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COMPETITION COMMITTEE**

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Working Party No. 3 on Co-operation and Enforcement

ROUNDTABLE ON BUNDLED AND LOYALTY DISCOUNTS AND REBATES

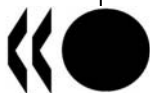
-- United States --

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The attached document is submitted by the United States to Working Party No. 3 of the Competition Committee FOR DISCUSSION under item III of the agenda at its forthcoming meeting on 10 June 2008.

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1. Introduction

1. This paper considers two forms of discounting that are ubiquitous throughout most developed economies - bundled discounting and single-product loyalty discounts¹. Generally they are efficient means of competing that do not raise antitrust concerns even if they may harm individual competitors at times. To the contrary, discounting of any type usually reflects the type of robust competition that the antitrust laws aim to foster. On the other hand, under certain assumptions, such discounting practices, when engaged in by a monopolist, may harm competition².

2. This paper considers the competitive implications of these practices in the context of United States case law and commentary. Because bundled pricing and single-product loyalty discounts involve related but somewhat different issues, they will be treated separately in the discussion that follows.

2. General legal framework regarding unilateral conduct

3. The United States does not have statutory provisions expressly dealing with bundled discounting and single-product loyalty discounting, as those terms have been defined for this Roundtable. The main statutory provision that addresses unilateral conduct, section 2 of the Sherman Act, does so generally, prohibiting monopolization and attempts to monopolize³.

4. Section 2 does not condemn monopoly itself; nor does it prohibit a firm from charging monopoly prices⁴. Indeed, the desire to reap the benefits of a lawfully obtained, dominant position induces firms to invest, innovate, and vigorously compete. That dynamic process is good for consumer welfare. Section 2 does bar anticompetitive *conduct* that improperly facilitates the acquisition or maintenance of monopoly power, or the dangerous probability of achieving monopoly power.

5. A basic problem, however, is this: it is often difficult to differentiate between “good” conduct, which constitutes aggressive competition and is to be encouraged, and “bad” conduct, which improperly facilitates the acquisition or maintenance of monopoly power and is to be condemned. As one leading antitrust authority has observed,

Aggressive, competitive conduct by any firm, even one with market power, is beneficial to consumers. Courts should prize and encourage it. Aggressive, exclusionary conduct is deleterious to consumers, and courts should condemn it. The big problem lies in this: competitive and exclusionary conduct look alike⁵.

¹ Bundled discounting refers to the practice of offering discounts or rebates contingent upon a buyer’s purchase of two or more different products. Single-product loyalty discounting refers to the practice of offering discounts or rebates on all units purchased of a single product conditioned on the level (or share) of purchases, i.e., the discounts or rebates apply to all units of the customer’s purchases of the product rather than just the units beyond the level (or share) of purchases needed to obtain them.

² See, e.g., Barry Nalebuff, *Exclusionary Bundling*, 50 Antitrust Bull. 321 (2005).

³ 15 U.S.C. § 2 (2000).

⁴ See, e.g., *Verizon Commc’ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 407 (2004).

⁵ Frank H. Easterbrook, *When Is It Worthwhile to Use Courts to Search for Exclusionary Conduct?*, 2003 Colum. Bus. L. Rev. 345, 345.

6. As the recently-completed Antitrust Modernization Commission (AMC)⁶ recommended, “[S]tandards for applying Section 2 of the Sherman Act’s broad proscription against anticompetitive conduct should be clear and predictable in application, administrable, and designed to minimize overdeterrence and underdeterrence, both of which impair consumer welfare.”⁷

3. Bundled and single-product loyalty discounts and rebates

7. As a leading antitrust treatise has stated, “Discounting is presumptively precompetitive and should be condemned only in the presence of significant market power and proven anticompetitive effects.”⁸ As with section 2 in general, the challenge in this area is thus to determine when bundled and single-product loyalty discounts and rebates are anticompetitive rather than beneficial to competition.

3.1 Bundled Discounting

8. The practice of sellers offering discounts contingent upon a buyer’s purchase of two or more different products is very common and generally benefits consumers. For example, restaurants often offer diners a choice between a la carte items and complete meals priced at a discount compared to a la carte. Or a telecom company may offer a package of multiple services at a reduced price. Generally, such package discounting is viewed as an efficient means of competing that raises no antitrust concerns. Bundled discounting can allow businesses to achieve economies of scope, save packaging costs, reduce transaction costs, induce existing customers to try new product or service offerings, and give retailers incentives to promote particular products and services. The benefits of bundled discounting, and the frequency of its use by firms with no market power, lead some commentators to conclude that similar consumer benefits are likely to result from bundled discounting when employed by firms with significant market power.

9. Commentators also point to strategic but non-exclusionary purposes that may underlie bundled discounting. In particular, firms may use bundled discounting to price discriminate among consumers who value goods differently, a practice that can increase output and benefit consumer welfare:

In brief, bundling may take advantage of the fact that different customers have different demand elasticities for individual goods. By bundling them and selling them at a single bundled price the seller can capture larger amounts of consumers’ surplus from customers. In the process, output can go up as well, and production and distribution costs can decline⁹.

10. Where a seller has market power in at least one of the products offered, however, bundled discounts (or bundled rebates) may, under certain circumstances, generate anticompetitive effects. Distinguishing anticompetitive from procompetitive bundled discounts, however, has proven difficult. Indeed, there is limited agreement on the theory of potential harm. Is the harm essentially that of predatory

⁶ The AMC was established by Congress “to examine whether the need exists to modernize the antitrust laws and to identify and study related issues” and to prepare and submit to Congress and the President a report containing “a detailed statement of the findings and conclusions of the Commission, together with recommendations for legislative or administrative action the Commission considers to be appropriate.” Antitrust Modernization Commission Act of 2002, Pub. L. No. 107-273, §§ 11053, 11058, 116 Stat. 1856, *amended by* Antitrust Modernization Commission Extension Act of 2007, Pub. L. No. 110-6, 121 Stat. 61.

⁷ Antitrust Modernization Comm’n, Report and Recommendations 88 (2007), *available at* http://govinfo.library.unt.edu/amc/report_recommendation/amc_final_report.pdf.

⁸ 3 Phillip E. Areeda & Herbert Hovenkamp, Antitrust Law § 749b, at 245 (Supp. 2007) (referencing *id.* §§ 739-40 (2d ed. 2002)).

⁹ *Id.* § 749b2, at 263-64.

pricing? If so, then as long as the post-discount price of the bundle exceeds its cost, there would be no harm. But others have suggested that consumer welfare may be harmed even when the bundled price is not predatory. As the Agencies recently observed,

*A bundled rebate or discount can—under certain theoretical assumptions—exclude an equally efficient competitor, if the competitor competes with respect to but one component of the bundle and cannot profitably match the discount aggregated over the other products, even if the post-discount prices for both the bundle as a whole and each of its components are above cost.*¹⁰

11. Consequently, some have suggested that the effects of bundled discounting, and thus the exclusionary theory, may more closely resemble tying, and should be analyzed accordingly.

12. Although there is general agreement that bundled discounting by a monopolist *can* be anticompetitive, there is less consensus on *how likely* that is. The Supreme Court has not yet rendered a bundled-discounting decision, and challenges to this conduct have all been private treble damage cases. Courts and commentators have been grappling with the question of how a court—and even more importantly, a business deciding whether to offer bundled discounting—should go about determining whether a particular bundled discount is anticompetitive¹¹. There are only a few federal court decisions analyzing bundled discounts under section 2, and the standards they have used are not entirely consistent.

13. Any such standards need to address the core elements of any section 2 violation: whether the conduct actually harmed competition or is likely to harm competition and not merely competitors; and whether the conduct is justified as competition on the merits, or by some other valid business rationale that is not outweighed disproportionately by harm to competition. In addition, standards need to be not only judicially administrable but also readily applicable by businesses based on information available to them at the time they are making pricing decisions.

3.1.1 Cost-based Standards

14. Most, but not all, of the federal court decisions, as well as the recent Antitrust Modernization Commission, have suggested that some type of objective cost-based standard be applied in evaluating bundled discounts. An issue arises in applying a cost-based test as to which prices and costs need to be compared.

- Total Bundle Predation-Based Test

15. Some have argued that the normal rule for predatory pricing should be applied with reference to the defendant's price and cost for the entire bundle¹². In the United States, the Supreme Court set forth the rule for predatory pricing of a single product in its *Brooke Group* decision¹³. Under this standard, the

¹⁰ Brief for the United States at Amicus Curiae at 13, *3M v. LePage's Inc.*, 542 U.S. 953 (2004) (No. 02-1865), *denying cert. to* 324 F.3d 141 (3d Cir. 2003).

¹¹ See, e.g., Areeda & Hovenkamp, *supra* note 8, § 749b2; 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); Patrick Greenlee et al., *An Antitrust Analysis of Bundled Loyalty Discounts* (Econ. Analysis Group Discussion Paper No. 04-13, 2006); Timothy J. Muris, *Antitrust Law & Economics: Exclusionary Behavior and Bundled Discounts* (Nov. 29, 2006); Barry Nalebuff, *Bundling As a Way to Leverage Monopoly* 24 (Yale Sch. of Mgmt., Working Paper No. ES-36, 2004).

¹² See, e.g., Muris, *supra* note 11.

¹³ *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

defendant could not violate section 2 if the price of the bundle of products exceeds the appropriate measure of the defendant's cost for the entire bundle. This is the least restrictive of the approaches commonly discussed - the one that would allow firms the greatest latitude in pricing bundles. The main virtues of this test are its simplicity and predictability, and the unlikelihood that it will lead to deterring precompetitive behavior; proponents of this test see these virtues as outweighing the risk of possibly missing some anticompetitive behavior.

16. Some have suggested applying such a total bundle predation-based test only in instances in which it is likely that other significant rivals would offer a comparable bundle¹⁴. Where such bundle-to-bundle competition is possible - whether because an individual competitor itself can provide all the products in the bundle, multiple competitors can team together to provide their own bundle, or sophisticated customers could assemble their own bundles - equally efficient competitors (alone or together) would be able to match an above-cost bundled price.

- “Equally Efficient Competitor” and “Discount Allocation” Concepts

17. A number of courts and commentators have sought to develop legal standards that reflect the possibility that a monopolist's bundled discounting could pass a predation-based test applied to the entire bundle and still exclude an equally efficient producer of one or more products in the bundle.

18. For example, in one of the earliest cases involving bundled discounts, *SmithKline Corp. v. Eli Lilly & Co.*¹⁵, the court appeared to focus on whether Lilly's use of bundled rebates could exclude an equally efficient competitor. Prior to SmithKline's entry into the market, Lilly had used a volume rebate plan to sell four patented antibiotics known as cephalosporins to nonprofit hospitals. When SmithKline licensed Ancef, a fifth cephalosporin, from a foreign firm and sold it in competition with Lilly's market-dominating Keflin, Lilly responded by licensing the same drug and selling it as Kefzol. Lilly then modified its rebate plan by simultaneously reducing the rebate offered by roughly three percent and adding a “bonus dividend” of three percent provided that the hospital bought specified minimum quantities of *three* cephalosporins. Lilly expected that hospitals would meet the target on its *two* most dominant cephalosporins, and that hospitals would have to purchase the minimum quantities specified for Kefzol in order to qualify for the bonus dividend. SmithKline would have to offer a rebate of more than twenty percent on its one product in order to match the “inducement” offered by Lilly's bundled rebate. Even if SmithKline were able to lower its costs to Lilly's level, SmithKline's drug would never be sufficiently profitable to justify remaining in the market. Thus, the court concluded that Lilly violated section 2 when it used its monopoly power in two products to exclude the “slightly less efficient” SmithKline from the market for the competitive product because the bundled rebates would have excluded SmithKline even if it were an equally efficient producer. Neither the district court nor the appellate court appeared to consider whether Lilly sold each of its products at a price above its average cost.

19. About twenty years after *SmithKline*, a different federal court analyzed a somewhat similar bundled-pricing plan by also applying the equally efficient competitor concept, but found that it did not violate section 2. In *Ortho Diagnostic Systems*¹⁶, blood donor centers (BDCs) required five “assays” used to test blood for various viruses, and only defendant Abbott made and sold all five. It had seventy to ninety percent of sales of four of them. The Council of Community Blood Bank Centers solicited bids on a contract to supply assays to member BDCs, asking for different pricing schedules depending on whether the BDC bought all the assays from the chosen seller. Abbott won the contract with pricing schedules that

¹⁴ See Areeda & Hovenkamp, *supra* note 8, § 749b, at 245-46, 258-59.

¹⁵ 427 F. Supp. 1089 (E.D. Pa. 1976), *aff'd*, 575 F.2d 1056 (3d Cir. 1978).

¹⁶ *Ortho Diagnostic Sys., Inc. v. Abbott Labs.*, 920 F. Supp. 455 (S.D.N.Y. 1996).

gave significant discounts on each of the assays for buying all of them from Abbott. Particularly because, as a practical matter, BDCs had to buy at least two of the assays from Abbott, the discount plan created a very significant incentive to buy all five from Abbott and none from Ortho.

20. The court, drawing on *SmithKline*, noted that the key question “is whether a firm that enjoys a monopoly on one or more of a group of complementary products, but which faces competition on others, can price all of its products above average variable cost and yet still drive an equally efficient competitor out of the market.”¹⁷ The court held that “pricing that could drive a more efficient competitor from the marketplace” is the standard “which separates legitimate from illegitimate competition.”¹⁸ Thus, said the court, a plaintiff “must allege and prove either that (a) the monopolist has priced below its average variable cost or (b) the plaintiff is at least as efficient a producer of the competitive product as the defendant, but that the defendant’s pricing makes it unprofitable for the plaintiff to continue to produce” the product¹⁹. Because Ortho did not claim that it could not sell its products at a profit as a result of Abbott’s bundled discounting, the district court found no section 2 violation.

21. Accordingly, some, including a leading antitrust treatise²⁰ and the most recent circuit court decision on bundled discounting²¹, have suggested a “discount allocation” or “discount attribution” approach, in which all of the discounts offered by the defendant for the bundle should be attributed to the competitive product(s) (i.e., the product(s) for which the defendant does not have market power). The resulting imputed price for the competitive product(s) would then be compared against the defendant’s costs for the product(s)²².

- The AMC Test’s Use of a Discount Allocation Safe Harbor

22. The Antitrust Modernization Commission proposed a three-part test for bundled discounts, requiring a plaintiff in a section 2 case to show:

*(1) after allocating all discounts and rebates attributable to the entire bundle of products to the competitive product, the defendant sold the competitive product below its incremental cost for the competitive product; (2) the defendant is likely to recoup these short-term losses; and (3) the bundled discount or rebate program has had or is likely to have an adverse effect on competition*²³.

¹⁷ *Id.* at 467.

¹⁸ *Id.* at 468 n.16.

¹⁹ *Id.* at 469. While the Ortho decision focuses on whether plaintiff was actually an equally efficient competitor, most other decisions and commentary properly suggest that the focus should instead be on whether a hypothetical equally efficient competitor could meet the defendant’s discount.

²⁰ Areeda & Hovenkamp, *supra* note 8, § 749b2, at 246 (supporting a discount allocation safe harbour in instances in which no significant rivals offer the same package); *cf. id.* at 258-59 (explaining that the package might be offered through implicit or explicit coordination of two or more firms).

²¹ Cascade Health Solutions v. PeaceHealth, 515 F.3d 883 (9th Cir. 2008).

²² See, e.g., Virgin Atl. Airways Ltd. v. British Airways PLC, 69 F. Supp. 2d 571 (S.D.N.Y. 1999), *aff’d*, 257 F.3d 256 (2d Cir. 2001) (citing *Ortho* as holding “that there would be an antitrust violation if the competitive product in the bundle were sold for a price below average variable cost after the discounts on the monopoly items in the bundle were subtracted from the price of that competitive product”).

²³ Antitrust Modernization Comm’n, *supra* note 7, at 99.

23. The AMC thus suggests employing a “discount attribution” or “discount allocation” approach, but only as a safe harbor in analyzing bundled discounting by a monopolist and not as the standard for liability.

24. The principal U.S. court decision addressing this issue since the issuance of the AMC proposal is the Ninth Circuit’s decision in *PeaceHealth*²⁴. The court relied in part on the AMC approach in adopting a discount allocation standard for evaluating bundled discounts. Under that standard,

*the full amount of the discounts given by the defendant on the bundle are allocated to the competitive product or products. If the resulting price of the competitive product or products is below the defendant’s incremental cost to produce them, the trier of fact may find that the bundled discount is exclusionary for the purpose of § 2*²⁵.

25. The court explained that “this standard makes the defendant’s bundled discounts legal unless the discounts have the potential to exclude a *hypothetical* equally efficient producer of the competitive product.”²⁶

26. PeaceHealth and McKenzie (the predecessor to Cascade Health Solutions) were competing providers of primary and secondary acute-care hospital services. PeaceHealth also provided tertiary care services in which it had a very high market share (upwards of ninety percent in certain sub-specialities). McKenzie did not provide tertiary care services. McKenzie, which asserted that it could provide primary and secondary care services at a price lower than PeaceHealth’s prices for those services, brought monopolization and attempted monopolization claims against PeaceHealth based on evidence that PeaceHealth offered bundled service packages to some customers (insurance companies), which provided discounts on all services if the customers made PeaceHealth their sole preferred provider for primary, secondary, and tertiary care.

27. In analyzing PeaceHealth’s bundled offerings, the Ninth Circuit rejected the non-cost-based approach of *LePage’s*²⁷, discussed below, explaining that “a fundamental problem . . . is that it concludes that all bundled discounts offered by a monopolist are anticompetitive with respect to its competitors who do not manufacture an equally diverse product line” and that it fails to consider whether such discounts may be procompetitive²⁸. The Ninth Circuit also noted that the Supreme Court, which in *Brooke Group*²⁹ and *Weyerhaeuser*³⁰ applied a cost-based test to predatory-pricing and predatory-bidding claims,

²⁴ *PeaceHealth*, 515 F.3d 883.

²⁵ *Id.* at 906.

²⁶ *Id.* The Ninth Circuit criticized *Ortho*’s requirement that plaintiff demonstrate *it* is an equally efficient producer of the competitive product and that defendant’s discount would require it to charge a price below its costs to compete. The Ninth Circuit explained that this element of the test would require firms that are considering offering a bundled discount to know their competitors’ costs, information firms likely will not have, and thus the test did not offer adequate guidance to sellers who wish to offer precompetitive bundled discounts.

²⁷ *See id.* at 903.

²⁸ *Id.* at 899.

²⁹ *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

³⁰ *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co.*, 127 S. Ct. 1069 (2007).

respectively, “forcefully suggested that we should not condemn prices that are above some measure of incremental cost.”³¹

28. In crafting its cost-based discount allocation standard for evaluating bundled discounts, the Ninth Circuit rejected PeaceHealth’s proposed “aggregate discount” rule, which would have allowed for liability only in those cases in which the discounted price of the *entire bundle* is below defendant’s incremental cost to produce the *entire bundle*. The court reasoned that this test fails to recognize that bundled discounts can serve to exclude an equally efficient competitor that produces fewer products than defendant (even where defendant’s prices are above cost for the entire bundle), because the competitor may not be able to match in one product category the aggregate discount defendant offers across all its product lines.

3.1.2 Non-cost-based standards

29. The 2003 *LePage’s* decision³² represents the principal departure from using objective, cost-based standards as part of the assessment of the legality of bundled discounts under section 2. In *LePage’s*, a manufacturer of “private label” transparent tape charged that 3M maintained a monopoly in the market for transparent tape through, among other means, a bundled rebate program for large retail chains. That rebate program conditioned certain discounts on retail customers meeting multiple target growth rates for their purchases of 3M products in diverse product lines such as home care products, home improvement products, and stationery products. The rebate program allegedly shifted purchases away from LePage’s private label tape and towards 3M’s branded and private label tape, because, if a customer failed to meet its target for purchases of 3M’s tape, the customer would lose the rebate on multiple products. To defeat this shift, LePage’s alleged, it would have to compensate the purchaser for the loss of rebates across product lines, not just for the loss of tape-specific rebates. The jury found liability for monopoly maintenance after hearing LePage’s evidence that bundled rebates and other conduct forestalled competition to 3M’s high-priced Scotch brand tape from LePage’s private label tape and thereby helped to maintain 3M’s transparent tape monopoly.

30. The Third Circuit ultimately affirmed the trial court’s judgment in favor of the plaintiff in an en banc decision. Notably, the court did not require LePage’s to prove that either it or a hypothetical equally efficient (as 3M) competitor could not meet the discount without pricing below cost. And once LePage’s showed that 3M’s bundled discount made it difficult for LePage’s to compete, the burden seemingly shifted to 3M to show cost savings approaching the total amount of the discounts.

31. The Supreme Court denied certiorari. The brief for the United States³³ had urged that certiorari be denied because of deficiencies in the record and to allow further case law development and academic analysis of bundled rebates. It did, however, criticize the Third Circuit’s decision for providing little guidance on how section 2 should be applied to bundled rebates, failing to explain why 3M’s conduct was unlawful, and perhaps encouraging challenges to (and therefore chilling the adoption of) procompetitive bundled rebate programs. Similar criticisms of *LePage’s* have been voiced by many others³⁴.

³¹ *PeaceHealth*, 515 F. 3d at 901.

³² *LePage’s Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003) (en banc).

³³ United States, *supra* note 10, at 13.

³⁴ See, e.g., Antitrust Modernization Comm’n, *supra* note 7, at 97 (criticizing the *LePage’s* decision as “too vague and therefore... likely to chill welfare-enhancing bundled discounts or rebates”); Daniel L. Rubinfeld, *3M’s Bundled Rebates: An Economic Perspective*, 72 U. Chi. L. Rev. 243, 250-51 (2005) (noting a “striking” lack of clarity in the *LePage’s* opinion and that in the absence of clear guidance “legitimate marketing practices may be discouraged”); see also *PeaceHealth*, 515 F.3d 883, 899-903 (rejecting *LePage’s* because it seemingly would find all bundled discounts by a monopolist to be

3.1.3 *Safe Harbors*

32. As discussed above, the AMC and others have proposed using the discount allocation test not as a standard of liability but rather as a safe harbor. It is important to recognize that use of a safe harbor in antitrust analysis can be counterproductive if businesses or courts improperly assume that failing to come within the safe harbor creates a presumption of anticompetitive conduct. In particular, a monopolist defendant's failing to come within the discount allocation safe harbor should indicate only that an equally efficient single-line competitor would be unable to compete for sales *to customers who buy both the monopoly product and the competitive product* (who are getting the benefit of the discount) - it does not by itself indicate harm to consumers in either market.

3.1.4 *Conclusions*

- The Need for Clear, Administrable Standards

33. While a monopolist offering bundled discounts or rebates *may*, in certain circumstances, produce anticompetitive effects, pricing that benefits consumers may be inhibited by legal uncertainty. Clear and administrable standards are needed to enable firms to know in advance if bundled discounting that they are considering may subject them to antitrust liability. The development of clear, administrable standards for analyzing bundled discounts would be furthered by use of an appropriate price-cost safe harbor.

- Use of Price-Cost Safe Harbors

34. The particular price-cost safe harbor that should be used depends at least in part on whether bundle-to-bundle competition is reasonably possible. If so, potential competitive harm mirrors predatory pricing, and a price-cost safe harbor could look to whether the discounted price of the bundle exceeds an appropriate measure of cost of the products constituting the bundle.

35. Where bundle-to-bundle competition is not reasonably possible, potential competitive harm more closely resembles the harm that can arise from tying. Such harm *may* exist in instances in which the bundled pricing would cause customers to take the monopolist's bundle instead of taking the competitive product from an equally efficient competitor. The "discount allocation" safe harbor suggested by the AMC and Professor Hovenkamp is a screen for whether such consequences are possible. The discount allocation safe harbor compares an appropriate measure of the defendant's cost for the competitive product (or products) in a bundle to the imputed price of that product (or products), which is the price after allocating all discounts and rebates attributable to the entire bundle to the competitive product (or products).

36. If the conduct falls outside a safe harbor, further analysis is required. Failure to come within the safe harbor should not create a presumption of anticompetitive effects. No bundled discounting should be condemned without an adequate showing of actual or probable harm to competition. In this regard, significant considerations include whether the plaintiff can show that rivals have exited or are exiting the market as a result of the challenged discounts. Further, a proven explanation for a bundled discount that does not depend on exclusion of rivals should defeat a section 2 challenge to the bundled discount unless the anticompetitive harms are significantly disproportionate to the benefits flowing from the proven explanation.

anticompetitive with respect to rivals who do not manufacture an equally diverse array of products and it fails to recognize that such discounts may be precompetitive, and further concluding that *LePage's* is inconsistent with the Supreme Court's *Brooke Group* and *Weyerhaeuser* decisions, which applied a cost-based test to predatory-pricing and predatory-bidding claims, respectively).

3.2 *Single-product loyalty discounts*

37. Compared to the voluminous legal and economic commentary analyzing bundled discounting (and other unilateral conduct, such as predatory pricing and tying), there has been relatively little commentary regarding single-product loyalty discounting - the practice of offering discounts or rebates on all units purchased of a single product conditioned upon the level (or share) of purchases.

38. Those who have addressed this subject generally agree that such discounts are most often procompetitive: for example, a manufacturer may use these discounts to induce retailers to provide increased brand support, or such discounts may be a way to compete for the most desirable customers. There is also consensus that, as with standard predatory pricing, these discounts can be anticompetitive where they bring the total price on all units sold to a customer below an appropriate measure of cost and there is the likelihood of recoupment. Some commentators have further posited that single-product loyalty discounts that are above cost when measured against all units sold to a customer can in theory be anticompetitive where a monopolist's customers must carry a certain percentage of the leading firm's products and the discount is structured so as to induce purchasers to buy all or nearly all needs beyond that "uncontestable" percentage from the monopolist³⁵.

39. Although there is general agreement that a monopolist's above-cost (on all units sold to a customer) single-product loyalty discounts *can*, under certain circumstances, be anticompetitive, there again is no consensus on *how likely* that is. Further, there are questions as to how a court should go about determining whether a particular single-product loyalty discount is anticompetitive and, even more importantly, how a business deciding whether to offer such a discount can know ahead of time whether it will be deemed illegal.

3.2.1 *Court Decisions*

40. As with bundled discounting, no single-product loyalty discount antitrust case has yet reached the Supreme Court, and the challenges to this conduct have all been private treble damage cases. The three cases that have thus far resulted in appellate decisions illustrate both the importance of factual evidence of an anticompetitive effect (rather than simply of an effect on a competitor) and the substantial judicial concern about deterring beneficial price cuts. These cases seem to accept that such discounting should be judged under some type of price-cost test, even if they do not conclusively establish precisely what that test should be.

41. The earliest case, *Barry Wright Corp. v. ITT Grinnell Corp.*³⁶, involved the market for "snubbers" used in nuclear power plants. Pacific Scientific had most of the market for snubbers (about 83%) because it was the only acceptable producer of mechanical snubbers for U.S. nuclear plants. Grinnell, which accounted for about half of snubber purchases had been trying to help the plaintiff Barry Wright become an alternative source. Pacific then offered Grinnell a large discount if it would agree to purchase large quantities of snubbers—the specified amounts constituted most, but not all, of Grinnell's anticipated purchases over a two-year period. Grinnell agreed, and Barry Wright subsequently abandoned its attempt to enter the market and sued, alleging that the discount was unlawful under section 2.

³⁵ See, e.g., Willard K. Tom et al., *Anticompetitive Aspects of Market-Share Discounts and Other Incentives to Exclusive Dealing*, 67 Antitrust L.J. 615, 627 (2000) (arguing that discounts can be used to achieve total or partial exclusivity where a "dominant firm is so well established among ultimate consumers that its consumers... have a base, inelastic demand for the firm's products").

³⁶ 724 F.2d 227 (1st Cir. 1983).

42. Both the district court and the court of appeals rejected the claim. In the First Circuit opinion, then judge (now U.S. Supreme Court Justice) Breyer explained that under conventional price-cost tests for predatory pricing, Pacific's discount was not predatory in that the resulting price was above any relevant measure of Pacific's cost, and that the theoretical possibility that such prices could harm competition did not justify the risk of deterring procompetitive price cutting by entertaining that possibility in litigation. As the court cautioned:

"[U]nlike economics, law is an administrative system the effects of which depend upon the content of rules and precedents only as they are applied by judges and juries in courts and by lawyers advising their clients. Rules that seek to embody every economic complexity and qualification may well, through the vagaries of administration, prove counter-productive, undercutting the very economic ends they seek to serve. . . . [W]e must be concerned lest a rule . . . that authorizes a search for a particular type of undesirable pricing behavior end up by discouraging legitimate price competition³⁷."

43. In the second of the cases, *Concord Boat Corp. v. Brunswick Corp.*³⁸, several boat builders challenged Brunswick's discount program on stern drive engines. Brunswick manufactured and sold the engines for recreational boats and had a large market share (about 75%). Beginning in the early 1980s, Brunswick (like its competitors) offered market-share discounts. Boat builders who agreed to buy a certain percentage of their engine requirements from Brunswick for a certain period received a discount off the list price for *all* engines purchased. Because the boat builders' customers preferred Brunswick engines, the boat builders arguably had to purchase a significant percentage of their engine needs from Brunswick; nevertheless the discounts might well have led them to purchase higher quantities from Brunswick than they otherwise would have. There was, however, evidence that at least two customers who had purchased more than 80% of their engines from Brunswick switched to a competitor for more than 70% of their purchases.

44. The court of appeals reversed a jury verdict in favor of the plaintiff. While the court did not quite state that the plaintiff's failure to show that Brunswick's prices were below cost was determinative, it relied on a strong presumption that prices above cost are lawful. It found nothing to overcome that presumption, particularly since the agreements were not exclusive-dealing agreements (buyers could purchase 40% of requirements from other sellers while still receiving loyalty discounts from Brunswick) and other engine sellers could compete with Brunswick by offering better discounts. While Brunswick offered testimony that the discounts served procompetitive purposes (beyond simply lowering prices) by increasing predictability of demand and thus lowering manufacturing costs, the court of appeals did not rely on this evidence, instead stating that "Brunswick's business justification . . . is that it was trying to sell its product by cutting prices³⁹."

45. *Virgin Atlantic Airways Ltd. v. British Airways PLC*⁴⁰ also involved an unsuccessful challenge to a first-dollar discount program. British Airways provided incentive programs that provided travel agencies with commissions, and corporate customers with discounts, for meeting specified thresholds for sales of BA tickets which applied to all sales, not just those beyond the target threshold. Virgin claimed that the result was below-cost pricing on certain transatlantic routes where it and BA competed.

³⁷ *Id.* at 234.

³⁸ 207 F.3d 1039 (8th Cir. 2000).

³⁹ *Id.* at 1062.

⁴⁰ 69 F. Supp. 2d 571 (S.D.N.Y. 1999), *aff'd*, 257 F.3d 256 (2d Cir. 2001).

46. Both the district court and the court of appeals concluded that Virgin failed to show below-cost pricing. Virgin's expert had assumed that the incentive agreements had generated additional flights to carry increased passenger load, and compared the incremental costs of those flights with the revenues they generated. The courts, however, were not sufficiently persuaded that the assumption reflected reality, and concluded that "the issue of whether British Airways is selling below-cost tickets to the marginal passengers on the five routes at issue in this case is a fact-rooted question as to which Virgin has not submitted direct evidence"⁴¹.

47. The disposition of the *Virgin Atlantic* case by the U.S. courts stands in marked contrast to that in the EU, where BA's travel agent discounts were found abusive under Article 82⁴².

48. An ongoing high-profile challenge to first-dollar rebates is also a major part of the section 2 challenge brought by Advanced Micro Devices (AMD) against Intel in the U.S. as well as a number of other jurisdictions throughout the world.

49. In its private suit pending in U.S. district court in Delaware, AMD alleges, *inter alia*, that Intel has "imposed on OEMs a system of first-dollar rebates that have the practical and intended effect of creating exclusive or near-exclusive dealing arrangements and artificially foreclosing AMD from competing for a meaningful share of the market."⁴³ However, the challenge appears not to rest solely on below-cost pricing, since the Complaint goes on to allege that "[e]ven where Intel's prices are above cost on the incremental volumes and overall despite its retroactive rebate schemes, these rebates enable Intel to lower prices selectively in the contested market segment" and "exacerbate normal impediments to entry and expansion."⁴⁴

50. In September 2006, the court dismissed AMD's claims with respect to foreign customers, finding that those claims failed to satisfy the jurisdictional requirements of the Foreign Trade Antitrust Improvements Act of 1982;⁴⁵ however, AMD's U.S. claims remain active. The case is reportedly scheduled to go to trial in April 2009.

3.2.2 Commentary

51. Commentators' analyses of above-cost (on all units sold to a customer) single-product loyalty discounts depend on their view of the likelihood of such discounts having anticompetitive impact and the feasibility of addressing any such impact with an administrable test that does not chill desirable, procompetitive discounting. For example, based on concerns regarding administrability and chilling procompetitive conduct, Professor Hovenkamp would apply "antitrust's ordinary predatory pricing rule" to all single-product loyalty discounts, finding the discount "lawful if the price [on all units sold] after all discounts are taken into account exceeds the defendant's marginal cost or average variable cost."⁴⁶ While acknowledging that such discounting can be viewed as purchasing exclusionary rights, he argues that there are important differences in that traditional exclusive dealing typically involves long-term contracts or

⁴¹ *Id.* at 580.

⁴² See Case Comp/34.780, *Virgin/British Airways*, 2000 O.J. (L30) 1 (14 July 1999); Case T-219/99, *British Airways v. Comm'n*, 2003 E.C.R. II-5917, *appeal denied*, Case C-95/04, 2007 E.C.R. I-2331 (ECJ, 15 Mar. 2007).

⁴³ Complaint para. 59, *Advanced Micro Devices, Inc. v. Intel Corp.*, No. 05-441 (D. Del. June 27, 2005).

⁴⁴ *Id.* paras. 70-71.

⁴⁵ See *In re Intel Corp. Microprocessor Antitrust Litig.*, 452 F. Supp. 2d 555 (D. Del. 2006).

⁴⁶ Areeda & Hovenkamp, *supra* note 8, § 749b, at 245 (referencing *id.* §§ 739-40 (2d ed. 2002)).

offerings in situations in which the buyer can purchase the good from another supplier only by giving up something else, such as its franchise or dealership. In such situations, he suggests, an equally efficient producer of the excluded product cannot win sales simply by offering a lower price. By contrast, the loyalty discount puts the buyer in a different position: when it purchases from a rival, it loses only the discount, and in this situation, “an equally efficient rival should be able to steal the sale as long as the fully discounted price is above cost.”⁴⁷

52. A predatory-pricing approach, though, could be criticized as failing to detect certain instances in which single-product loyalty discounts might result in anticompetitive foreclosure. For example, it has been argued that “market share discounts structured to produce total or partial exclusivity should be judged according to the same economic principles that govern exclusive dealing” and should be condemned under existing case law “if they produce anticompetitive effects without counterbalancing procompetitive effects.”⁴⁸ In this view, when customers have a strong initial preference to buy a substantial “uncontested” percentage of a product from a certain firm, an overall above-cost loyalty discount schedule may be established that convinces consumers to buy all their products from that firm, in effect inducing exclusive dealing, with potentially anticompetitive consequences. These analysts conclude that a rule of reason assessment might condemn discounts that effectively lock up such a large portion of available business that competitors cannot achieve substantial scale economies that significantly reduce their marginal costs or have sales volumes sufficient to make investments in quality improvements profitable⁴⁹.

53. Another commentator acknowledged that non-linear pricing could achieve the same results as exclusive dealing, but recommended that antitrust intervention “be used rarely and apply only to extreme pricing conditions . . . where marginal pricing below marginal cost is unambiguous. . . .”⁵⁰ In his view, “Such nonlinear pricing can reflect real economic savings that are difficult to measure . . . or simply may be ways that firms choose to compete for the most desirable customers.”⁵¹

54. Anticompetitive effects that have been theorized from above-cost (on all units) single-product discounts appear possible only where some significant portion of the market is uncontestable due to factors external to the parties. An approach requiring courts to determine whether a portion of a market is uncontestable and to quantify that portion, as well as to analyze whether a discount deprived plaintiff of efficient scale, would be difficult to administer. More importantly, such an approach would not provide clarity to firms deciding whether to offer such discounts and could chill desirable price competition.

3.2.3 Conclusions

55. A predatory-pricing approach to single-product loyalty discounting has certain advantages, including, in particular, its administrability, and may be the best test to apply in most situations. However, in light of ongoing discussion among commentators and the relatively limited case law on these types of discounts, further assessment of the real-world impact of such discounts is necessary before concluding that standard predatory-pricing analysis is appropriate in all cases.

56. In any situation in which a foreclosure-based approach is used, plaintiff should be required to demonstrate that the discount forecloses a significant amount of the market and harms competition.

⁴⁷ Herbert Hovenkamp, *The Law of Exclusionary Pricing*, Competition Pol’y Int’l, Spring 2006, at 21, 28.

⁴⁸ See Tom et al., *supra* note 35.

⁴⁹ See *id.* at 622-23.

⁵⁰ 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).

⁵¹ *Id.*

Further, as with bundled discounting, plaintiff's (and any other rival's) ability to remain in the market should be a significant factor in assessing competitive effects. In situations where harm to competition is implausible, courts should uphold the discount. Also, as with bundled discounting, when plaintiff demonstrates actual or probable harm to competition, a single-product loyalty discount should be illegal only when the discount produces harms significantly disproportionate to any procompetitive benefits.

4. Conclusion

57. United States law has tended to tread very cautiously in the areas of bundled discounting and single-product loyalty discounts. The concern is that the cost of uncertainty in these areas may harm consumers by deterring firms from engaging in beneficial price cutting, which is antithetical to what the antitrust laws aim to do. Within the past several years, there has been increased attention to both of these areas. There appears to be emerging consensus that price-cost safe harbors can be used to provide greater clarity to market participants, and that administrable standards are needed.