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DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE

ROUNDTABLE ON LOYALTY OR FIDELITY DISCOUNTS AND REBATES

-- Note by the United States --

This note is submitted by the United States Delegation to the Competition Committee FOR DISCUSSION at its forthcoming meeting on 5-6 June 2002.

1. Firms offer a wide range of discounting programs, from straight quantity discounts to programs involving minimum share requirements and/or multiple products. Such programs typically have procompetitive effects. The potential for anticompetitive effects will depend upon the specific details of the programs and the market power of the firms involved. It is thus important not to use terms such as "fidelity" discounts too loosely. If the term is meant generically to apply to any type of discount program, it cannot be used to infer that there is a likelihood of competitive harm from such discounts. If the term is meant to apply only to those types of programs that have the potential for competitive harm, it is important to distinguish what types of programs would be covered. Even in the latter case, a detailed, fact-based investigation of any particular program would be needed to assess its actual competitive effects. The U.S. antitrust agencies cannot recall any enforcement actions challenging "market share" discount schemes, but a number of recent private suits have started to develop the law in this area. In this paper, we summarize the private suits and then discuss some of the applicable economic theory with regard to discount programs. The U.S. agencies do not necessarily endorse the reasoning of the cases described, but the cases illustrate the issues well.

US Antitrust Cases on Discount Programs

Single Product Discounts

2. The few American antitrust decisions that have dealt with simple discounts or rebates 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. Courts are generally unwilling to assume these discounts are anticompetitive, even if the discounter has market power; they are reluctant to force monopolists to charge high prices.

3. In *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227 (1st Cir. 1983), Pacific had most of the market for "snubbers" used in nuclear power plants because it was the only acceptable producer of mechanical scrubbers for U.S. nuclear plants. Grinnell, which accounted for about half of U.S. snubber purchases, had been working to help Barry Wright become an alternative source of these snubbers. Pacific then offered Grinnell a large discount on its total snubber purchases if Grinnell would promise to buy large quantities of snubbers from Pacific; Pacific offered the discount to get Grinnell

competition, but on other products as well. The practice is generally found not to constitute unlawful tying, because the seller is willing to sell the products separately. But courts examine these practices carefully to determine, based largely on the facts regarding competitive impact, whether there is a violation of Section 2 of the Sherman Act.

8. *SmithKline Corp. v. Eli Lilly & Co.*, 427 F. Supp. 1089 (E.D. Pa. 1976), *aff'd*, 575 F. 2d 1056 (3d Cir. 1978), is the first and most influential of these cases. In what was found to be the relevant market of sales of a class of antibiotics known as cephalosporins to nonprofit hospitals in the United States, 575 F.2d at 1058, Lilly sold four drugs on which it held the patent; it was the only lawful source of these drugs, *id.* at 1059. Like other pharmaceutical firms, Lilly used a volume rebate scheme for these products, intended to

of various viruses. Blood donor centers (BDCs) require all five. *Id.* at 458. Only defendant Abbott made and sold all five; it accounted for from 70 to 90 percent of the sales of each of four of them. *Id.* at 459. (For purposes of summary judgment, the court accepted the inference of market power. *Id.* at 463-65.) Its only significant competitor, Ortho, sold four assays, although one lacked widespread customer acceptance. *Id.* at 459. The Council of Community Blood Centers, to which many BDCs belong, solicited bids on a contract to supply assays (and certain equipment not discussed here) to member BDCs who chose to buy on the terms specified in the winning contract. The solicitation called for different pricing schedules depending on whether the BDC bought all the assays from the chosen seller or only any two or three of them. *Id.* at 459-60. Abbott won the contract, with pricing schedules that gave significant discounts on each of the assays for buying all of them from Abbott. *Id.* at 460. Particularly because, as a practical matter, BDCs had to buy from Abbott at least the two assays only Abbott supplied, the discount scheme created a very significant incentive to buy all five from Abbott and none from Ortho — in Ortho's view, the scheme effectively forced buyers to pay a financial penalty for buying any assays from Ortho, *id.* at 461. Ortho alleged the pricing scheme violated Section 2.

13. The court concluded that Ortho's Section 2 claims failed if Abbott's pricing was "legitimately competitive" because the offenses Ortho alleged all required a showing of "predatory or anticompetitive conduct or an inappropriate use of monopoly power by the defendant." *Id.*

loss. The result, allegedly, was that, as a practical matter, customers would lose significant benefits unless they stopped buying tape from LePage's, in whole or significant part. And, as with the pricing schemes in *SmithKline*

Procompetitive and Anticompetitive Effects of "Market Share" Discounts

20. Some discount programs take the form of "market share"discounts where "market share" refers to the percentage of the customer's total purchases. To encourage customers to buy more from the discounting seller and less from rival sellers, a seller may grant discounts to a customer where the discount is tied to the proportion of the customer's total purchases from that seller. This was the discount scheme used in the Brunswick boat engines case described above. Thus a buyer might get a five percent discount from the seller if it buys fifty percent of its purchases from that seller, a ten percent discount for sixty percent, a twenty percent discount for seventy percent, etc.

21. Frequently market share discounts increase more rapidly than the market share thresholds. In this instance, for example, the discount increased by fifty percent (from ten to fifteen percent) when the market share threshold rose by only sixteen percent (from sixty to seventy percent). For customers seeking to meet market share thresholds, market share discounts may have disproportionately large effects in discouraging purchases from rival sellers. The rival seller must compete not simply on the price of the marginal unit purchased but must also compensate the customer for discounts lost on each inframarginal unit purchase. As market share thresholds increase and discounts deepen, rival sellers may find it very difficult to compensate customers for lost discounts.

22. Market share discounts can have either anti-competitive or pro-competitive effects. In order for market share discounts to have an anti-competitive effect, the firm offering such discounts must have market power in a relevant market. Thus the first step in investigating whether loyalty discounts have anti-competitive effects is to determine whether the firm offering such discounts has market power.

23. However, the fact that a firm has market power is not sufficient to prove that its loyalty discounts are anti-competitive. Here are some ways in which loyalty discounts, i.e., market share discounts, can be pro-competitive:

- When the manufacturer has significant fixed costs, average costs of production will exceed marginal costs, at least up to full capacity utilization. The manufacturer can reduce price and increase profits if the margin at the current price exceeds the inverse of the firm's own elasticity of demand. However lowering price (below current price) in order to sell more units of output can be even more profitable if the manufacturer can avoid lowering price on all units of output. The manufacturer could use volume discounts or loyalty discounts to avoid lowering the price on all units. Loyalty discounts will be more profitable and more efficient than volume discounts when customers' sales quantities vary greatly across customers (regardless of the size of the seller's fixed costs). Small customers may not be able to purchase sufficient quantities to trigger volume discounts but can receive loyalty discounts by committing to purchase a certain percentage of its inputs from the manufacturer. Indeed to the extent that disproportionate discounts under the loyalty program encourages the buyer to pass along those cost reductions, society may benefit from greater production due to the loyalty discount than would occur with a volume discount or an across-the-board price reduction. (To the extent however that loyalty discounts simply shift purchases amongst buyers, discriminating according to their demand elasticity without increasing total production, these shifts are simply transfers from one buyer to another and do not represent production efficiencies.)

- Society can also benefit if loyalty discounts also reduce costs of production. For example, suppose that loyalty discounts are introduced for market share levels at or near current levels. The effect will be to reduce the manufacturer's sales fluctuations. The reduced variance in sales will lower the manufacturer's inventory costs. If marginal costs are increasing with capacity utilization, then reduced variance in sales will also lower production costs. (For example, the average cost of production will be less if capacity utilization is at a steady eighty percent per year rather than if it fluctuates unpredictably between seventy and ninety percent.) Finally the manufacturer's future sales (and profits) can be increased if loyalty discounts increase sales stability and prevent the manufacturer from being caught short by an unexpected increase in demand that harms its reputation for service and supply reliability.

24. On the other hand loyalty discounts can serve to exclude competitors and harm consumers. The necessary conditions include not only market power in the relevant market but also:

- Market share discounts would be sufficiently deep and triggered at market share thresholds close to 100% so that if the buyer attempted to buy a portion of its supplies from another supplier, the net effect of such a purchase would be a very large increase in price from the discounting manufacturer. The necessary condition is that the structure of the market share discounts have the effect of forcing the buyer to purchase a very large proportion, if not all, of its supplies from the manufacturer offering the discount or shifting a very large proportion, if not all, of its purchases to another supplier.

- Buyers must be unwilling or unable to rely upon alternative suppliers exclusively, thus remaining tied to the discounting manufacturer.

- Rival suppliers can't vertically integrate downstream into the business of the purchaser. If suppliers can so integrate, then the OEM stage is not the critical bottleneck that the discounting manufacturer would like it to be. Vertical integration of course requires that rivals have sufficient resources (including capital) to make the needed acquisitions. It also requires that the rivals can successfully make sales to final consumers relying on their own manufactured products rather than the products of the discounting manufacturer.

- No single buyer, or group of buyers, is willing to purchase sufficient volumes from an equally efficient rival of the discounting manufacturer to make sure that the rival survives. The discounting manufacturer can exacerbate this problem if it can create barriers that inhibit buyers from searching to find an alternative and equally efficient rival supplier and thereby circumvent the anti-competitive effects of loyalty discounts.

25. Discount programs can also appear in the form of unilateral practices such as the seller bundling its products (3M) and its services (British Airways). The effect of requiring the customer to purchase a bundle of products and services may be the same as requiring a market share commitment. The customer may find in either case that attempting to purchase from rival suppliers causes it to lose the savings associated with bundling or discounting and thus make the effective price of supplies from a rival supplier unacceptably high.

26. Antitrust enforcers are concerned whenever a firm as efficient as the most efficient in the market exits. We naturally wonder if there is some practice associated with one or more firms in that market that caused the exit. And we object if we find some practice adopted by such firm(s) that is responsible. However, as the checklist above suggests, it will be difficult to prove that a practice such as loyalty discounts or bundling is in fact responsible for such exit. that a practice such as loyalty discounts or bundling is in fact responsible for such exit. Moreover, depending on the extent to which such bundling leads to lower prices, as it very well can, antitrust enforcers must acknowledge that consumers may benefit despite the exit of the efficient competitor.

27. Recently three commentators 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."[2] Those commentators noted in particular that "if the financial benefits of a market-share discount are effectively concentrated on the decision whether to buy a relatively small number of marginal units, even prices that technically are 'above cost' on average may be below cost as to those marginal units."[3] Where these discounts effectively lock up such a large portion of available business that competitors cannot achieve a minimum viable scale, the authors suggest that a rule of reason analysis might lead to the conclusion that on balance the antitrust laws should prohibit them. A response by Profess(ely)3(PrDen(tiv)1s13av)13.3 PrDen(tiv)1s1a -1.14rl(tiv)tisiotrtfof reason11711.6(o)4(s ld)-10( )-1