loyalty discount practices use the prospect of ostensibly lower prices to incentivize sales, courts sometimes liken them to predatory pricing. Loyalty discounts, however, can exclude competition in a different way. Loyalty discounts can have an exclusionary effect even if the average price does not fall below an appropriate measure of cost. Indeed, a dominant supplier can earn a supra-competitive return on every customer while using a loyalty discount to deprive rivals of substantial sales.

14. In *ZF Meritor, LLC v. Eaton Corp.*, 696 F.3d 254 (3d Cir. 2012), the dominant supplier, Eaton, relied on long-term contracts to sell heavy-duty transmissions to truck manufacturers. The contracts provided for rebates based on market share targets of 65% to 98% and potentially required repayment of the rebates if customers did not meet the market share targets. Prior to Eaton's adoption of the long-term contracts, its primary rival, ZF Meritor, achieved a 30% market share, but its share

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3 *Jefferson Parish Hospital Dist. No. 2 v. Hyde*, 466 U.S. 2, 45 (O'Connor, J., concurring).

4 *See, e.g., id.* ("In determining whether an exclusive-dealing contract is unreasonable, the proper focus is on the structure of the market for the products or services in question—the number of sellers and buyers in the market, the volume of their business, and the ease with which buyers and sellers can redirect their purchases or sales to others."); *McWane, Inc. v. FTC*, 783 F.3d 814, 833-35 (11th Cir. 2015); *United States v. Dentsply International, Inc.*, 399 F.3d 181, 191-97 (3d Cir. 2005).

plummeted to 4% within five years following Eaton's adoption of its long-term contracts, and it then exited the market. ZF Meritor filed suit under Sections 1 and 2 of the Sherman Act and Section 3 of the Clayton Act, and a jury found in its favor. The central issue on appeal was whether the primary mechanism of exclusion was a pricing practice requiring proof that prices were below cost, or a combination of Eaton's price and non-price contract terms that, taken together, was subject to the effects assessment applied to exclusive dealing. The court observed that "when price is the clearly predominant mechanism of exclusion, . . . so long as the price is above-cost, the procompetitive justifications for, and the benefits of, lowering prices far outweigh any potential anticompetitive effects." However, the court held that the price-cost test used in predatory pricing cases was inappropriate because "this is not a case in which the defendant's low price was the clear driving force behind the customer's compliance with purchase targets, and the customers were free to walk away if a competitor offered a better price." The court held that Eaton's long-term contracts amounted to de facto exclusive dealing and determined that the evidence was sufficient for the jury to have found a substantial foreclosure effect.

15. A firm with market power might use a loyalty discount because lowering the price at the margin can add profitable sales without reducing profits on other sales. Just as a monopolist benefits from discriminating among customers, a firm with market power could benefit from discriminating among units sold to a given customer. Loyalty discounts used for this purpose may be procompetitive.

16. In *Eisai Inc. v. Sanofi-Aventis U.S., LLC*, No. 14-2017, 2016 WL 2600321 (3d Cir. May 4, 2016), the Third Circuit recently rejected antitrust claims predicated on market-share discounts for an anticoagulant drug. Sanofi, which had more approved uses for its anticoagulant than any rival, began offering discounts of 1-30% conditioned on its share of the customer's total purchases within the relevant therapeutic class, with the highest discount applying if a hospital both purchased over 75% of its anticoagulants from Sanofi and did not favor another anticoagulant. Eisai filed suit under Sections 1 and 2 of the Sherman Act and Section 3 of the Clayton Act. After discovery, Sanofi moved for summary judgment. The district court granted the motion, and the appeals court affirmed. Eisai argued that Sanofi's pricing unlawfully bundled contestable and incontestable demand for Sanofi's drug, but the courts found that Eisai failed to demonstrate the substantial foreclosure needed to support a claim of de facto exclusive dealing. The Third Circuit held: "Even if bundling of different types of demand for the same product could, in the abstract, foreclose competition, nothing in the record indicates that an equally efficient competitor was unable to compete with Sanofi." Although Sanofi's market share exceeded 80%, some customers bought most of their anticoagulants from Eisai, and Eisai's share more than doubled even in the face of Sanofi's loyalty rebates. The appeals court also found that Eisai failed to establish any incontestable demand for Sanofi's product. The appeals court declined to accept Sanofi's argument that Eisai's claim should be dismissed under the price-cost test applied in predatory pricing cases. The court was "not persuaded" that Eisai's claims fundamentally relate to pricing practices and did not address "when, if ever, the price-cost test [would] appl[y] to this type of claim."

17. Courts in the United States have adopted a discount-attribution price-cost test for bundled-discount cases.[5] While some commentators have suggested applying a version of this test in single-product loyalty discount cases, no U.S. court has done so, and there are good reasons not to. The suggested test compares the defendant's marginal cost to an implicit price calculated by allocating all of the discount a customer receives to just the "contestable volume"—what the defendant risks losing absent the loyalty discount. The discount-attribution test may prove difficult to apply in single-

5 *See Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883, 906 (9th Cir. 2008) (applying a discount attribution price-cost test to bundled pricing). S*ee also Masimo Corp. v. Tyco Health Care Group*, 350 F. App'x 95, 97 (9th Cir. 2009) (noting that *PeaceHealth* "le[ft] open the possibility that application of the discount attribution price-cost test may be inappropriate outside the bundled pricing context, for example, in tying or exclusive dealing cases" (internal quotation marks omitted)).

product cases due to complications in determining the contestable volume of sales and is unlikely to shed much light on the ultimate question of competitive effect.

18. Loyalty discounts are apt to fail the discount-attribution test only if the contestable sales volume is small, in which case the practice can have only a small foreclosure effect. And a loyalty discount failing the discount-attribution test might yield efficiencies. Perhaps more importantly, a loyalty discount practice passing the discount-attribution test still might have an exclusionary effect. If a dominant firm sets a high target for its loyalty discount, rivals could compete for just the remaining sales, but that low volume of sales could be insufficient to allow even one of them to operate profitably, given their fixed costs. Rivals could compete for all the contestable sales by undercutting the dominant firm's average unit price after the discount, but that too could be unprofitable given their fixed costs.

19. Loyalty discounts by dominant suppliers are sometimes said to raise rivals' costs. They could cause rivals to adopt a smaller scale of operations than they otherwise would, with correspondingly higher costs. Rivals' scale, however, often is determined before the dominant supplier adopts the loyalty discounts. Loyalty discounts by dominant suppliers could cause rivals to operate at a lower volume than they otherwise would and with higher marginal costs as a result. It may be the case, however, that marginal costs do not vary significantly with output once the scale of operations is chosen. Critically, an exclusionary effect from loyalty discounts depends on neither of the foregoing possibilities. Because they have fixed costs, rivals' average total costs increase when they are forced to sell a lower quantity. The fixed costs can be critically important because the inability to cover fixed costs when selling a lower quantity could force rivals to exit the market. Loyalty discounts can be unlawful under U.S. antitrust law even if rivals have not been forced to exit.

4. U.S. Agency Enforcement Actions Involving Loyalty Discounts

20. The Agencies have not adopted any particular legal test to identify anticompetitive loyalty discounts. The Agencies make enforcement decisions on the basis of detailed assessments of the specific facts and competitive conditions at issue.

21. In 2009, the Commission issued an administrative complaint alleging that Intel Corp. was violating Section 5 of the FTC Act by using a variety of unfair methods of competition, including market share discounts on PC central processing units (PC CPUs). Intel was the dominant producer of PC CPUs, with a share of over 75%. In 2010, the Commission settled the case through a consent order prohibiting Intel from, among other things, conditioning any benefit to a customer on the share of PC CPUs the customer purchased from Intel. The Commission's Analysis of Proposed Consent Order to Aid Public Comment explained that: "In a market such as this one, where the most realistic mode of competition by competitors to a monopolist involves their selling initially modest quantities to direct buyers who also buy large quantities from the monopolist, such conditioning can amount to a tax on the growth of such competition, and can enable the monopolist to sustain high prices at the same time as it limits competition and decreases consumer choice." [6]

22. In 2011, the Department filed a complaint in federal court alleging that United Regional Health Care System (United) violated Section 2 of the Sherman Act by penalizing commercial insurers if they also contracted with United's rivals. United operated the dominant hospital in Wichita Falls, Texas with a 90% share of inpatient hospital services sold to commercial insurers and a 65% share of outpatient surgery sold to commercial insurers. United offered contracts with a 25% discount off standard billing rates if the insurer contracted with it exclusively, and a 5% discount if they also contracted with one of United's small rivals. As a result, many insurers contracted exclusively with United, and the complaint alleged that the practice prevented entry and expansion by rivals and resulted in higher prices. United consented to a judgment prohibiting all conditional discounts. The Department's Competitive Impact Statement published with the proposed judgment explained that the

[6] 75 *Federal Register* 48338, 48343 (Aug. 10, 2010).

contracts "closely resemble *de facto* exclusive dealing arrangements," lack a "valid procompetitive business justification," and fail the discount-attribution price-cost test.[7]

23. Experience with loyalty discount practices in the United States has indicated that they can, in some instances, have anticompetitive effects and that the antitrust laws, by focusing on harm to competition, can deal with them. Experience has also indicated that antitrust analysis of any loyalty discount practice requires a thorough understanding of the particular facts. In determining whether to challenge a loyalty discount practice, the Agencies perform a detailed evaluation of the practice's actual or likely competitive effects.

7 76 *Federal Register* 13209, 13220 (Mar. 10, 2011).